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## Effectiveness of mechanisms of the owner's supervision in capital companies of municipal sector

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**Key words:** corporate governance, municipal economy, effectiveness of supervisory mechanisms

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**Summary:** The article presents the specificity of the corporate governance of municipal firms. It also presents the result of empirical research concerning effectiveness of the mechanisms of the owner's supervision of municipal firms. The final part of the article presents the directions of the improvement of the corporate governance of these firms.

### 1. Introduction

The essence of the present system of the corporate governance is the assurance of pro-development balance between the interests of all subjects involved in functioning of the corporation, including: investors, managers, workers, suppliers, customers. This balance should be assured by different legal and economic institutions and mechanisms, forming the formal and informal regulation system, which concerns all entities taking part in the economic life of the country. A history of present corporations is the continuous development of legal and economic institutions. These institutions help to restrict the scale of changeability in the relations resulting from the theory of agency.

An attempt to reconcile the groups of stakeholders in the firm demands the implementation of both economic and social tasks at the same time. Practically, this is very

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difficult. A lot of objectives create also serious barriers to the efficient management, such as: the impossibility of creation of coherent and long-term strategic plans, the blurring of systems of effectivity's measurement, the difficulties in building systems of incentives (Barwacz, 2009).

## 2. Creation of the municipal economy

Competitiveness of the region and its potential of development are mainly determined by the quality of lives of the population living on the given area. Suitable communal infrastructure and high standard of communal services greatly influence the competitiveness of the region and its potential of development. Municipal service satisfy basic needs of the population: water supply, heat and electricity, and influence the attractiveness of cities as a place to settle. The priority of satisfactory maintenance of cleanness and order—through the suitable managing of waste, the state of roads and communication—leads to the efficient way of getting around within the community and the region. Consequently, services of the public utility become an element of the investment—the climate.

Reforms introduced a few years ago in Poland at the level of local government caused the takeover of different objectives and the implementation of various economic tools. The improvement of the effectiveness in the functioning of firms and the reduction of costs carried by local governments may seem to be the main target.

According to the Polish Constitution local government has taken over some of public tasks. This law allowed the authorities of local governments to become the entity which can administer their own finances and be the entrepreneur taking part in economic processes.

The municipal economy (Ustawa, 1997) is to perform publically useful functions, in order to satisfy collective needs of the community. It particularly considers publically useful tasks whose purpose is the current and uninterrupted fulfilment of collective needs of the population by serving universally accessible services. In compliance with municipal law, local government is responsible for the assurance of suitable supply of services, which does not mark the immediate necessity of its realisation. In order to execute the tasks local governments can create organisational units, including firms, and conclude contracts concerning deliveries of services with other subjects. The choice of the form of the organisation of communal services is an element of the local governments' policy.

The purpose of its activities is the satisfaction of collective needs of the local community, and not the pursuit of the profit. That is why business managed according to the communal subjects stays at odds with market rules of business. It effects in differences among public needs of the local community and requirements of the economic effectivity of subjects serving these services. Such situation leads to differences of aims of local governments as an organiser of municipal services and subjects serving

it. Local governments dealing with the realisation of municipal services appear in two different, contradictory parts:

- businessmen who should be well-informed in the maximisation of the profit;
- a representative of business of the local community which has to take into account priorities of their own electors.

The condition of implementing market solutions in the municipal economy is to overcome this contradiction. One can accomplish that by means of privatisation of firms and focus on the role of the regulator—an organiser of the market or a customer who buys services according to the public orders procedures. The implementation of market mechanisms by local government to the municipal economy comes from attempts to achieve the following aims:

- improvements of quality of municipal services;
- minimisation of budget expenses prior to the unchanged range and unchanged quality of services;
- eliminations of influence of political factors on economic decisions;
- rationalisation of consumption of some goods and municipal services by means of elimination or diminution of subsidies;
- engagements of private capital in municipal investments.

The success of these aims is not easy and demands conscious creating and support, by local governments, of competitive arrangements and market regulations for firms which function in monopoly.

### **3. Mechanisms of owner's supervision of municipal firms**

Supervisory mechanisms are the courses of action consequential from the influence of supervisory institutions on the firm. In consideration of the subject performing supervision we divide them into internal and external. Internal mechanisms are: contracts concluded by managers with owners, manners of exertion of the influence on the management by board of directors, ways of workers' participation or the influence of the structure of property. External mechanisms are connected with the influence exerted on the firm first of all by capital market, market of the inspection of firms, market of products, market of manager talents.

The topic of supervision of capital companies of communal sector in Poland will be examined in the context of owner's supervision, which is obligatory in our country (in capital companies with the majority of participation of local governments in particular), a system of corporate governance—because of practical tools used in it, and a supervision of closed ownership—because of its supervisory character (insiders). All this makes it closer to owner's supervision than to corporate supervision.

Based on the analysis of structures of organisational communal companies and the review of literature of the subject, a model of supervisory mechanisms had been constructed (Figure 1).

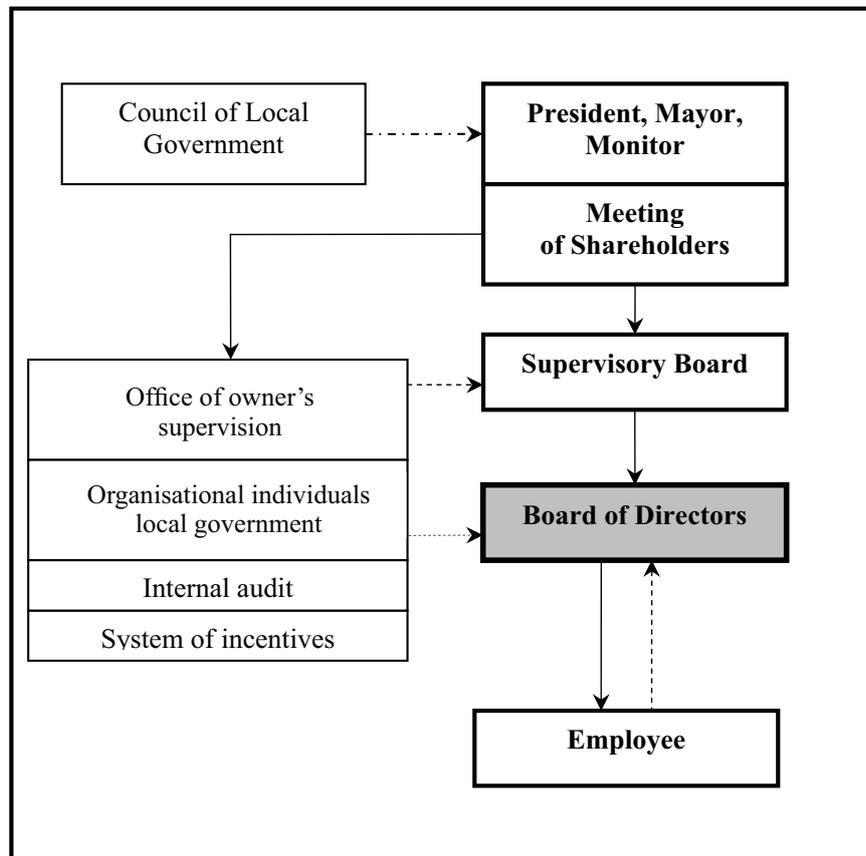


Figure 1. Model of supervisory mechanisms in the structure of an organisation and the management of a capital company of the business' communal sector with participation of local governments

S o u r c e: author's own study based on: Koziół, Barwacz, 2009, p. 388.

The acceptance of such model of mechanisms of supervision results in conviction that effectivity of the corporate supervision of capital companies of communal sector depends on the effectivities of its internal mechanisms. Besides that, a research of the efficiency of supervisory mechanisms has a wider dimension than it would result for example from economic indicators. It is difficult to determine the effectivity of internal supervisory mechanisms in a measurable way. The use of behavioural (the qualitative analysis) approach creates greater possibilities. It is based on the research of behaviours and on accepted diagnostic statements derived from the criteria of estimation formulated beforehand.

Such interpretation of the research problem was the consequence of realisation by local government of the accepted strategy of the management of municipal economy. Territorial government uses communalised property, and then in order to undertake decisions in the range of its structural-ownership transformations, relying mostly on commercialisation and privatisation, it shapes the definite model of organisational strategy of the management of the communal economy. The research was thus an attempt to elaborate the methodics of diagnosing the mechanisms of the corporate supervision in the sector of communal business and general estimation of the effectivity of this supervision.

#### 4. Research methods applied and the outcomes

The effect of the research carried by the author was the construction of a tool, thanks to which it would be possible to make estimations of the effectivity of mechanisms of the owner's supervision in the commercial code of a company's in municipal sector. This tool, in the form of specially designed diagnostic sheet, helped to achieve the main objective of the dissertation—the identification of mechanisms of the owner's governance, adequate for this type of firms. It also helped to work out the methodology of diagnosing and estimation of the effectivity of the corporate governance in municipal firms.

Categorisation<sup>1</sup> is the base of the conduct of the research helping to diagnose the rules and supervisory tools, used in the system of corporate governance of firms in municipal sector. Generally, categorisation is the research procedure aimed at defining the category of quality of a given firm. It serves the qualifying role in the firm undergoing the research to define category of quality in terms of functioning and achieved results.

Using the analyses of literature and statements of experts, to estimate the degree of the effectivity of the owner's supervision of the municipal sector in examined firms, the following criteria of the estimation had been used:

1. Defining of objectives for the municipal firms;
2. Influence of groups of stakeholders on decisions made by the management;
3. A role of the board of directors and the manner of its work;
4. Competence of members of supervisory board;
5. Manners of paying salary to the managing board of the company;
6. A degree of influence of external supervisory institutions;
7. Barriers which make it difficult for the company to participate in capital markets;
8. The quality of audits and research of year's balances;

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<sup>1</sup> The characterisation of 'categorisation' is introduced in: Stabryła, 2005.

### 9. Information policy used by the management.

Categorisation of researched companies led on to comparative analysis of rules and supervisory tools, used in the system of corporate supervision of firms of communal sector, to determine the effectivity of mechanisms of the owner's supervision in commercial code of the company in this municipal sector.<sup>2</sup> Figure 2 presents results of estimation of accepted criteria, made by the presidents of managements of researched companies, according to accepted criteria.

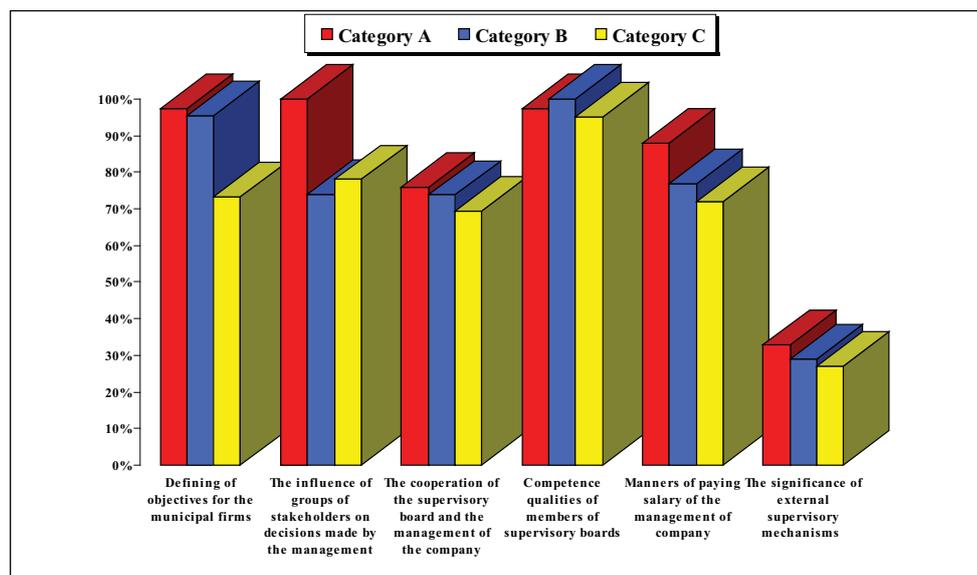


Figure 2. Results of estimation of accepted criteria made by the presidents of the board of researched companies according to accepted categorisation

S o u r c e: elaboration according to the outcome of the research.

Figure 3 presents the estimation of the same criteria made by chairmen of the boards of directors, also according to accepted criteria.

<sup>2</sup> Category A—good companies, Category B—average companies, and Category C—weak companies.

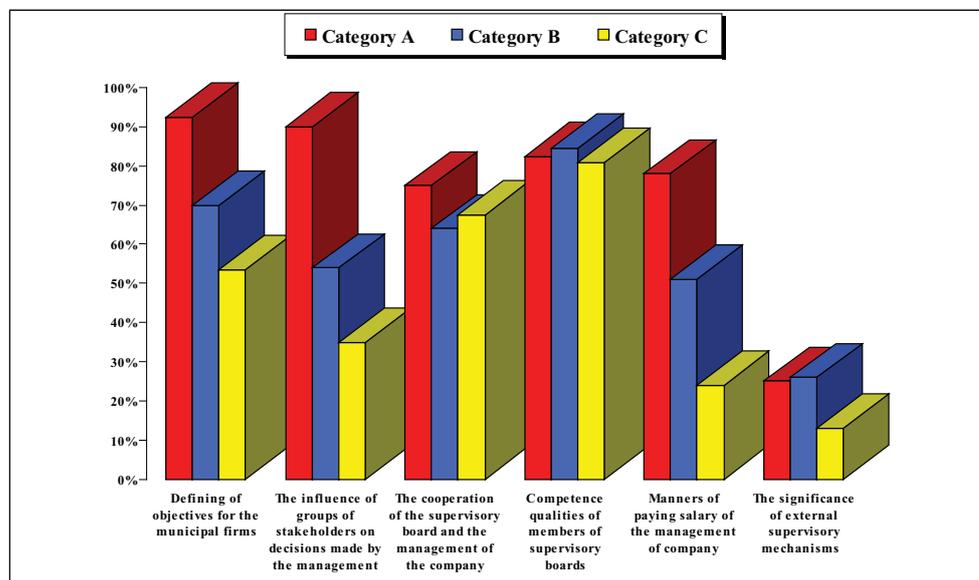


Figure 3. Results of estimation of accepted criteria made by chairmen of the boards of directors of researched companies according to accepted criteria

Source: elaboration according to the outcome of the research.

## 5. Conclusions of the research

Results of the research point to the necessity of reconstruction of the existing model of the owner's governance in municipal firms with bigger participation of territorial government. The research confirmed that only about 30% of the firms examined fulfill the accepted criteria, though the meaning of some mechanisms is treated marginally. The role of the supervisory board and the manner of its work was assessed rather weakly. Besides, answers given by chairmen of supervisory boards to the questions concerning the essential problems connected with the matter of municipal economy or corporate governance differed significantly from the accepted criteria.

The essential differences are:

- among representatives of supervisory boards, especially companies of Categories B and C, existed the problem with qualification of objectives for the municipal company;
- for representatives of supervisory boards, especially companies of Categories B and C, i.e. for about 70% of respondents, these not customers are the most important group of stakeholders in the municipal company, deciding about the character of the public utility, and local government or provincial government;

- the same group of respondents ignored manners of justification warranting: a longer time of work of managements, definite objectives or the management's capital involvement into the company.

Both groups of respondents completely ignored as well the possibility of the company's participation in capital markets, where among many barriers the basic one is the lack of interest on the part of territorial government, that is the owner of the firm.

In firms researched there was no use of effective owner's governance, which is very essential for leadership. Neither there was no use of internal mechanism of the governance, that is internal audit. The results confirmed this fact, which can be alarming, because lack of this mechanism and growing level of complexity of functioning of an organisation greatly limits the possibility of direct control of their activity. Also the situation of companies in the context of the system of controlling looks pessimistic.

That is why the reconstruction of the model of the owner's governance for municipal companies with the major participation of territorial government assumes introduction of internal audit as one of the essential mechanisms of the owner's governance.

On the basis of conclusions from the research, the model of the supervision comes from the monistic (one-level) model. It is based on the construction of the uniform supervisorial—administering authority, present in Anglo-American system and in a European company. Such construction of supervisorial-manageresses authorities will allow to eliminate weakly rated in the research board of directors whose mechanisms showed low effectivity. Besides, a replacement of the model of dualistic (two-level) supervision with a monistic model will greatly increase elasticity of the management, it will extend economic freedom and can contribute to the decrease of costs of personal owner's supervision. By reconstructing the performance of the supervision of companies of the communal sector, on the basis of the change of this model to one-level, one refers to the idea of multidimensional interpretation of the system of management, including following aspects: objective, subjective, functional, structural and instrumental, emphasising the last two.

A structural aspect comes down to the qualification of the place and the part of supervisory mechanisms in the organisational structure of the firm and to its environment, and—what's more essential—to the qualification of their effectivity. Determinants of the structural aspect are among other things internal mechanisms of the owner's supervision of firms in municipal sector.

Functioning of municipal firms is connected with the multistage of relation of the agency, and this two-level model introduces the additional level of such relation in the form of the board of directors. Reconstruction of the supervision model of the companies in municipal sector, based on monistic model, will simplify the institution of supervision.

That is why, to practical application, one accepted the idea of the modification of the institution of the internal (the board of directors) supervision, both regarding the manner of the work, qualifications or rules of the recruitment. System of the supervision proposed in here became supplemented in additional internal mechanisms.

Considering the results of own research, as well as the research of predecessors, most effective internal mechanisms for the performance of the owner's supervision of companies in municipal sector are:

- internal audit and controlling;
- motivating mechanisms based on proeffective contracts;
- support of existing with innovative mechanisms Balanced Scorecard (BSC) and Accountability Scorecard (ASC).

Taking this into consideration, the schema of the model of the owner's supervision for municipal companies with the major participation of territorial government has been presented. Light grey colour below marks new elements described above, denoting the essence of proposed changes (Figure 4).

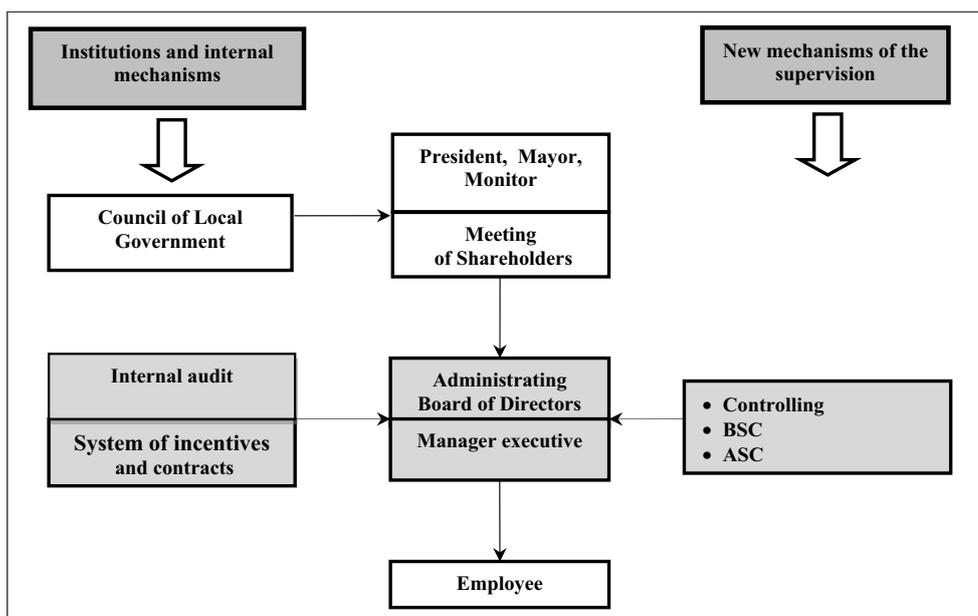


Figure 4. The model of the system of the supervisory boards structure constituting the reconstruction of monistic model of the owner's supervision for municipal companies with the participation of territorial government

Source: author's own study.

Solution presented above is a novelty in Polish legislation (Law about European Company) (Ustawa, 2005) and that is why indirect solution—having its justification

in Polish legal system, and more precisely in the Code of Commercial Companies—is being introduced.

The difference between presented models lies in keeping in indirect model of the two-level system with the support of such mechanisms of supervision as internal audit or motivational way of reward. This model assuming the cooperation of the management and the board of directors in the way of constructive cooperation, competence and knowledge—aims towards the reconstruction of the supervision via changing the way of work of the supervisory board by new mechanisms which are highly effective (see Figure 5).

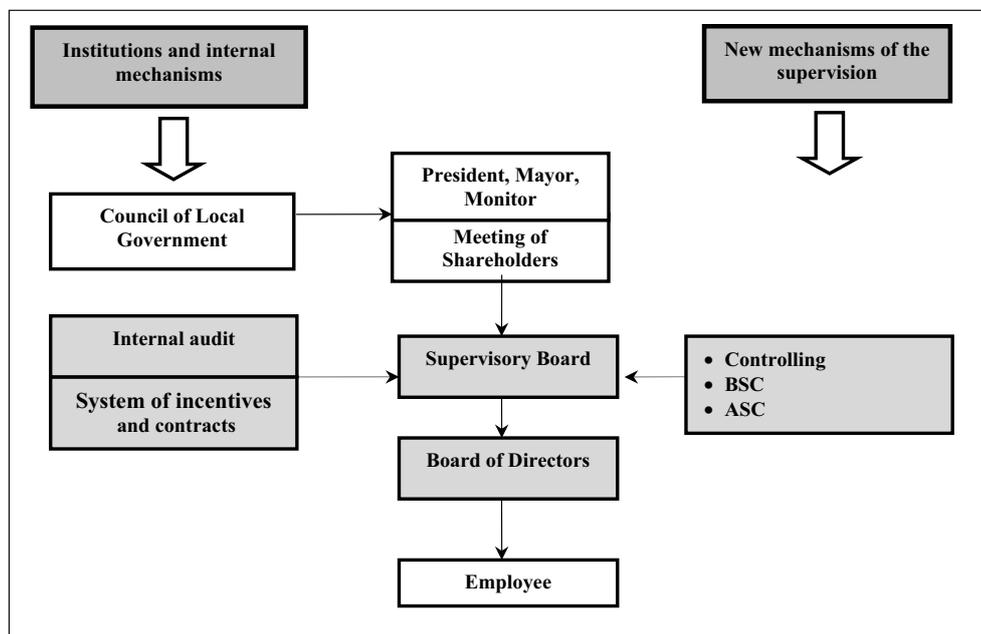


Figure 5. Model of the system of supervisory boards structure being the reconstruction of the dualistic model of the owner's governance for municipal companies with participation of territorial government

Source: author's own study.

Model of the owner's supervision in companies of municipal sector with major participation of territorial government, presented in the commercial code, is a new solution in this field, as in Polish literature it is difficult to come across any examples of a model of the owner's supervision for this sector, apart from the adaptations of solutions for the need of the municipal economy, existing in the market economy. Agencies of the municipal sector have their own specificity as well as special features, so taking this into consideration one needs to realise that solutions working in private sector demanded previous verification and modification.

Problems of functioning of the municipal sector in Poland, characterised above, create an image of the model as well as quality of the owner's supervision, performed by territorial government.

## 6. Conclusions

Proposed reconstruction of existing structure of the supervision, based on the monistic model, is a pioneer solution in the field of the owner's supervision of municipal firms. However, in consideration of the lack in the Code of Commercial Companies of legal regulations concerning of the monistic system, this model is a future solution, the final stage of development of the owner's supervision of municipal firms (Barwacz, 2010).

The model of the owner's supervision for companies of the municipal sector should reflect accepted „philosophy” in the range of manner of the supervising with regard of:

- the function of public utility;
- huge fortune these companies can use;
- multitude of agencies or the common agency;
- rationality of decision in short and long period of time.

Beneficiaries of increase in the effectiveness of the municipal firms are broadly understood shareholders, among other; customers-voters, workers-voters and territorial government. That is why the way of looking at this sector should consider on the one hand problems of the agency, but on the other hand the idea of shareholders, being the surface of functioning of this section. Research of predecessors, concentrating on the strategy of the development of territorial government, that the problem of the supervision over municipal firms has its own roots, reaches the accepted „philosophy” in the range of the model of the management in this sector. The acceptance and the realisation of the model of governance over municipal companies is the derivative of the strategy accepted by territorial government, meaning the level of knowledge and experience as well as the decision-makers' willingness to learn.

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## Badanie efektywności mechanizmów nadzoru właścicielskiego w przedsiębiorstwach sektora komunalnego

**Streszczenie:** W artykule zaprezentowano specyfikę nadzoru korporacyjnego przedsiębiorstw komunalnych. Ponadto przedstawiono wyniki badań empirycznych dotyczących efektywności mechanizmów nadzoru właścicielskiego przedsiębiorstw komunalnych. W końcowej części artykułu omówiono kierunki doskonalenia nadzoru korporacyjnego tych przedsiębiorstw.

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**Słowa kluczowe:** nadzór korporacyjny, gospodarka komunalna, efektywność mechanizmów nadzorczych

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