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UPDATING TRANSPARENCY AND ACCOUNTABILITY MECHANISMS FOR UTILITY COMPANIES UNDER DECENTRALIZATION

Abstract. The object of the research is oversight and audit mechanisms of utility companies and the improvement of these mechanisms as part of the decentralization reform in Ukraine. One of the most problematic issues is the application by local authorities of the norms of legislation recently adopted in connection with reforms in the course of decision-making on the formation of supervisory boards in utilities and the appointment of an independent auditor to audit their annual financial statements. A research was made on the basis of the state of communal property management by the newly formed amalgamation of territorial communities, the amount of which is now at their disposal due to decentralization processes and is steadily increasing. During the research, an approach was taken to identify key risks and problems in this area, taking into account the need for Ukraine to take measures to implement the Association Agreement with the EU and apply the provisions of this document in local practice regarding local government, accounting and auditing. There are no studies of these problems in the modern economic literature in the context of a combination of these two areas of reform – adapting updated legislation on accounting and auditing of financial statements with requirements for the disclosure of socially necessary information managed by utility companies. This made it possible to formulate suggestions on the criteria for mandatory creation of supervisory boards in utility companies and to develop practical recommendations for local authorities regarding the selection procedure by the supervisory boards of independent auditors (audit companies) for the mandatory audit of the utility companies' annual financial statements. The suggested recommendations will bring the activities of utility companies in Ukraine closer to international standards of transparency and accountability and ensure further adaptation of domestic legislation in the field of oversight and audit in the communal sector to European directives and best practices.

Keywords: utility companies, supervisory board, audit, transparency, accountability, amalgamation of territorial communities.

JEL classification: H72, M42.

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ОБНОВЛЕННЯ МЕХАНІЗМІВ ПРОЗОРОСТІ І ПІДЗВІТНОСТІ КОМУНАЛЬНИХ ПІДПРИЄМСТВ В УМОВАХ ДЕЦЕНТРАЛІЗАЦІЇ

Анотація. Об'єктом дослідження є механізми нагляду й аудиту комунальних підприємств та поліпшення цих механізмів у межах реформи децентралізації в Україні. У статті проаналізовано зміни законодавства з бухгалтерського обліку й аудиту

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фінансової звітності в контексті забезпечення прозорості і підзвітності управління комунальним господарством з боку органів місцевого самоврядування. Визначено ключові ризики та проблеми у сфері децентралізації й формування об'єднаних територіальних громад на тлі реалізації Україною завдань з імплементації Угоди про асоціацію з ЄС у вітчизняну практику. Виконання євроінтеграційних завдань для нашої країни передбачає створення умов для доступу до фінансово-економічних показників діяльності комунальних унітарних підприємств та підвищення їх підзвітності населенню територіальних громад. Сформульовано пропозиції щодо оприлюднення інформації про діяльність комунальних унітарних підприємств і надано практичні рекомендації для органів місцевого самоврядування стосовно категорій комунальних підприємств, де мають бути створені наглядові ради, та критеріїв відбору незалежних аудиторів для проведення обов'язкового аудиту річної фінансової звітності таких підприємств.

Ключові слова: комунальні підприємства, наглядова рада, аудит, прозорість, підзвітність, об'єднані територіальні громади.

Рис. 3. Табл. 1. Літ. 30.

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ОБНОВЛЕНИЕ МЕХАНИЗМОВ ПРОЗРАЧНОСТИ И ПОДОТЧЕТНОСТИ КОММУНАЛЬНЫХ ПРЕДПРИЯТИЙ В УСЛОВИЯХ ДЕЦЕНТРАЛИЗАЦИИ

Аннотация. Объектом исследования являются механизмы надзора и аудита коммунальных предприятий и улучшение этих механизмов в рамках реформы децентрализации в Украине. В статье проанализированы изменения законодательства по бухгалтерскому учету и аудиту финансовой отчетности в контексте обеспечения прозрачности и подотчетности управления коммунальным хозяйством со стороны органов местного самоуправления. Определены ключевые риски и проблемы в сфере децентрализации и формирования объединенных территориальных общин на фоне реализации Украиной заданий по имплементации Соглашения об ассоциации с ЕС в отечественную практику. Выполнение евроинтеграционных заданий для нашей страны предполагает создание условий для доступа к финансово-экономическим показателям деятельности коммунальных унитарных предприятий и повышения их подотчетности населению территориальных общин. Сформулированы предложения относительно обнародования информации о деятельности коммунальных унитарных предприятий и представлены практические рекомендации для органов местного самоуправления касательно категорий коммунальных предприятий, где должны быть созданы наблюдательные советы, и критериев отбора независимых аудиторов для проведения обязательного аудита годовой финансовой отчетности таких предприятий.

Ключевые слова: коммунальные предприятия, наблюдательный совет, аудит, прозрачность, подотчетность, объединенные территориальные общины.

The basis of the decentralization processes, which are currently being actively implemented in Ukraine, is the creation of an efficient and capable local self-government institute at the basic level – the amalgamation of territorial communities (hereinafter – ATC). Pursuant to the provisions of the European Charter of

Local Self-Government, the implementation of national decentralization reform envisages, in particular, the voluntary unification and consolidation of territorial communities, financial decentralization and the granting of new powers and capacities to the ATC. Thus, in the framework of the implementation of the national reform on decentralization it is presupposed, in particular, voluntary unification and enlargement of territorial communities, financial decentralization and obtaining of new powers and opportunities by ATC.

One of the most important challenges nowadays is to form capable communities by means of improving the efficiency of managing the community's assets and funds and by ensuring transparent and responsible financial, including budgetary, management at the municipal level, which must meet high international standards of transparency and accountability of utility companies (hereinafter – UC).

Due to the UC, which are functioning today in Ukraine in large numbers¹, the state realizes its social, regulatory and control functions that cannot be performed by private enterprises. At the same time, compared with these enterprises, UC demonstrate lower profitability and inefficiency of internal corporate management. So, according to the results of the research study provided by the Center for Economic Strategy, UC, *ceteris paribus*, receive lesser profits than private enterprises, the average loss per UC amounted to more than 1 million UAH and the total losses – more than 6 billion UAH [2].

At the present stage, one of the most effective mechanisms for managing public utilities is establishment of the collegial governing bodies, namely, supervisory bodies. The need to strengthen the supervision of enterprises within the state and municipal sectors of the economy is noted in the Report on the Effectiveness of Public Finance Management in Ukraine (PEFA) prepared by the World Bank in 2015. Supervision of such enterprises is weak and fragmented, which makes it difficult to obtain data and supervise their activities. Improvements in transparency and accountability, according to experts of the World Bank, can be achieved via the mandatory disclosure of the operational goals, including non-commercial prices, independent annual audits and analysis of the performance measurement structure, which should include standard indicators and methodologies for evaluating the activities of state and public utilities [3, p. 74, 75].

Theoretical aspects and problems of organization of control and audit in the context of changing mechanisms of interaction between the government and economic entities and requirements for disclosure of information in the financial statements and arguments in favor of the expediency of introducing a decentralized model of public finance management and control were studied in scientific works by such Ukrainian scientists as V. D. Bazilevich [4], N. G. Vygovsky [5], L. V. Dikan [6], I. K. Drozd [7], T. I. Yefimenko [8], T. O. Kamenska [9] and others. Among the researchers who studied the conceptual and applied aspects of the activities of local authorities in public utilities management and problems of effi-

¹ According to the State Statistics Service of Ukraine, as of December 1, 2019, the number of registered utility enterprises amounted to 13 774 legal entities [1].

ciency increasing of UC activity can be identified: T. Kobzeva [10], V. Kuybida [11], A. Lelechenko [12], A. Liva [13], N. Fomitska [14], and others.

Particular attention is paid to the improvement of the mechanisms of UC management efficiency in the context of updating the legislation of Ukraine in connection with the implementation of the Association Agreement between Ukraine and the European Union [15] and the approximation of Ukrainian legislation to the EU legislation on the effectiveness of supervisory boards of enterprises of communal ownership and introducing new internationally recognized principles of managing them at the local authority level. After the entry into force on the September 1, 2017 of the Agreement, annual EU monitoring is subject to the progress in the implementation of all activities covered by the Agreement, in particular those that provide for strengthening administrative capacities at the central and local levels, building the capacity of regional and regional development, implementation of regional policy on multi-level governance and partnerships, with particular emphasis on the integrated application of international standards and a gradual approximation to the EU legislature (Art. 387, 475 [15]).

The purpose of the article is to explore possible ways to increase accountability and transparency of ATC activities in the framework of decentralization reform in Ukraine. The article is a continuation of the author's research and provides for the development of the provisions outlined in [16; 17]. The article explores the possibility of solving the problems of improving the efficiency of management of communal property of ATC on the basis of a combination of two areas of reform – adapting updated legislation on accounting and auditing of financial statements with requirements for the discovery of socially necessary information managed by UC.

Legislative preconditions for transparency and accountability of UC to the people of ATC are secured through laws and regulatory legal acts of Ukraine [18–20].

However, changes in the legislation of accounting and auditing have touched, in particular, the introduction of the practice of the obligatory audits of annual financial statements for enterprises of public interest, and obligations on the publication of various audited financial statements by various categories of enterprises (Table).

Table. Classification of enterprises and criteria for their distribution in accordance with changes in the accounting legislation

Companies	Micro	Small	Average	Large
Balance sheet total	Up to 350 thousand Euro	Up to 4 million Euro	Up to 20 million Euro	Over 20 million Euro
Net turnover	Up to 700 thousand Euro	Up to 8 million Euro	Up to 40 million Euro	Over 40 million Euro
Average number of employees	Up to 10	Up to 50	Up to 250	Over 250

Compiled according to: [21].

The requirements for information that should be presented by enterprises in financial statements and the respective format of these statements have also changed. New regulatory requirements for the compulsory audit of financial statements of enterprises of public interest relate not only to auditors and auditing entities, that provide services, but also to these enterprises themselves, that should organize an adequate system of internal control and risk management.

Changes in legislation concern the disclosure of information about the activities of utility companies and, thus, form the legislative prerequisites for the transparency of such information and the accountability of these enterprises to the public within local communities, and also provide a useful basis for substantiating the list of criteria for classifying utility companies into categories and groups, where obligatory supervisory boards must be created and the conditions for a transparent competition on to an independent auditor selection must be provided.

The formation of supervisory councils at UC presupposes the application of high international and European standards and principles of management of large corporations¹ for the UC of the cities of Ukraine in order to increase their competitiveness and, accordingly, decrease their unprofitability. The urgency of creating supervisory boards for UC, which become the property of the established ATC, is also explained by the fact that nowadays the information on the activities of these enterprises is closed to the public. UC leaders do not realize their own responsibility for disclosing socially significant information and financial and business results, and the accuracy of this information/moreover, there is inadequate control over UC activities by the local councils. The lack of understanding of the functions of supervisory boards and their role within the implementation by local authorities of their own powers to manage UC, on the one hand, and the unresolved issue of determining the criteria for creating supervisory boards at the state level, on the other, lead to the abuses and violations in this area, that have a negative impact on efficiency UC activities.

At the same time, it is necessary to pay attention to the fact that, despite the significant amount of information that is socially necessary and which can be controlled by UC and conditions have been created for ensuring the transparency of information on the financial and economic indicators of these enterprises, it is difficult to control their activity.

In the context of the decentralization reform and the increase in the number of ATC, which are formed through these processes, the organization of proper control over their activities is extremely important. Today, according to the

¹ The Organisation for Economic Co-operation and Development (OECD) is an international organization bringing together 34 countries in the world, most of which are high income countries and high Human Development Index. The OECD Principles of Corporate Governance provide specific guidance for policymakers, regulators and market participants in improving the legal, institutional and regulatory framework that underpins corporate governance, with a focus on publicly traded companies. They also provide practical suggestions for stock exchanges, investors, corporations and other parties that have a role in the process of developing good corporate governance. They have been endorsed as one of the Financial Stability Forum's 12 key standards essential for financial stability.

Government of Ukraine, 988 ATC s have been created, which unite 4,530 communities, accounting for 70 % of the population and over 38 % of the territory of Ukraine [22].

With the increase in the number of ATCs, the amount of property at the disposal of utilities enterprises is growing at a significant pace, which is ahead of the growth rates of state enterprises (Fig. 1).

According to the calculation of revenues per person, ATC own revenues increased by 62.6 % compared to the same period in 2017, and amounted to UAH 3354.4 per person in 2018. Taking into account that 299 ATC, in which the first local elections were held in 2017, only in 2018 received 60 % of the revenues from the personal income tax, their own resources, compared to the same period last year, increased by 2.7 times, or UAH 5.5 billion and amounted to UAH 8.8 billion. So, with a significant increase in assets owned by ATC (at the end of 2017 – by UAH 64.1 million or by 23.2 %), the growth in income over this period was more slowed down (by UAH 3362 million (or 0.4 %) compared to 2016) [23–24].

Obviously, the lack of public control and the accountability of the UC to society leads to inefficient spending of resources and different types of abuses.

Three years ago, with the adoption of the Law of Ukraine “On Amendments to Certain Legislative Acts of Ukraine Concerning the Management of State and Municipal Property” dated 02.06.2016 Nr. 1405-VIII [25], the Verkhovna Rada of Ukraine provided an opportunity for local authorities to significantly increase accountability and activity efficiency as well as to realistically prevent corruption in the UC communities. City councils received the right to create collegial governing bodies UC – supervisory boards.

However, presently not all city councils have exercised this right, and even among those that have used it, there is a formal approach to the creation of these bodies. As a result, UCs remains predominantly inefficient, unprofitable, and therefore are constantly supported by subsidies from city budgets. In the absence of effective supervisory boards under the UC, these enterprises remain uncontrolled structures in Ukraine and regards as a source of risks of political corruption and abuse of power.

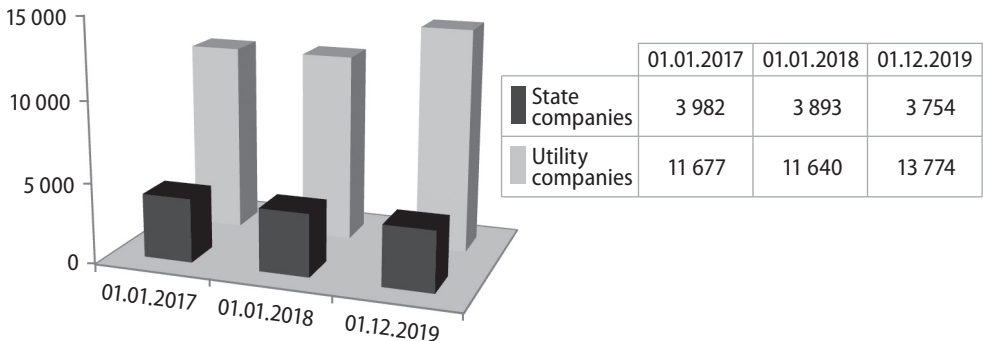


Fig. 1. The quantity of state and utility companies in Ukraine

Compiled according to: [1].

So, according to the State Audit Service of Ukraine during January – October 2019, the non-earmarked expenses and shortages of utilities resources totaled more than UAH 414.2 million that constituted 36.8 % of the total amount of state resources used in violation of legal acts. In addition, the losses of revenues by local budgets, utilities, institutions and organizations were more than UAH 210.7 million, where almost UAH 150,8 million were within the local budget funds. Significant violations in the use of communal resources were at enterprises, institutions and organizations of the city of Kiev and Kiev region, Mykolaiv region, Zaporizhzhia region, Dnipro region, Chernihiv and Cherkasy regions, where the amount of the losses of local budget funds and communal property in January – October 2019 constituted UAH 46.8 million, more than UAH 43 million, more than UAH 33 million, more than UAH 28.8 million, almost than UAH 28.6 million, and almost UAH 25.4 million respectively [26].

The total volume of such violations, revealed by the State Audit Office in the regions during January – October 2019, is shown in Fig. 2.

In order to make a utility sector potentially more profitable, competitive, and most importantly open to the public, it is important to change the approaches to the management of the UC activities, raising the management standards of these enterprises to a higher professional level by creating supervisory boards.

So, according to article 34 of Law “On the audit of financial reporting and auditing activities” [27], large enterprises are required to create an audit committee or to put the appropriate functions on the audit committee or supervisory

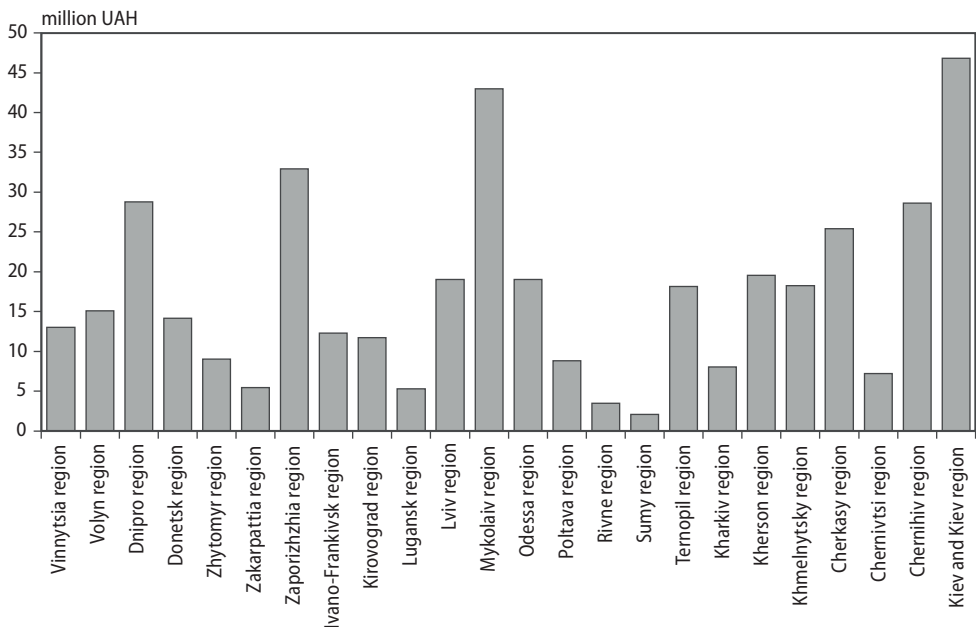


Fig. 2. The total volumes of illegal, non-earmarked expenses and shortages of utilities resources during January – October 2019

Compiled according to: [26].

board, which is created in accordance with the law. Other enterprises that belong to enterprises of public interest may assign the functions of an audit committee to a separate subdivision of the governing body or to the supervisory authority.

These powers impose certain requirements on local governments, whose prerogative is the implementation of the requirements of the provisions of current legislation relating to the organization and to conducting of the external audit and internal control in the UC. At the same time, the present situation indicates problems, that presuppose that e deputies of local councils and their leaders should not emphasize the role of supervisory boards, the formal approach to their education at the local government level, and as a result – conducting a formal or unjustified audit of the financial statements as a whole.

The state cannot stand aloof from these problems and, as an institution, remains a regulator for local authorities in these matters, however, these decisions on the use of community property, its accounting, control and audit are taken independently based on the principles of autonomy.

Now the Government of Ukraine has adopted the Procedure for promulgation of information on the activities of state unitary enterprises and economic societies [28]. The actual development and approval of the criteria for classifying state and municipal unitary enterprises to those whose financial statements are subject to mandatory audit.

We believe that supervisory boards can be formed in the UC by decision of district or regional (local) council session. The supervisory boards will be introduced to the UC governing bodies along with the head of the enterprise. However, it is not economically feasible for all UCs to set up supervisory boards.

In accordance with part 30¹ article 26 of the Law of Ukraine “On Local Self-Government in Ukraine” [29] and part 7 article 78 of the Commercial Code of Ukraine [18], as well as amendments to accounting legislation [21], the Supervisory Board is obligatory formed in the communal unitary enterprises in the case of the presence of one of the criteria shown in Fig. 3.

Taking into account the need to make adjustments in the indicators (characteristics) of categories of enterprises, we will formulate recommendations for local authorities on the criteria for selection of independent auditors (audit companies) to conduct a mandatory audit of the annual financial statements of UC:

1) Book value of UC assets:

by category of enterprises listed in the Law of Ukraine “On Accounting and Financial Reporting in Ukraine” [21] (see Table), UC financial statements are subject to mandatory audit, the book value of assets of which is over EUR 20 million (large) and up to EUR 20 million (average).

2) UC ownership structure:

the financial statements of the UC is subject to the compulsory audit, if in the statutory capital of which the share of the amalgamation of territorial communities is 100 percent, and which, according to clause 5.3 of article 90 of the Economic Code of Ukraine [18] are required to disclose information about their activities to the public, including audit opinions on the annual

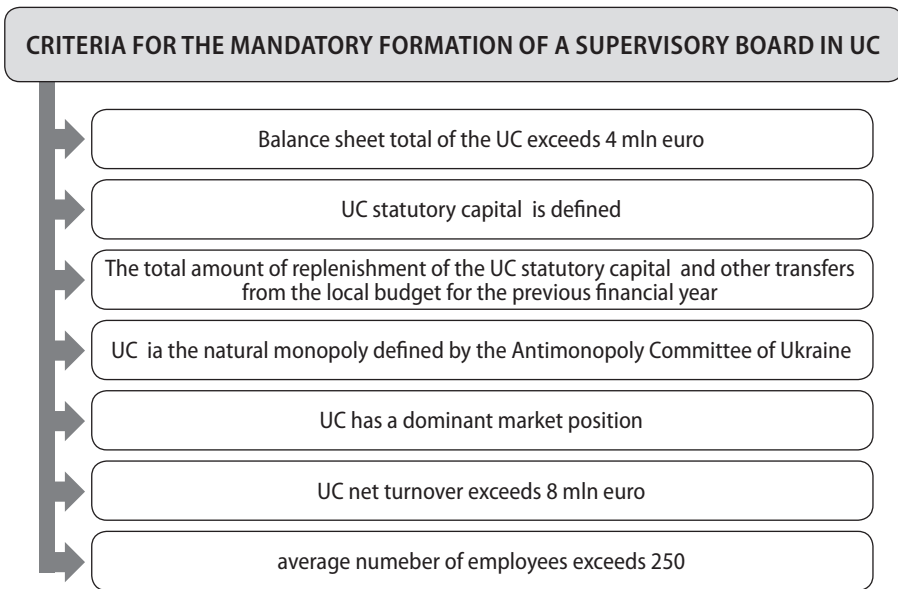


Fig. 3. **Criteria for the mandatory formation of a supervisory board in utility companies**

Suggested by author on the basis of [18; 21; 29].

financial statements (including consolidated) for the last three years, if the audit was conducted in accordance with the requirement of the law, except for the cases established by law, by posting it on its own web page (website) or on the official website of the management entity, performing its management functions.

- 3) The existence of expenses for the fulfillment of non-commercial goals of state policy and the sources of their financing in UC, including availability of sources of funding from state and/or local budgets;
- 4) Availability of information on operations and obligations of UC with state and/or local budget, state and/or local institutions, enterprises and organizations, including contractual obligations (financial and non-financial) arising from the execution of public-private partnership contracts [28].

Despite the created legislative conditions for ensuring access to financial and economic performance indicators and improving the management efficiency of utility companies of local authorities, there are a number of problematic issues that need to be addressed.

1. The national market requires the provision of additional conditions to increase the transparency and efficiency of management of municipal resources, accountability to the public within the amalgamation of the territorial communities.

2. Low profitability or unprofitability of utility companies, inadequate control over UC activities by local councils negatively affect not only the ability of these

enterprises to be socially useful, but also to ensure the implementation of state social, regulatory and control functions.

3. The absence of the implementation of internationally approved standards and European principles for the management of large corporations within UC of Ukraine.

4. The absence in the Ukrainian legislation of the provision on the obligatory establishment of supervisory boards for UC and the determination of the corresponding powers by the district and regional councils. Now this is advisory in nature and only for UC, established by the decision of the sessions of rural and city councils.

5. The absence of the criteria for classifying state and utility enterprises as such, the financial statements of which are subject to mandatory audit. This does not facilitate the implementation of a systematic control over the budget execution in regions and the effective management of communal property as well as conducting of an annual mandatory audit of financial statements within the uniform approaches. The functions of supervisory boards should be in accordance with those defined in the legislation on accounting and auditing. In addition, at the present stage of development of the country's economy, we consider it expedient to take into account the approaches to the classification of enterprises for accounting purposes, which were presented in the Law of Ukraine "On Accounting and Financial Reporting in Ukraine" [21], to characterize (indicators) UCs, in which it is advisable to create supervisory boards and select an independent auditor to conduct mandatory audit of annual financial statements. In the future, these indicators should be taken in account as the basis for the development and adoption of a management decision at the government level to approve common approaches to the economic feasibility of creating supervisory boards and criteria which presuppose that UC financial reporting is subject to mandatory independent audit.

6. The absence of the defined norms of financial plans of utility companies concerning the costs for consulting (auditing) services, including the possible restrictions on the financing of such expenses. Currently enterprises while forming the financial plans and approving them and planning the costs for consulting (audit) services are forced to take into account the restrictions established by the Government [30] as early as 2006. In the absence of modern standards for determining the volume of expenses for conducting an independent audit of the annual financial statements, UC cannot plan an amount greater than 1.5 percent of the net profit.

7. The absence in the national legislation provision on the powers and competencies of district and oblast councils concerning UC, created by the decision of the session of such a council.

8. The absence of the appropriate legal framework for expanding the rights of municipal administration to the European standards and the full use of existing legal regulations for managing local finances in the context of limiting budget financing and delineation of the financial support for own and delegated powers of the established ATC.

So, a significant increase in municipal property proves a certain improvement in the performance of the ATC. And, as these enterprises are created to meet the specific needs of the territorial community, the efficiency and profitability of their activities are of great importance. A supervisory board should provide the achievement of goals of improving the efficiency of management of public utilities, the effective work of which will make the enterprise more transparent and effective for the territorial community of the city. Also, UCs are managers of socially necessary information of public interest that is subject to disclosure in the open resources such as Internet. Access to such public information and its detailed list should be in line with the national legislature.

However, despite the existence of public information that is open, as well as legislative framework that have been created to ensure access to the financial and economic indicators of UCs activities, these enterprises, as natural monopolies in the national market, need to provide additional conditions for increasing the transparency and efficiency of managing public utilities, accountability to the public within the amalgamation of territorial communities.

Due to the fact that as a result of the decentralization reform, the number of ATCs and the amount of communal property increase, it is extremely important to carry out reforms of internal corporate governance within UCs. Low profitability and insufficient motivation for these enterprises for the disclosure of the socially significant information and financial and economic performance, administrative corruption and lack of understanding by UCs managers of their own responsibility for the accuracy of financial reporting, inadequate control of UCs activities by local councils, negative affect the ability of these enterprises to be socially useful. In order to make UCs competitive compared to the private ones, it is necessary to introduce internationally approved standards and European principles and the best practice of managing large corporations in the UCs activity of Ukrainian cities. The creation of supervisory boards within UCs can be considered as the first step on this path. In the future, common approaches to the economic feasibility of creating supervisory boards should be formulated and developed at the government level, and uniform criteria should be adopted to classify utility companies as such those financial statements are subject to mandatory audit.

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