



EURORAI Seminar on 18 October 2018 in Székesfehérvár (Hungary)

The audit of local authorities' participations

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HESSISCHER
RECHNUNGSHOF

Agenda

1. What are participations of local authorities?

2. What particularities have to be taken into account regarding the audit of economic activities by local authorities?

2.1 Participation management

2.2 Consolidated financial statements

2.3 Audit of annual financial statements and information rights

2.4 Economic advantage of participation / risk-adequate profit distribution

3. Conclusion

1. What are participations of local authorities?

Spectrum of local authorities' participations

- Participations of local authorities are enterprises under private law (e.g. limited companies) that are related to local authorities (e.g. limited companies) in order to provide public services.
- Participations of local authorities execute for example supply and disposal tasks (municipal utilities, waste disposal companies), infrastructural tasks (e.g. local transport), social tasks (e.g. hospitals) or economic policy tasks (e.g. sponsorship by saving banks).
- City-owned enterprises generate the largest part of value created by local authorities - especially in big cities.



1. What are participations of local authorities?

Legally based requirements for economic activity (§121 HGO)

- Local authorities may found an enterprise if
 1. the public purpose justifies the activity,
 2. the type and scope of the activity are appropriate in terms of the economic conditions and the anticipated needs, and
 3. the purpose is not or cannot be fulfilled just as well and economically by a private third party.

1. What are participations of local authorities?

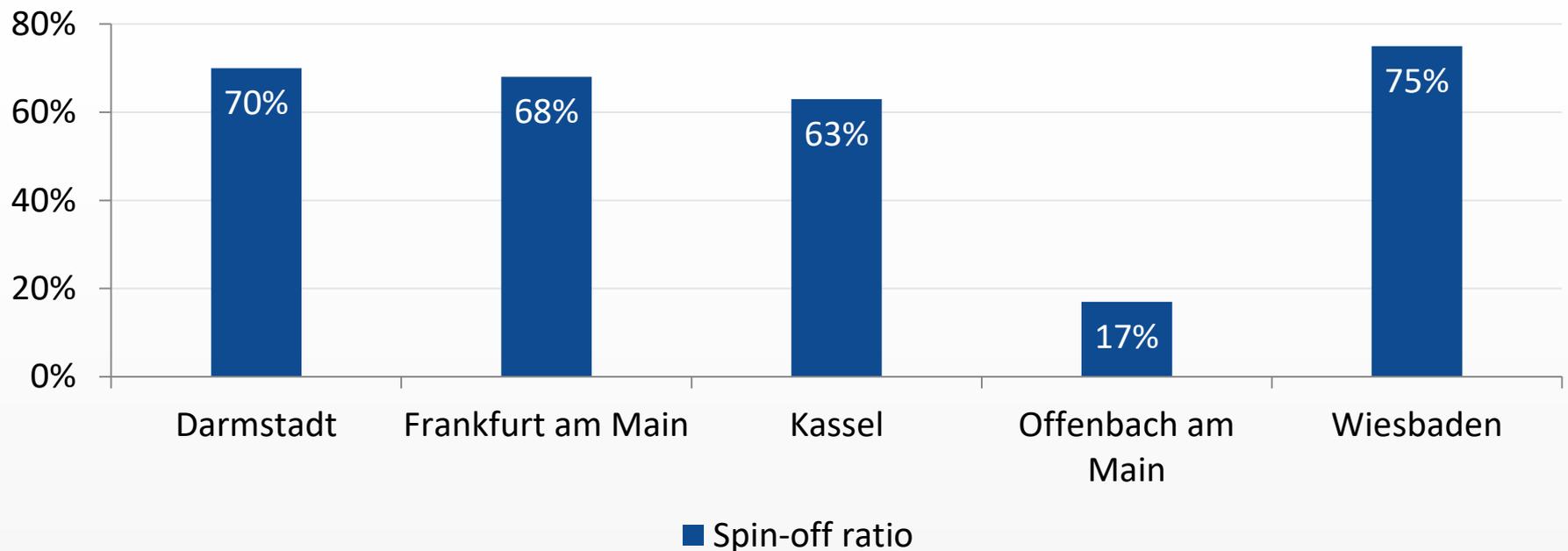
Requirements for economic activity (§121 HGO)

- The income of each enterprise shall at least
 1. cover all expenses and imputed costs,
 2. enable equity contributions necessary for the financial sustainability of the enterprise and its technical and economic development, and
 3. achieve a regular-way return on equity.

1. What are participations of local authorities?

Example: Spin-off ratio of loan liabilities

In relation to the respective ratio, the spin-off ratio describes the part of the overall liabilities that is allocated to the participations.



Source: Own calculations based on the financial statements of the municipalities selected, as of September 2015

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2. Particularities which have to be taken into account

Participation management

- Participation management of local authorities is the overarching, strategic management of all enterprises that are owned by the local authority or in which the latter holds a share.
- The strategic management is carried out by a Supervisory Board; in Germany this Board is usually staffed by representatives of the local authorities
- Participation management shall be an organizational unit in the local authority. Functions: strategic and operational management of holdings, including support of mandate-holders (preparation and follow-up of the representatives delegated to the supervisory board by the local authority).

2. Particularities which have to be taken into account

Participation management

In principle, Supervisory Board members are obliged to act in the enterprise's best interests

§ 394 AktG

Reports of the Supervisory Board members

§ 395 Akt G

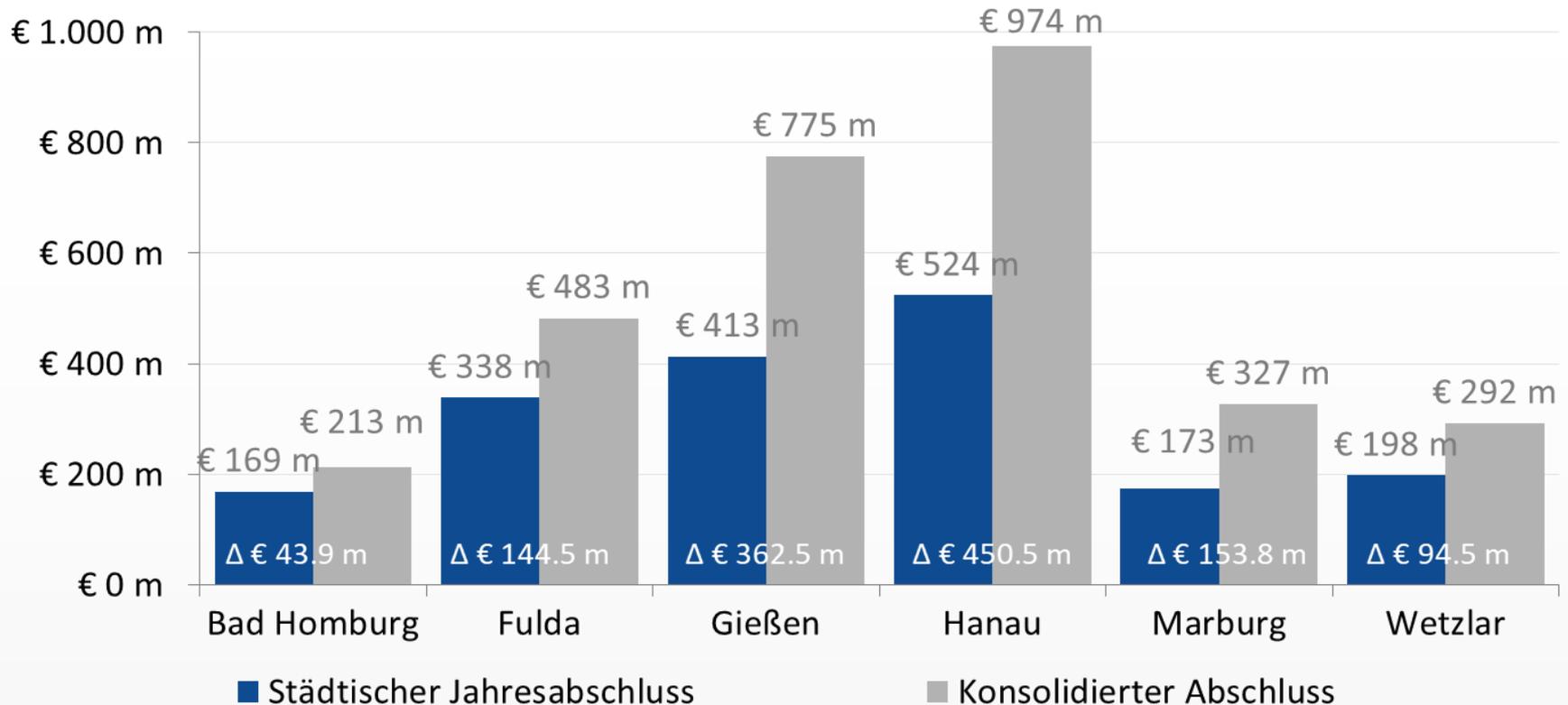
Confidentiality obligations

This obligation also applies for public sector auditors.

2. Particularities which have to be taken into account

Liabilities in the annual financial statements and consolidated financial statements

Example - The city of Hanau: The difference in liabilities was € 451m.



Source: Own calculations based on the holdings' reports and the annual financial statements as of January 2012

2. Particularities which have to be taken into account

First-time preparation of consolidated annual financial statements (consolidated financial statements)

- The Court of Auditors has recommended this comprehensive approach. This recommendation led to a legislative procedure.
- The consolidated annual financial statements (consolidated financial statements of local authorities) in Hesse were required to be prepared for the first time for the year 2015 by the 30th of September 2016.

2. Particularities which have to be taken into account

Audit of annual financial statements and information rights

§ 53 HGrG

Rights in relation to enterprises under private-law companies

§ 54 HGrG

Information to the audit authority

2. Particularities which have to be taken into account

Example – The City of Wiesbaden: Partial privatization of the municipal hospitals



Source: <https://www.helios-gesundheit.de/kliniken/wiesbaden-hsk/unser-haus/>

2. Particularities which have to be taken into account

Recommendation of the Court of Auditors led to amendment of the law

- Based on the recommendation of the CoA the Hessian parliament decided on 18 July 2014 to amend the HGO to ensure that the CoA is granted information and inspection rights.
- But: In the case of 39 private-law participations of the Hessian cities, the audit rights were only partly granted despite the existence of the legal requirements mentioned.
- The Court of Audit has reminded the cities of their legal obligation to adjust the partnership agreements

2. Particularities which have to be taken into account

Economic advantage of participation / risk-adequate profit sharing

	Messe	ABG
Annual result	€ 46,9 m	€ 66,2 m
Ratio of ownership	60%	100%
Distribution of profit to the local authority/ to Ffm.	€ 6,6 m (14%)	€ 7,5 m (11%)



Source: Messe: © Messe Frankfurt Venue GmbH
ABG: ABG Frankfurt Holding Wohnungsbau- und Beteiligungsgesellschaft mbH, Urheber: Stefan Forster Architekten

2. Particularities which have to be taken into account

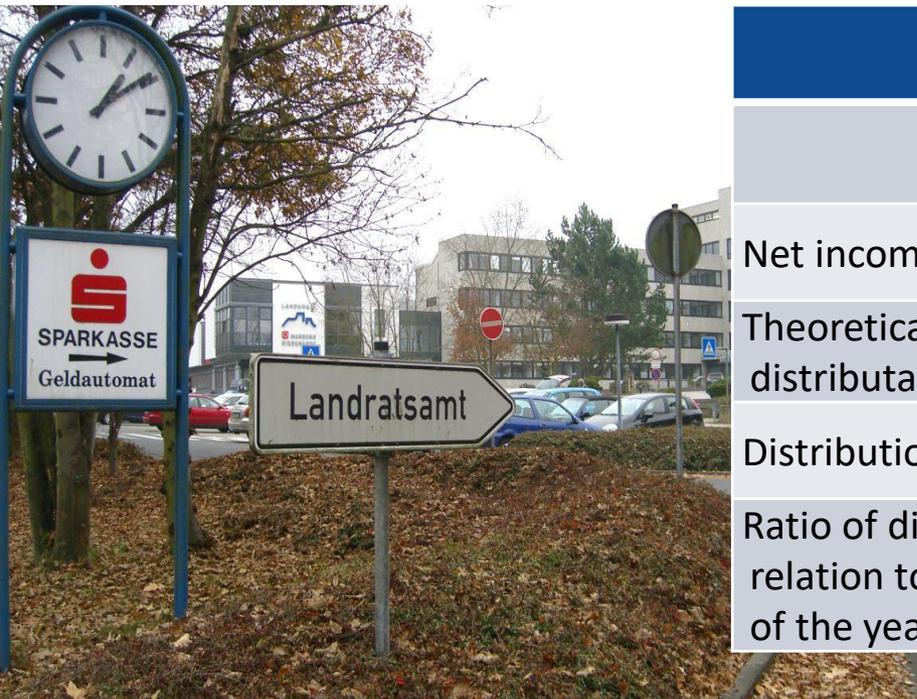
Economic advantage of participation / risk-adequate profit sharing

- Savings banks are particular institutions that only exist in this form in Germany, Austria and Italy.
- As “quasi-municipal” banks their purpose is to provide loans to the regional economy
- From a legal point of view the local authorities are not the owners of the savings banks, but there is an owner-like relationship.

2. Particularities which have to be taken into account

Economic advantage of participation / risk-adequate profit sharing

Audit of savings banks in 2012 and 2018



Appropriation of net income for the year			
	2009	2016	Percent change
Net income of the year	€ 145,5 m	€ 184,1 m	26,6 %
Theoretically distributable	€ 97,0 m	€ 122,8 m	
Distribution (gross)	€ 20,2 m	€ 31,9 m	57,7 %
Ratio of distribution in relation to net income of the year (gross)	13,9 %	17,3 %	

Source: Annual financial statements of the saving banks and information by the trustees

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Conclusion

- Spin-offs that used to be part of the municipal administration must be legally permitted and reasonable from an economic point of view.
- A spin-off is accompanied by a loss of control - also with regard to the risks of the company.
- This also leads to a loss of information for politicians and citizens.
- This loss of control could be reduced by implementing an adequate holding's management, the loss of information could be reduced by implementing consolidated financial statements, extended annual financial audits and information obligations.
- Local authorities should insist on risk-adequate profit distribution

Thank you very much
for your attention.

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