

**TRANSPARENCY OF THE FINNISH MUNICIPAL  
COMPANIES FROM THE VIEWPOINT OF THE LOCAL  
AUTHORITY AUDIT COMMITTEES**

**Jyväskylä University  
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**Author: Vilho Vaarnamo  
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Supervisor: Liisa Kurunmäki**



**JYVÄSKYLÄN YLIOPISTO  
UNIVERSITY OF JYVÄSKYLÄ**

**ABSTRACT**

<i>Author</i> Vilho Vaarnamo	
<i>Title</i> Transparency of the Finnish Municipal Companies from the Viewpoint of the Local Authority Audit Committees	
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<p><i>Abstract</i></p> <p>This Master's thesis studied the transparency and accountability of Finnish municipal sector and specifically municipal limited liability companies from the local authority audit committees' viewpoint. The study was conducted as qualitative research. The data of the empirical part of the study consists of 10 semi-structured interviews of members of the local authority audit committee of different medium to large size Finnish municipalities.</p> <p>Municipalities have incorporated many of their activities to publicly owned companies in the recent years. One of the main reasons for this is the revision of national laws in accordance with the laws of the European Union. Other reasons for incorporating include promoting competition, improving efficiency and comparability in addition to securing market-based pricing to ensure competition neutrality. Transparency of these public organisations and accountability of the public and elected officials are vital in successful public sector corporate governance.</p> <p>In this thesis, audit committee members were interviewed as they are among the rare few who have access to the confidential records of the municipality. The interviewed members of the audit committee saw their role as more focused on the performance audit while the auditors conduct the technical work. Many of the audit committee members thought that getting information from the municipal companies is challenging. The most significant problems observed in the municipal group and companies concerned the double roles and self-interest of elected and public officials. The interviewees considered increasing the transparency of municipal companies desirable. Transparency could be increased, for example, through municipal ownership control or by extending the Act on the Openness of Government Activities to municipal-owned companies in accordance with the Swedish model. However, some of the interviewees considered excessive publicity to be detrimental to municipal companies operating in the market. Further research could study the effects of extending the scope of the Act on the Openness of Government Activities to the municipal limited liability companies.</p>	
<i>Key words</i> Transparency, Corporate Governance, Auditing, Public sector, Municipal Companies	
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## TIIVISTELMÄ

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<p>Tässä Pro Gradu -tutkielmassa tarkastellaan kuntayhtiöiden läpinäkyvyyttä sekä niiden tarkastusta erityisesti kuntien tarkastuslautakuntien näkökulmasta. Tutkimus toteutettiin kvalitatiivisena eli laadullisena tutkimuksena. Tutkielmaa varten haastateltiin kymmentä tarkastuslautakunnan jäsentä kahdeksasta eri Suomen kunnasta. Haastattelut toteutettiin teemahaastatteluina, joiden tarkoituksena oli tutkia tarkastuslautakunnan jäsenten mielipiteitä liittyen kuntayhtiöiden tarkastukseen sekä lautakunnan toimivaltuuksiin.</p> <p>Kuntien julkista toimintaa on lisääntyvässä määrin yhtiötetty niiden omistamille osakeyhtiöille. Kuntaomisteisten yritysten lukumäärä on moninkertaistunut kahdessakymmenessä vuodessa, ja samalla myös veroilla kerätyjä rahoja käytetään osakeyhtiöiden kautta yhä enemmän. Yhtiöittämisen tavoitteena on usein edistää kilpailua, turvata markkinaperusteinen hinnoittelu sekä parantaa kustannusrakenteen läpinäkyvyyttä, taloudellista tehokkuutta ja tuloksien vertailtavuutta. Corporate governance eli hyvä hallinnointitapa on tärkeä osa myös julkisen sektorin hallintojärjestelmää. Olennainen osa hyvää hallinnointitapaa on tilivelvollisuuden ja läpinäkyvyyden korostaminen julkisissa organisaatioissa.</p> <p>Kunnan salassa pidettäviin asiakirjoihin pääsee käsiksi vain tarkkaan rajattu joukko, kuten esimerkiksi kunnan tarkastuslautakunta. Haastatellut tarkastuslautakunnan jäsenet näkivät tarkastuslautakunnan roolin tärkeänä erityisesti kuntakonsernin toiminnantarkastuksessa. Monen haastatellun mielestä tiedonsaanti kuntayhtiöistä on tällä hetkellä haastavaa tarkastuslautakunnan jäsenenä. Merkittävimmät havaitut ongelmat kuntakonsernissa ja -yhtiöissä koskivat erityisesti virkamiesten ja luottamushenkilöiden kaksoisrooleja ja jääviyttä kuntakonsernin sisällä. Läpinäkyvyyden lisäämistä kuntayhtiöissä haastateltavat pitivät tavoiteltavana. Läpinäkyvyyttä voitaisiin lisätä esimerkiksi kunnan omistajaohjauksen kautta tai ulottamalla julkisuuslaki koskemaan myös kunnan omistamia yhtiöitä Ruotsin mallin mukaisesti. Osa haastatelluista piti kuitenkin liiallista julkisuutta haitallisena avoimilla markkinoilla toimiville kuntayhtiöille. Julkisuuslain ulottamisen vaikutuksista julkisomisteisten yhtiöiden toimintaan tulisikin tehdä selvitys.</p>	
<i>Asiasanat</i> Läpinäkyvyys, Tilintarkastus, Corporate Governance, Kuntayhtiöt, Julkinen sektori	
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# 1 INTRODUCTION

## 1.1 Background

In recent years, the transparency of publicly owned companies especially in the municipal sector has drawn attention in the Finnish media, and a public debate about whether the publicity of municipal companies is adequate is underway. The ability to conceal activities can increase the risk of corruption in the companies. Transparency of actions is an integral part of preventing malpractices and even corruption.

The principle of publicity has been an important part of Finnish government and administration since the times Finland was part of Sweden. The principle implies the right to be informed about the activities of public authorities. According to the Act on the Openness of Government Activities (1999) "Official documents shall be in the public domain, unless specifically provided otherwise in this Act or another Act." However, while the principle of publicity binds the actions of authorities in the public governmental organizations, it does not extend to municipally owned companies. These companies follow the Limited Liability Companies Act (2006), which does not include a principle of publicity.

Activities of the public sector have been increasingly incorporated to the publicly owned companies, especially in the Finnish municipalities. Municipalities own over 2800 companies and the total staff of the companies exceeded over 48 400 in 2018 (Kuntaliitto, 2020). The companies operate in several different sectors and many of them are vital for the public infrastructure.

The Local Government Act (365/1995) was revised in 2013 in accordance with the laws of the European Union, which led to the increase of the number of municipally owned companies significantly. The change and thus the current law (410/2015) concern the incorporation of municipal activities:

“ When a municipality carries out functions referred to in section 7 in a competitive market environment, it must assign these to a limited liability company, cooperative, association or foundation to perform (corporatisation obligation).”

Other reasons for incorporating include promoting competition, improving efficiency and comparability in addition to securing market-based pricing to ensure competition neutrality. Usually in the municipal sector, it is primarily a question of how the duties are organized. The reason for the incorporation can be also financial as the municipal company receives the capital and then must be self-sufficient. However, it is unclear if companies that are controlled by a public entity have been allowed to go bankrupt (Wallin, 2019).

A good example of a failure of transparency in a municipal company is the case of Länsimetro Oy. It is a limited liability company that is jointly owned by the cities of Espoo and Helsinki. Its purpose was to build and develop the West Metro system in the cities of Helsinki and Espoo. However, the budget of the project was exceeded by hundreds of millions. A report was made that covered the delays and the costs of the whole project, but it was not made available to the public even though the funding of the project came from the public sector (YLE, 2017).

Good governance demands that operations are open to the public, which emphasizes the importance of the transparency of operations and decisions (Hallintoakatemia, 2019). The transparency of economic activity, which is the subject of my research in more detail, is of particular interest, as economic activity involves several different areas that have a decisive impact on the operation of the municipality. The number of reported financial crimes has been increasing slightly recently, probably partly due to increased controls (Danielsson, 2018). The transparency of this area is thus a vital part of the fair and inclusive activities of the municipalities. However, full transparency of the functions of the municipal companies may also be detrimental to their competitiveness, as often they are competing in the markets against private companies.

The purpose of this thesis is to study what challenges the auditing and the accountability functions of the municipally owned companies have especially from the viewpoint of the local authority audit committee.

## **1.2 The aims of the study**

In this thesis I study the accountability and transparency of the municipally owned companies in the municipal group. I also explain the major reasons behind incorporation of the activities of the public sector and especially municipalities. The accounting framework of the study is related to corporate governance and the New Public Management.



According to a report by the Finnish Competition and Consumer Authority (2019), only a very limited group such as the local authority audit committee has the access to the business operations of these municipally owned limited liability companies. According to a survey carried out in 2017, 79% of the members of the local authority audit committee did not know how the risk management is organized in their subsidiaries and only one-fifth of the subsidiaries reported their management actions to the municipality (Finnish Competition and Consumer Authority, 2019).

Therefore, I study the subject from the viewpoint of the local authority audit committee by interviewing audit committee members about their views on the role and the relationship of the accountability responsibility between the audit committee and the statutory external auditors of the municipally owned companies. I study the incorporation of municipal operations, how it has affected the audit of municipal companies, and what kind of challenges the members of the audit committee face in the audit of a municipal group. Also, I examine the effect of politics on the boards of municipal companies and the work of the audit committee, because both are important to the functionality of the municipal group.

The main research questions for the thesis are the following:

- What challenges do the members of the local authority audit committee face in the audit of the municipal companies?
- How do the members of the local authority audit committee see their role in the governance of municipalities and municipal companies?

The thesis also includes a sub-research question:

- How politics affects the boards of the municipal companies and the work of the local authority audit committee?

### **1.3 Structure of the thesis**

The thesis is divided into six sections. The introduction explains the background of the thesis and the main goals of the study. After the introduction, the second section includes the theoretical framework of the study starting with defining incorporation and the main reasons behind it including the doctrine of New Public Management. After that I discuss corporate governance and its application in the public sector organisations. The third section explains how the auditing and accountability functions are organized in the Finnish municipalities and their subsidiaries.

After the theoretical part of the thesis, the fourth section discusses the data and the chosen methodology for the empirical part of the thesis. The fifth section includes the results and the analysis of the interviews. As the last section, the

sixth section concludes the results, evaluates the thesis and its limitations, and suggests possible topics for future research.

## 2 THEORETICAL FRAMEWORK

### 2.1 Incorporation in the public sector

Since the 1990s, municipalities have outsourced, privatized, and incorporated many of their activities for numerous reasons. Municipalities have become both a buyer and a seller of services through municipal companies (Eskelinen, Harjunen, Hirvonen & Jokinen, 2017). This new way of thinking has its roots in different causes. The phenomena can be looked from the viewpoint of New Public Management, which aims to make public organisations more effective by implementing private sector practices. The principle of competition is also a major driver behind the movement towards creating markets even for public organisations, as competition aims to make markets more efficient. Competition is also thought to aim to establish stable conditions to improve efficient use of labour and capital (Saarinen, Salmenniemi & Keränen, 2014). The change of the welfare state by trying to slow the growth of public expenses and creating innovative public companies can also be the factors behind the phenomena (Anttonen, Haveri, Lehto & Palukka, 2012). In this thesis, I will be focusing especially on the incorporation of public services and activities.

Incorporation is the act of creating a legally recognized company. The decision-making and the responsibility of the decisions is transferred to the company's management from the municipality. According to Ruohonen et al. (2017), this transition is major in principle, as the board of directors and the CEO of the company then have the main responsibility. In Finnish municipalities the activities of the public sector have been increasingly incorporated to the publicly owned companies. Most of the time the companies created through incorporation are limited liability companies (Ruohonen, Vahtera & Penttilä, 2017). However, co-operatives and foundations are possible types of companies as well. Incorporation should not be confused with the term privatization as in the former the

public organisation remains the majority shareholder and therefore has the decision-making power in the company. In privatization the activities or services are transferred or sold to the private sector. Reasons for incorporation are numerous including, for instance, implementing more effective practices from the private sector and the incorporation obligation from the law.

Most of the municipal companies currently are profit seeking (Penttilä et al., 2015). The incorporated company should be self-sufficient, and the municipality should consider what are the financial conditions of the company. Even though the Limited Liability Companies Act allows the company to determine that it does not intend to make profit, usually the premise in the public administration has been that the company should be profitable (Wallin, 2019).

According to Eskelinen et al. (2017), incorporation is the result of a long-term policy and its roots are in neoliberal policies. Neoliberal policies are not a similar doctrine everywhere and they depend on the national context (Harvey, 2008). Eskelinen et al. (2017) suggest that the ordoliberal school of neoliberalism also helps to understand the incorporation process of municipal enterprises. Ordoliberalism emphasizes the importance and role of the state in providing sufficient competitive conditions. Its roots are in German doctrines of economic policies and is based on guaranteeing order in the competition. According to Harjunemi (2015), the role of the state is to provide and guarantee the juridic framework for competitiveness to avoid cartels and monopolies, as from ordoliberalist point of view, the public sector can be seen as such. Ordoliberalism has also been utilized in organising the European markets and creating the common economic policies of the European Union. According to Eskelinen et al., (2017), this is reflected in supranational solutions to social issues in the EU. In Finland, the ordoliberal features of economic policy have manifested themselves, for example, in the compulsory incorporation of public enterprises, which has been justified by the EU Competition Directive (Eskelinen et al., 2017).

According to Vesterinen (2006), incorporation can be a consequence of wanting to avoid democratic decision-making, which makes the strategic planning of the incorporation important. Therefore, it is necessary to have the planning of the incorporation consider the overall interest of the municipality. Control and ownership of the municipal group should be in democratically elected municipal bodies (Vesterinen, 2006). Incorporation has also been advocated as making the funding of the municipality easier. However, this claim is controversial as the share capital of the company must be funded by the municipality itself (Vesterinen, 2006).

Usually, incorporation is executed by transfer of assets or by regular asset acquisition (Vesterinen, 2006). In transfer of assets, the organisation or corporation transfers all the assets and debts of a certain part of the business to a newly formed company in exchange for shares in the company. For example, if a public utility company (*kunnallinen liikelaitos* in Finnish) decides to incorporate part of its functions by transfer of assets, the new company will be a subsidiary of the public utility company. The Act on the Taxation of Business Income (360/1968,

52 d §) states that if the incorporation is done by transfer of assets, the transferring company must engage in business activities at the time of the transfer and that the activity to be transferred must also be a business activity. According to Vesterinen (2006), transfer of assets is the best suitable option for incorporation if the activity does not generate considerable amount of taxable income or if the amount of assets to be transferred is significant and would require larger asset transfer tax.

Asset acquisition on the other hand is a better option if the activities to be incorporated generates significant amount of taxable income as a municipal owner does not have to pay capital gains taxes (Vesterinen, 2006). Asset acquisition enables the municipality to directly own the new company. However, it requires value determination. When incorporating through an asset acquisition, it is possible to plan the company capitalization optimally for the future. For example, share capital and the amount of restricted capital is determinable (Vesterinen, 2006).

### **2.1.1 Corporatisation obligation**

Finland received two notices from the European Commission regarding competition neutrality. The first one was given in 2006 since Destia, a Finnish state-owned road infrastructure organisation, was seen to receive state aid against the regulations of the European Union (EU). The second notice in 2010 concerned Palmia, a service provider owned by the city of Helsinki. Palmia was seen to have advantage against its competitors as it could not go bankrupt and did not have to pay corporation taxes. The case of Palmia was highly disputed and the association of Public and Welfare Industries (JHL), which represented Palmia employees, was trying to influence the municipal decision-makers to reject the incorporation. Both Destia and Palmia were incorporated, Destia in 2008 and Palmia in 2015. The notices by the European Commission then led to the amendments to the Local Government Act (2015).

Chapter 15 of the Local Government Act (2015) concerns the regulation of municipal activities in the market. The main aim of the chapter is to ensure competition neutrality (Kuntaliitto, 2016). Municipalities can compete in the markets and engage in financial activities. However, when the municipality is competing in the markets, it must choose forms of activity where the competition neutrality is secured and where it does not have an advantage compared to the private competitors. Therefore, the municipality must assign these activities to a limited liability company, cooperative, association or foundation. This principle is called the corporatisation obligation. The obligation is supervised by the Finnish Competition and Consumer Authority. The authority also supervises market-based pricing in the municipal companies. For instance, most energy plants, district heating, and ports must be incorporated (Penttilä et al., 2015).

Generally, a municipality has four options in case a corporatisation obligation is noticed (Penttilä et al., 2015):

1. Incorporation of the activities
2. Competitive tendering of the activities
3. Withdrawal from the competitive market
4. Dividing the activities to the ones that must be incorporated and the ones that will stay part of the municipal's own activities

There are some exceptions to the obligation, which are stated in section 127 of the Local Government Act (2015). These exceptions include, for instance, activities that are minor, providing support for its subsidiaries and statutory services of the municipality (Local Government Act, 2015).

According to Ruohonen et al. (2017), in the future years the incorporation due to the incorporation obligation will continue to be on the rise. There is still a significant number of municipal consortiums that act on the competitive markets and might have to be incorporated. The biggest municipalities of Finland have surveyed the areas that have to be incorporated due to the corporatization obligation (Penttilä et al., 2015). For instance, Helsinki, Oulu, Turku, and Kuopio decided to incorporate energy and port operations. Some of the municipalities have seen the possibility of benchmarking incorporated companies with private sector companies to be an advantage of incorporation. However, the delays of incorporation are thought to be results of uncertainties related to the tax treatments and the amendments to the Local Government Act. The municipalities have also considered to incorporate activities that are not covered by the actual incorporation obligation. According to Penttilä et al. (2015), this is an indication that the municipalities have expectations of improved efficiency for the activities.

### **2.1.2 Act on the Openness of Government Activities**

The main idea of the Act on the Openness of Government Activities is to ensure that the public has access to the documents of the authorities. The principle of publicity is included in the Constitution of Finland, which makes it a fundamental right to information (Wallin, 2019).

The objectives of the Act on the Openness of Government Activities (621/1999, 3 §) are: "... to promote openness and good practice on information management in government, and to provide private individuals and corporations with an opportunity to monitor the exercise of public authority and the use of public resources, to freely form an opinion, to influence the exercise of public authority, and to protect their rights and interests." The right of access to information makes it possible to monitor public authority and the use of public funds. The principle of publicity helps to prevent malpractices and corruption, and therefore, can boost people's confidence in public institutions (Wallin, 2019).

The requirement of publicity also concerns municipal authorities including public utility companies (kunnallinen liikelaitos in Finnish). The Act does not directly concern the limited liability companies owned by municipalities or the state. However, according to the section 4 of the Act " The provisions on an au-

thority also apply to corporations, institutions, foundations and private individuals appointed for the performance of a public task based on an Act, a Decree or a provision or order issued by virtue of an Act or a Decree, when they exercise public authority". Therefore, the act is partially applied to municipal companies if the documents deal with public power (Wallin, 2019). An official document is defined as a document in the possession of an authority and prepared by an authority or a person in the service of an authority.

Even though the act itself does not concern municipal or other public limited liability companies, the act applies to municipal and state documents in different situations (Wallin, 2019):

1. The Act on the Openness of Government Activities applies to all documents held or controlled by an authority. Thus, the documents that the companies provide to authorities in different contexts fall within the scope of the Act on the Openness of Government Activities (e.g., documents delivered for corporate ownership steering; registers for general use)
2. The Act on the Openness of Government Activities also applies to documents issued or drawn up because of a task entrusted to a private operator by a public authority. Therefore, the use of purchasing services does not reduce the scope of the Act, but the documents are under the control of the authority.
3. The Act on the Openness of Government Activities also applies to private operators who perform duties under the law and exercise public authority or who perform public administrative function and are required by a special provision to comply with the Act.

Wallin (2019) presents three different options for expanding the use of the Act on the Openness of Government Activities to municipal and state-owned companies in a report made for the Ministry of Justice. The first option would extend the act to all municipal companies except the ones that compete in the open markets. It would make major part of the documents of the commercial municipal companies confidential to protect the business secrets of the companies. The publicity requirement, however, would concern the commercially operating companies which, by the type of their functions and the objectives of their activities, are not comparable to companies that genuinely operate in open markets. The second option is narrower, and the act would not be applied to any public companies that operate in markets. The third option is the widest and would concern all public companies except for state-owned listed companies. The concern with this option is that the business of municipal companies that compete in the markets may suffer harm from too much publicity of their internal affairs. However, Wallin (2019) states that the provisions of section 24 of the Act

on the Openness of Government Activities already protect the business secrets of public sector entities in accordance with the principle of neutrality.

Finland's Act on the Openness of Government can be compared with Sweden's similar publicity act. In Sweden, public access to general documents has been extended to any municipal business in which the municipality or county council has dominant position. Therefore, in Sweden the publicity act concerns also the municipal limited liability companies if the municipality exercises decision-making power in them. The act is directly applied to the companies that are fully owned by the municipalities, which means that requests for documents can be made directly to the companies. If the municipality partially owns a company, the city council must contribute to the public's access to the documents in the company as the public cannot directly demand the documents (Salokannel, 2019). If a private owned company is entrusted with tasks of the municipality, the municipal law in Sweden requires the municipality to supervise the activities of these private companies.

## 2.2 New Public Management

One of the factors affecting the incorporation of public services is the doctrine of New Public Management. In the 1970s, the social and economic environment were changing as the oil crisis led to a worldwide economic depression, thus ending the post-war Keynesian era (Yliaska, 2015). Western countries responded with several economic policies and techniques to adapt to the new situation. In most cases this led to the reforms of the public sector functions and organisations. Some of the reforms radically changed public administration (Yliaska, 2015). In the 1980s large public organisations were often thought to be slow and inefficient. This thinking led to the development of the doctrine of New Public Management (NPM). The doctrine proposes applying different management and operating practices from the private sector to public sector organisations. NPM reforms were first introduced in New Zealand in 1980s. In the United Kingdom, British Prime Minister Margaret Thatcher drove the privatization of public companies and the reduction of public administration also in 1980s. The ideas of NPM have affected the trend of incorporating public activities as well. However, a certain NPM reform model does not exist. NPM is more like a general term for public management reforms and some even consider it a paradigm (Schedler & Proeller, 2000).

New Public Management is not exclusive to the UK and its ideas have spread throughout the OECD-countries and beyond. Finland too has reformed public sector organisations following the principles of NPM. According to Peters (2001), NPM gave the western public sector reforms a common set of values and guidelines. The common guidelines focused on improving productivity, decentralization, strengthening self-government, and shifting public service functions



to the markets. A new view of the role, duties and responsibilities of public authorities has led to privatization, competition, and the application of purchaser-producer models (Peters, 2001).

The term New Public Management was introduced by Christopher Hood in 1991. According to Hood (1991) the rise of the NPM was linked to four administrative megatrends:

1. attempts to slow down or reverse government growth in terms of overt public spending and staffing;
2. the shift toward privatization and quasi-privatization and away from core government institutions, with renewed emphasis on 'subsidiarity' in service provision;
3. the development of automation, particularly in information technology, in the production and distribution of public services; and
4. the development of a more international agenda, increasingly focused on general issues of public management, policy design, decision styles and intergovernmental cooperation, on top of the older tradition of individual country specialisms in public administration.

Hood (1991) listed seven doctrines that have been most discussed about the NPM. Most of the doctrines have affected at least partly the public reforms in the OECD countries. Firstly, Hood (1991) mentions the 'Hands-on professional management' in the public sector. This means more visible and active leadership, where the managers have more liberties to make decisions. This has been justified by saying that accountability needs a clear assignment of the responsibilities for action. Secondly, Hood (1991) mentions explicit standards and measures of performance. These measures and standards aim for clear goal and targets that are expressed in quantitative terms, because accountability and efficiency need objectives that can be attained. The second doctrine is closely linked with the third doctrine, which Hood (1991) lists as greater emphasis on output controls. Its aim is to allocate resources and rewards depending on the measured performance. Thus, it is possible to emphasize the results instead of the procedures. Fourthly, Hood (1991) mentions the shift to disaggregation of units in the public sector. The idea is to break up bigger units and form the units around products. The shift has been justified by the need to create more manageable and efficient units. This way the units can get advantages using contract arrangements in and out of the public sector. Fifthly, Hood (1991) lists the shift to greater competition in the public sector, which means the use of term contracts and public tendering. Competition is thought to be significant in lowering costs and creating better standards. Sixth doctrine according to Hood (1991) is the stress on private sector styles of management practice. Its idea is to transfer out from the military-style 'public service ethic', have greater flexibility in hiring process, and to use increasingly PR techniques. This has been argued by the need to bring already proven private

sector practices to the public sector. The finally and seventhly Hood (1991) adds the stress on greater discipline and parsimony in resource use. This means lowering direct costs, raising the discipline of employees, resisting demands of the labour unions, and limiting the compliance costs to business. These have been justified by making public sector more efficient and checking the resource demands. According to Hood (1991), not all these seven cases were present in all countries' reforms and many of them were overlapping with each other.

### 2.2.1 Characteristics

NPM itself is a loose term to cover efforts of trying to reform the public sector to be more business-like. Gruening (2001) gathered the main characteristics of the NPM agreed by academics on table 1.

TABLE 1. Characteristics of the New Public Management (Gruening, 2001)

Characteristics of the New Public Management	
Undisputed characteristics (identified by most observers)	Debatable attributes (identified by some, but not all, observers)
Budget cuts	Legal, budget, and spending constraints
Vouchers	Rationalization of jurisdictions
Accountability for performance	Policy analysis and evaluation
Performance auditing	Improved regulation
Privatization	Rationalization or streamlining of administrative structures
Customers (one-stop shops, case management)	Democratization and citizen participation
Decentralization	
Strategic planning and management	
Separation of provision and production	
Competition	
Performance measurement	
Changed management style	
Contracting out	
Freedom to manage (flexibility)	
Improved accounting	
Personnel management (incentives)	
User charges	
Separation of politics and administration	
Improved financial management	
More use of information technology	

On the left side of table 1, Gruening listed characteristics of the NPM that are generally agreed by academics. The attributes on the right side have been agreed by some of the academics but not all. Budget cuts, accountability for performance and performance auditing aim for lower costs and more efficient administration. As seen in the table 1 on the left side, privatization is also seen as an important characteristic. Incorporation can be a logical step towards privatization. For instance, a Finnish public bus firm Helsingin Bussiliikenne Oy was incorporated in

2005. The incorporation was criticised on the basis that it would lead to the privatisation of the company (YLE, 2017). Eventually the firm was privatized and sold to the private company Viikin Linja Oy. New Public Management reforms therefore may lead first to incorporation, and then to the privatization of the public organisations.

The ideas and theories that have affected New Public Management are not new. According to Gruening (2001), the basis of NPM components arrives from different background theories. The emphasis on competition derives from public-choice theory. If the different departments are motivated through internal competition, it can emerge from organic management models. User charges are based on public-choice theory as well. Gruening states that accountability for performance is derived from classical thinkers and their idea of benchmarking public organisations. Therefore, many influences and theories have affected the development of New Public Management. Gruening also argues that New Public Management is not a new paradigm for the behavioral-administrative sciences and that almost none of the behavioural-administrative sciences even have a paradigm (Gruening, 2001).

New Public Management has also been criticised. Çolak (2019) argues that NPM faces criticism as it aims to bring private sector principles, which can be controversial, to the public sector without questioning them enough. NPM may not value the principles of equality, impartiality, justice, and public interest properly, as economic values are prioritised over them (Çolak, 2019; Balfour and Grubbs, 2000). It can be difficult and ineffective to implement private sector management practices to the public sector. Most sections of the public administration have specific political, social, ethical, and constitutional dimension that differentiate it from the private sector (Pollitt, 1990; Armstrong, 1998).

NPM has also been accused of not having concrete basis and having no substance (Hood, 1991). NPM might be more about hype and from this viewpoint, it has not changed the management of public organisations except in the speeches of public managers. The criticisers wish for actual binding contracts of change between ministers and managers. NPM has been criticised of not being able to lower costs against its promises and of pursuing the interests of "new managerialists" instead of greater good as in lower costs for public citizens (Hood, 1991). Hood (1991) continues that even though NPM advocates claim it to be universal, it has been criticised that administrative values of NPM have also different implications for the fundamental aspects of administrative design.

Mongkol (2011) points out two main criticisms against NPM: paradox of decentralization and applying controversial practices from the private sector. One of the goals of the NPM is to decentralize the administration. However, if the public managers have more authority and decision-making power, it may concentrate the decision-making solely to them. Therefore, the decisions will be centralized to the public managers (Kaboolian, 1998; Maor, 1999). Also, instead of cutting the size of the management, NPM applications have often resulted in expanding the management of public organisations (Martin, 1983).

New Public Management can provide greater transparency, but it may also lead to corrupt practices (Barberis, 1998). Minogue (2001) agrees with Barberis and argues that the increased autonomy of the public managers has made the accountability shadier and therefore increased the risk of the managers becoming corrupt.

## 2.2.2 New Public Management in Finland

New Public Management has also had a significant impact on the Finnish reforms of public organisations in the 1980s and 1990s. The reforms have had strong political support (Temmes 1998; Lähdesmäki, 2003). According to Lähdesmäki (2011), there are different reasons affecting the will for the reforms. The 'reform elite' has consisted of leading politicians and senior officials and they have had a common view on the guidelines of public sector modernization. The reforms have been consistent and continuous during the terms of different governments of the state as the reforms have been more practical and economic than politically or ideologically charged. The reform agenda has been to increase productivity and reorganize public service production (Lähdesmäki, 2011).

Finland suffered from recession in the 1990s and the economic crisis forced Finnish government to reform public sector organisations. Finland and the other Nordic countries have been known for their well-established welfare state. However according to Yliaska (2015), the crisis of the 1970s ended the growth of the welfare state and the role models of public administration transferred from the Nordic countries to the Anglo-Saxon countries. The government had to cut the costs of public sector organisations as the welfare state was built on growing economy (Lähdesmäki, 2003).

For example, Finland reformed the pay system of the civil servants in the 1990s and 2000s based on principles from the NPM. The aim of the reform was to improve equality of pay, increase employee motivation, enhance the efficiency of organizations and the competitiveness of organizations as employers (Lähdesmäki, 2011). The salary is now determined based on the demands of the job and personal performance. NPM has also reformed Finnish administrative policies by reducing the size of administrative organisation and decentralizing the control systems. Lähdesmäki (2011) describes the reform of the central government to be pragmatic and critical reassessment of the administrative organisation.

According to Lähdesmäki (2011), the NPM reforms in 2010s and after are based more on the reconciliation of efficiency and ethics, managing people instead of just results, and different cooperation models in the production of services. Incorporation in Finland is closely linked with the principles of NPM as the public sector has tried to make its organisations more efficient and accountable.

## 2.3 Corporate governance

There is no single definition of corporate governance as it is a multi-dimensional concept. Generally corporate governance is the set of practices, policies, and systems on how the company is managed and controlled. It includes considering the interests of different stakeholders of the company including for instance shareholders, the government, and the customers. The OECD (2005) defines corporate governance as:

“ Procedures and processes according to which an organisation is directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among the different participants in the organisation – such as the board, managers, shareholders, and other stakeholders – and lays down the rules and procedures for decision-making.”

The importance of good corporate governance concerns also municipal companies. A key element is that the company must balance the interests and be accountable to its different stakeholders. The importance and attention to well established corporate governance has risen after corporate scandals such as the accounting fraud of Enron in 2001. Enron exploited accounting loopholes, hid billions in debt in special purpose entities, and eventually went bankrupt as the fraud was revealed. The scandal also led to the downfall of Enron’s auditing firm, Arthur Andersen, which contributed to the fraud.

Corporate governance is based on fundamental principles and international guidelines. The Report of the Committee on the Financial Aspects of Corporate Governance (1992) emphasizes three important fundamentals of corporate governance: openness, integrity, and accountability. OECD (2015) has published international guidelines for corporate governance. The guidelines are made for mainly public listed companies. However, each country applies their own legislative recommendations. According to OECD (2015), effective corporate governance requires well established regulatory, institutional, and legislative framework that the market participants can trust when formulating their private contractual relations. The framework of corporate governance should ensure proper disclosure is made for all the material records regarding the corporation. The strong disclosure regime should promote transparency as a key feature of the market-based companies (OECD, 2015).

Tricker (1994) divides corporate governance into two different aspects: conformance and performance. Conformance consists of two main elements, firstly monitoring and supervising performance of the executives, and secondly maintaining accountability to those who have the right to expect feedback. The performance aspect refers to strategy formulation and policy making and is the input of the people who govern the organisation and its performance (Tricker, 1994).

Private sector tends to focus more on the performance aspect of corporate governance, but in public sector the conformance aspect is also seen to be equally important (Hodges et al., 1996).

Corporate governance is also essential in the public sector. Public organisations use public money to fund their activities. This makes the organisations accountable to the whole society.

### **2.3.1 Accountability, transparency, and corruption**

To discuss public sector corporate governance, the concepts of accountability and transparency should be discussed, as they are major part of good corporate governance. Accountability generally means being responsible for one's actions and being called to account for them.

Bovens (2006) defines accountability as "a relationship between an actor and a forum, in which the actor has an obligation to explain and to justify his or her conduct, the forum can pose questions and pass judgment, and the actor may face consequences". The actor in public sector context can be an individual, such as a civil servant, or an institution, such as a government agency. The forum can also be an individual or an institution but also a larger entity such as the whole general public (Bovens, 2006). Bovens (2005) also suggests that accountability suffers from having too many eyes and hands, which in this case means account-receivers and givers. This makes it challenging for the account-receivers to specify who of the individuals are responsible and who within an organisation have conducted the actions (Bovens, 2005). Mulgan (2000) states that the meaning of accountability has already been extended to multiple directions from its core meaning. For instance, accountability is also referred to the sense of individual's responsibility as an 'internal' sense (Mulgan, 2000).

The Foreign, Commonwealth & Development Office (FCDO) of the UK, which was known as the Department for International Development (DFID) until September 2020, categorizes accountability into three forms of accountability: vertical, horizontal, and diagonal accountability. In vertical accountability the citizens hold the government and its institutions accountable for their actions relying on elections or informal institutions such as the press. Horizontal accountability focuses on accountability between the state's own institutions. One department can perform internal checks on other departments or agencies. Diagonal accountability combines the vertical and horizontal dimensions. It focuses on direct citizen engagement of people with state processes such as auditing and budgeting (DFID, 2006).

Transparency is closely related to accountability. Transparency, in the context of this study, refers to a situation where economic activities are carried out openly and unencrypted, in which case the activities can be considered honest and fair. In the public sector, transparency is part of effective governance and financial management.

Carolyn Ball (2009) identifies three different ways of defining transparency in her article. The first definition describes transparency as a public value and a

norm that works against corruption. According to the second definition, open decision-making is synonymous with transparency. Transparency means open and easy access to organizational information. The easier it is for people to access information, the more transparent it will be. The third definition describes a slightly more complex approach. Transparency is formed here through evaluations and the creation of policy plans. Transparency is thus created through well-functioning and clear processes. (Ball, 2009.)

Accountability and transparency are important in preventing corruption. According to an EU-report (2017), corruption costs the European economy 120 billion euros per year. The report discusses corruption and its consequences to the economy and society. Corruption hinders economic growth and has multiple effects on the economy and society. It also reduces the efficiency of the limited public resources as capital is moved away from effective activities. Transparency in the public sector reduce the possibilities for corruption. This will increase competitiveness, increase the collection of taxes, and strengthen the rule of law (EU-commission, 2017). Bribery and other forms of corruption is based on rational, calculated, and controlled decisions while other types of misconducts are more based on quick emotional reactions (Pieterse & Biermann, 2014). According to Niinimäki (2019), the criminal offense threshold is higher in business than in the public sector, which can also pose risks of corruption in municipal companies. An examination of bribery within a municipal limited company raises the question of whose trust the acceptance of bribery in those organizations violates. Like normally in business, municipal companies are not considered to have a similar principal whose trust would be violated by bribery (Nazarenko & Niinimäki, 2019).

Lambert-Mogiliansky (2015) describes the links between accountability, transparency, and corruption in her study. She suggests that without any signals of the official's behaviour, such as performance measurement, citizens cannot prevent the official from diverting money as the official is not accountable for the use of public resources. Piotrowski and Borry (2010) agree with this and state that if the policies, activities, and different performance measurements are transparent, suspicious behaviour is noticed more easily and the public officials are more likely to be held accountable for their activities.

### **2.3.2 From the private sector governance to public sector**

The public sector includes the state, municipalities, and other public service organizations. Public sector funding comes mainly from taxation. The size of the public sector is significant in the Finnish context. In 2014, the ratio of public expenditure to GDP in Finland was 58,7% of the Gross Domestic Product (GDP): the highest in the whole European Union (Eurostat, 2015).

Private sector may also be involved in providing services and projects for the public sector partly because of following the doctrine of New Public Management. A prime example of this are the public-private partnerships (PPP). PPPs are co-operative agreements between public and private sector organisations to

provide certain services, usually in the long-term. PPP is a hybrid solution that is intended to divide and manage the risks of projects and services between both sectors (Skelcher, 2005). The PPPs provide challenges to their governance as previously the governance was based on the hierarchy, bureaucracy, and specific regulation, and is now governed through different networks of interdependence, negotiation, and trust between actors of the public and private sectors (Shaoul, Stafford & Stapleton, 2012; Bevir, 2004 & Sørensen and Torfing, 2005).

According to Jordan (2014), the different processes and frameworks of corporate governance in public sector organisations have been studied in the last 25 years, but this research has mainly been done using quantitative methodologies. The implementation of corporate governance practices has been led by the countries of the British Commonwealth. So far studies have discussed and concluded that the private sector corporate governance models cannot be directly applied to the public sector as the public sector organisations are not structured for one model fits all approach (Jordan, 2014).

Public sector organisations may include for example state or municipally owned enterprises. According to Zhou et al. (2017), a feature of publicly owned enterprises is that the governments do not always act in the best interest of the people their task is to represent. A part of corporate governance is the agency theory. Its premise is that there is a situation where a person (principal) authorizes another person (agent) to act on behalf of the principal (Jensen & Heckling, 1976). Therefore, a principal-agent relationship is created between the two parties. Generally in the public sector, the government acts as the agent and the public as the principal. If the principal is less informed and gathers less information about the agent's actions, it is also less capable of knowing which of the agent's actions have influenced certain firm outcomes when compared to external factors that the agent cannot control such as luck (Jia, Huang & Zhang, 2019). According to Jia et al. (2019) while traditional corporate governance literature has focused on the regulation of the agents, recent research has also emphasized the importance of governance of principals. Public officials can also be seen as the principal to the managers (agent) in the publicly owned companies. In their study they show that if public officials are a part of high-quality government, the officials fulfil their role as principals of publicly owned companies to reduce the moral hazard risk of the agents in the companies.

Private sector corporate governance often focuses on the relationship between the board of the company and its shareholders. According to Dubnick (2007), private sector governance has a short-sighted view which emphasizes the importance of shareholders over other stakeholders. Public sector organisations on the other hand are accountable to multiple different stakeholders and thus might have conflicting corporate governance and accountability obligations to manage (Shaoul et al., 2012). Barrett (2002) agrees with Shaoul and states that public sector tends to have more explicit and strict value systems that accentuate notions of ethics and codes of conduct based on legislation. While in private listed



companies the members of the board are usually chosen by complimentary competency, in municipal companies the members might be chosen depending on the political party the members are in (Penttilä et al., 2015). This makes good corporate governance challenging in municipal companies, as politics may interfere with the process.

In private sector the regulations' purpose is also to make the organisation provide better financial information so that the shareholders can make better-informed decisions concerning their investments. This same idea has been also transferred to concern the public sector in many countries, which can be seen irrelevant in public context (Shaoul et al., 2012). According to Mulgan (2000), the private sector's focus on profitability is an efficient way to implement accountability. However, the width of different activities that the private sector managers are held accountable is significantly narrower than the ones which affect public managers and politicians. Thus, the structures of accountability in the public sector appear to be stricter than in the private sector (Mulgan, 2000).

Barrett (2002) identifies three main aspects of successful corporate governance in both public and private sectors:

- a clear identification, and articulation of, the definitions of responsibility;
- a real understanding of relationships between the organisation's stakeholders and those entrusted to manage its resources and deliver its outcomes; and
- support from management, particularly from the top of an organisation.

There are multiple factors affecting the governance of public entities. Figure 1 on page 26 illustrates the importance of inter-relationship between the elements of governance. These elements must be balanced as they are all connected to each other and are needed to achieve good governance.

FIGURE 1. Elements of governance of public sector entities. (Barrett, 2002)



Barrett (2002) continues to the six main principles that the public sector entities must undertake to achieve better governance. Three principles – leadership, integrity, and commitment – are related to the personal qualities of the people in the organisation. The next three principles – accountability, integration, and transparency – are results of proper policies, systems and strategies implemented in the organisation. Good public corporate governance involves integrating the principal aspects within a framework that is suited best for the goals and the operating environment of each agency (Barrett, 2002).

Smith, Mathur & Skelcher (2006) state that there are four specific elements of governance and accountability in the public sector. These are public access, internal governance, member conduct and external accountability.

Public access means the institutionalised practices that ensure openness and transparency. The aim of these institutions is to make public officials more responsive to the public (Shaoul et al., 2012). Shaoul et al. (2017) argue that in financial reporting it is not sufficient to only publish the information, as the way of the presentation and the location of the information affect the actual public accessibility. Transparency needs to meet elementary epistemic and ethical standards to be relevant (O’Neill, 2006). This refers to the requirement that the spread material must be accessible to relevant and right audiences.

Internal governance systems and structures are an important part of accountability. The private sector has emphasized the aims of improving the quality of reporting and changes in the operation of the Board. The quality of reporting is often increased by focusing on internal control systems and the interdependence of external auditors (Shaoul et al., 2012). Audit committees should be

instructed to supervise the preparation of the financial statements, inspecting the chosen accounting policies and practices, the internal control systems, and the work of internal and external auditors (Audit Commission, 2006).

Board members' conduct considers the ethical behaviour, acting for the public interest, and the diversity in the board of directors. Significant part of the accountability of the board members is recognizing potential conflicts of interest (Smith et al., 2006). The public officials and governors are expected to act in an ethical manner with integrity and probity (Shaoul et al., 2012).

External public accountability emphasizes reporting information that helps to assess past decisions and actions, and compliance with expenditure allocations by Parliament in addition to the normal decision-useful information required by the private sector (Shaoul et al., 2012). Shaoul et al. (2012) argue that external accountability should entail horizontal accountability and thus cover, amongst other things, the use and stewardship of resources; the quality of services, financial probity, and financial control over public funding. Public authorities using only private sector reporting standards may raise the question whether the information given is enough to deliver external public accountability (Shaoul et al., 2012). Shaoul et al. (2008) state that financial statements do not provide budget information routinely, which makes it more difficult to compare the expenditure of the organisations against the allocations of the public money. Even though reporting of financial information is vital in, for example, large scale projects, disaggregated non-financial information for individual large projects can also be considered critical if the assessment of service quality is possible (Shaoul et al., 2012).

## **3 AUDITING AND ACCOUNTABILITY OF FINNISH MUNICIPAL COMPANIES**

### **3.1 Background**

In Finland, municipalities and organisations of municipalities spend about EUR 44 billion a year on providing services to citizens. Half of this expenditure is covered by taxes, about a quarter by fees and sales revenue, and less than a fifth by state contributions, depending on the municipality. Some of the services to citizens may be provided by municipally owned companies. Finnish municipalities own over 2800 companies. These companies are at least 50% owned by the municipality. The companies have over 48 000 employees (Kuntaliitto, 2020).

On page 29 is a table of the municipal companies in Finland sorted by legal form. Most of the companies are regular limited liability companies. Municipalities also own over 1000 property and real estate companies. Nearly 60% of the companies operate in the real estate industry, 10% in energy supply and close to 10% in water and waste management (Wallin, 2019).

TABLE 2. Municipal companies by legal form in 2018. (Kuntaliitto, 2020)

Legal form	Staff number	Number of companies
Limited liability company	44658	1235
Foundation	2043	89
Joint-stock property company	1350	597
Non-profit association	281	6
Mutual Real Estate Company	82	530
Cooperative association	5	2
Housing association	4	373
Other	0	1
Deemed partnership	0	1
Other association	0	1
<b>Total</b>	<b>48423</b>	<b>2835</b>

In the municipal companies, decision-making power is exercised by the board of directors and the CEO. The most important body of a limited company is the annual general meeting, where the shareholders can affect the company affairs. The general meeting approves the financial statements and decides on the use of the profits. A municipal company has always a representative, who has a legitimate power of attorney, representing the municipality in the general meetings. If a municipal company has only one shareholder, the municipal representative must attend the general meeting for the meeting to be lawful. Usually, the decisions are unanimous in municipal companies as the municipality is often the only shareholder (Ruohonen et al., 2017).

The municipality can establish greater control and transparency in the limited liability companies through the corporate steering function of the municipality. Ownership steering means the different measures that the municipality can do using the owner's decision-making power to affect the subsidiaries or other parts under the municipality. These measures can be, for instance, changing the treaties, contracts, or the provisions in the articles of association (Kuntaliitto, 2018). The city council decides the principles of the ownership steering and the municipal government is responsible for the ownership steering of the municipality's functions. The municipal group management, which includes the municipal manager and the municipal government, is responsible for the implementation of the decisions and principles of the ownership steering in accordance with the decisions made by the city council.

The board of directors and the management of the company are important in the handling of everyday matters in the company. The board's responsibility is to organize the company's administration. The board has general judicial power, which means that if a certain matter is not the responsibility of the annual

general meeting or the CEO, it is the responsibility of the board of directors. Municipal companies can add supplementary demands for being a member of the board. This can be for example a requirement to be a resident of the municipality that owns the company (Ruohonen et al., 2017). The Local Government Act (2015) requires that the municipal companies must consider the expertise of the business and the duties of the composition of the board. The guidelines of good corporate governance have affected the forming of the board of directors in the last 10 years, especially in the subsidiaries that are socially significant (Ruohonen et al., 2017).

The CEO of the limited liability company is a voluntary body. However, usually municipal companies have a CEO, and in bigger companies, also a deputy managing director (Ruohonen et al., 2017). The responsibility of the CEO is to take care of day-to-day administration.

The board of directors of the company and the CEO have an obligation not to disclose information that may be harmful to the company. Violation of the obligation may result in criminal sanctions or liability of damages. This may make the management of the company hesitant to even discuss about the internal affairs of the company with the owners (Ruohonen et al., 2017). However, municipalities themselves have to obligation to improve the openness of their actions creating a contradictory situation.

This can cause problems for the transparency of publicly owned companies. According to the report Black Economy and Procurement (Harmaa talous ja Hankinnat in Finnish) by the Finnish Competition and Consumer Authority (2019), public sector companies are governed by private law, in which case the elimination of conflicts of interest rests with the organisation's own personnel and organizational measures. Eliminating conflicts of interest based on voluntary action by the organization makes it difficult to control, regulate and increase transparency of the use of public funds. There is a lack of transparency in the use of public funds through public company activities, as well as its control and regulation.

In the same report, the working group of the Finnish Competition and Consumer Authority stated that a report should be made on the transparency of public spending and its responsibilities. The report should:

- Assess the relationship of the Act on the Openness of Government Activities with municipal subsidiaries and associated companies that use public funds
- Identify ways, including legislative ones where appropriate, to prevent and expose conflicts of interest more effectively
- Assess the relationship of official liability regulation with subsidiaries and associated companies that use public funds
- Assess the adequacy of municipal internal audit powers.

The working group that prepared the report included experts from the Finnish Competition and Consumer Authority's cartel control and procurement control,

the Ministry of Employment and the Economy, Hansel, the Association of Finnish Municipalities, which produces joint procurement for public actors, and the Ministry of Finance and the Ministry of Justice.

According to Ruohonen et al (2017), the exclusion of municipal companies from the scope of the Act on the Openness of Government Activities can be justified with the fact that municipal companies often have records and documents that would be confidential even by the act on openness. However, when a municipal company submits relevant documents of its activity to the municipal group management, the documents fall within the scope of the act of openness.

The municipal control system consists of internal and external control. External control includes the evaluation of the local authority audit committee and the statutory audit. Internal control is part of the day-to-day management of the municipality.

### **3.2 Auditing and external control**

The auditing of municipal companies is divided between the statutory audit made by an official auditor and the auditing by the local authority audit committee. The statutory audit is focusing on the compliance audit of the company and does not take a stand on the expediency of the functions (Penttilä, Ruohonen, Uoti & Vahtera, 2015, p.138). According to the Auditing Act (2015), the statutory audit includes the company's accounting and financial statements of the financial year, the annual report, and the management audit.

The auditor must follow good auditing practice. The auditor must make his or her own assessment of the accuracy of the financial statements and the adequacy of the information presented in them. The auditor must also check that the financial statements and consolidated financial statements give a true and fair view of the municipality's financial responsibilities as stated in the Local Government Act. For example, contingent liabilities such as loan guarantees can pose a risk. In addition, the annual reports of the municipality can be challenging to certify as they include much non-numerical data (KPMG, 2008).

The task of the local authority audit committee is to ensure the coordination of the audit of the municipality and its subsidiaries. The municipal council chooses the auditor for the municipality. The auditor must be a certified public accountant (JHT-auditor). The auditor for the subsidiaries should be the same audit firm than for the municipality unless there is a justified reason to depart from the principle (Kuntaliitto, 2019). Even though the smallest companies are exempt from the audit, often the articles of association of the municipal companies demand an audit. The auditor also might have to assess if the municipality has lawfully performed its corporatisation obligation (Penttilä et al., 2015). The auditor must perform the duties formally and materially independent of outside influence.

The city council can set the objectives for the municipal companies in its yearly budget. The local authority audit committee focuses on assessing if the municipality and its subsidiaries have reached these set goals and objectives. Thus, the current municipal management model is highly based on controlling and assessing the goals (Penttilä et al., 2015). The committee prepares a yearly assessment report for the city council on how the subsidiaries have performed on their set objectives. This assessment must be also published in a public information network (Local Government Act, 2015). Objectives must be set for the municipal company, which must be in line with the company's purpose, so that the audit committee can carry out its own assessment of legality and expediency. The different aspects of municipal, limited liability company and tax law are combined in the assessment of performance of the municipal companies, on the one hand of the city council, and on the other hand of the auditor level (Penttilä et al., 2015).

Municipal financial control can be divided into internal control such as monitoring, and external control such as EU-control, authorities of the state and citizens. For instance, the citizens of the municipality have the right to make a municipal complaint. EU-control is established through the subsidies granted to the municipalities and their projects (KPMG, 2008).

### **3.3 Local authority audit committee**

The city council sets up a local authority audit committee to organise the audit of administration, finances, and assessment of the municipality. The audit committee is part of the external control of the municipality and its subsidiaries and thus performs a parliamentary supervising function (KPMG, 2008). The chairman and the vice chairman must be members of the city council. The members are elected at a council meeting in June for a four-year term unless the council decides on a shorter term. The audit committee acts as the link between the auditor and the municipality. According to the Local Government Act (2015), the political responsibility of the organising of the auditing lies with the audit committee. The audit committee may not restrict the auditor's role beyond the requirements of the Local Government Act. However, the audit committee may, if necessary, provide the auditor specific parts to be inspected which would not otherwise be audited as part of the statutory audit (KPMG, 2008).

Audit committees' tasks usually require decisions from the entire committee. Thus, the individual activities of the chairman, vice-chairman or member of the committee may only be the preparation of the affairs of the committee and shall be based on the decision of the whole audit committee. According to Kuntaliitto (2018), the audit committee can be divided into different divisions. These divisions are one way of preparing matters for the committee.

The amendments to the Local Government Act (410/2015) did not change the role of the local authority audit committee and were mostly just recording



already established practices to the act (Kuntaliitto, 2018). The only new duty was the supervision of reporting the liabilities to the council. The municipal officials and elected officials must report their liabilities such as important positions in private companies. The audit committee supervises this and may demand the official to make a new liability notification or supplement an existing notification.

According to the Local Government Act (410/2015 § 121), the duties of the local authority audit committee are:

- 1) conduct preparatory work on matters for the decision of the local council concerning audit of the administration and finances;
- 2) assess the extent to which the operating and financial targets set by the local council have been achieved in the municipality and the local authority corporation and whether or not the activities are arranged in a cost-effective and appropriate manner;
- 3) assess the extent to which the finances were balanced in the accounting period and the adequacy of the current financial plan if the municipality's balance sheet has an uncovered deficit;
- 4) ensure that the auditing of the municipality and its subsidiaries is coordinated;
- 5) oversee compliance with the obligation to declare private interests as laid down in section 84, and submit the declarations to the local council;
- 6) draw up proposals for the local executive concerning provisions in the administrative regulations covering the committee's tasks and for the auditing budget.

The audit committee must take care of coordinating the audit of the municipality and its subsidiaries. According to Kuntaliitto (2018), coordination means for example organizing the tendering of the municipal group's audit services regarding e.g., preparation of the call for tenders and the comparison of tenders and appointment of auditors to group entities. The audit committee must also give instructions to the auditor if necessary. The auditor must follow the instructions unless they are in contrast with the law. Then the audit committee must monitor the implementation of the audit through reports and other reports issued by the auditor (Kuntaliitto, 2018). The auditor must inform the audit committee of any encountered problems. The audit committee then must monitor the measures taken to solve the problems.

The audit committee must assess the realization of the financial balance during the financial year and the adequacy of the current financial plan and operational program if there is an uncovered deficit in the municipality's balance sheet. The assessment must be made based on the report submitted by the municipal government in connection with the annual report and any other information describing the financial position of the municipality (KPMG, 2008). The audit committee has also different preparatory tasks. These include preparation

of a draft decision on the selection of the auditor, preparation of a draft decision on approving the financial statements and the release from liability, giving relevant explanations for the reminders presented in the audit report, and obtaining statements from the municipal government (Kuntaliitto, 2018).

The committee has the right of access to information about confidential documents if it is necessary for the assessments (Local Government Act, 2015 § 124.1). However, this right is limited only for the documents possessed by the municipality and the committee cannot ask for the documents directly from the company. The right applies only to the committee and not its individual members.

The audit committee bases its evaluation on the annual report in which the local government reports on the realization of operational and financial objectives in the municipal group. The evaluation done by the audit committee is highly depended on the objectives set by the budget of the city council. According to KPMG (2008), If the objectives are set comprehensively, the basic task of the audit committee is to present its assessment of whether the objectives have been achieved. However, the setting of proper and comprehensive objectives can be incomplete in many municipalities. This is problematic, as the audit committee must focus the critique on the inadequacy of the objectives set by the council (KPMG, 2008). The resources available to the audit committee vary depending on the size of the municipality. The bigger municipalities may have an auditing office that assists the audit committee. The auditing office may acquire information, benchmark data, and research methods to aid the committee's work. Benchmarking to previous years and to other municipalities may help the evaluation to be more impactful. The resources should be aimed to support the improvement of the actions and the financial state of the municipality (KPMG, 2008).

The results of the audit committee's evaluation work are reported in the form of an evaluation report. The evaluation report is the audit board's view of how different parts of the municipality group have succeeded in carrying out the council's objectives (Kuntaliitto, 2018). In practice, evaluation reports vary from municipality to municipality in terms of both content and scope. In some municipalities, the auditor participates in the making of the evaluation report, which is problematic because the report should be represent the viewpoint of the elected representatives (KPMG, 2008). A good evaluation report is clear and useful to the city council, officials, and the citizens. According to the Local Government Act (Section 121.4), prior to the completion of the evaluation report, the audit committee may provide the city council with accounts that it deems necessary. These types of account may be for example observations of interim financial reports of the municipality. The audit committee may also report significant observations before publishing the evaluation report if it seems it necessary before the finishing of the yearly report (Kuntaliitto, 2018).

### 3.4 Internal control

Internal control is the part of the management and governance system that allows management to ensure that the organization operates as it wishes financially and effectively. Through internal control, the municipality receives information of the situation of the municipality and its subsidiaries. The local government and management of the municipality organises the internal control.

There are five main components of internal control: management and control practices, risk management, control measures, information and communication, and monitoring (KPMG, 2008). Management and control practices refers to the environment where the control functions and defines the style how people act, assess risks and changes, and measure objectives. Risk management refers to proper recognition of risks and their assessment. Control measures mean the operating principles and procedures that help to ensure that the activity is in accordance with the guidelines set for it. Proper information and communication aim to ensure the accuracy and timeliness of information. Finally, the monitoring is vital to upkeep and improve the system as the information from internal control directs the activities of the whole municipality. Therefore, all the factors mentioned above are essential in good internal control (KPMG, 2008).

The management of the municipality can also use internal audit as part of the internal control. The aims of the internal audit usually depend on the needs of the management. Internal audit can be related to the activities of both the auditor and the local government audit committee. Many bigger municipalities use private auditors to perform the internal audit (KPMG, 2008). However, internal audit cannot replace the statutory audit.

Internal control is an integral part of, among other things, the fight against corruption. For example, the links between public sector decision-makers, trustees and companies providing services and products are a risk factor in public procurements. However, only a small proportion of municipalities make use of internal audit. For example, in 2015, only 33% of municipalities with a population of 10,000-50,000 used internal control services (Finnish Competition and Consumer Authority, 2019). According to Antti Norkela, Head of Cartel Supervision at the Finnish Competition and Consumer Authority, the internal audit of municipalities should have the right to inspect subsidiaries and associated companies (Kaleva, 2019).

However, internal control and external control should be separated from each other. Internal control is mainly a tool of the group management while the external control has a more supervisory function.

### 3.5 Public procurements

Transparency of the public procurements of municipal companies is significantly decreased as the companies follow the Limited Liability Companies Act (2006) and are not bound by the Act on the Openness of Government Activities (1999). According to the directive 2014/24/EU of the European Parliament and of the Council of 26 February 2014 on public procurement and repealing Directive 2004/18/EC, member states must require the contracting authorities to implement appropriate measures to fight fraud, favouritism, and corruption and to effectively prevent and detect conflicts of interest in access rights contracts. States must also avoid distortions of competition and ensure the transparency of the procedure of the contracts, in addition to equal treatment of all candidates and tenderers. However, ensuring proper transparency of the public procurements can be challenging.

The Finnish Competition and Consumer Authority (2019) states that public procurements and activities in corporate form pose a challenge to combatting corruption and conflicts of interest in Finnish municipalities. Many Finnish municipalities do not have the resources or the power to carry out inspections to the municipal companies or their subsidiaries (FCCA, 2019). Even if the public procurements are done through municipal companies, they still must follow the Act on Public Procurement and Concession Contracts (2016), which requires the documents of the procurement to be partially public with only a few exceptions such as certain defence and security procurements. However, the requirement of publicity is significantly lesser than on the Act on the Openness of Government Activities. This means that for instance the contracts of the procurement are public to only those who are involved in the procurement process instead of the whole public (FCAA, 2019).

Inspecting public procurements has been an active subject in the media in recent years. The expediency, proper planning and the economic efficiency of the procurements are important to public governance. Fair competition and transparency are important for both the public organisation and the private contractors (Salminen, 2015).

Public procurements done by municipal companies pose a risk of corruption at different stages of the process. The risks include for instance favouring certain tenderers or relatives, avoiding competition, and approving additional bills out of budget for services or money in return. Government or municipal officials may have close relations with one of the companies of the possible tenderers (Peurala & Muttillainen, 2015; Salminen, 2015).

### 3.6 The right to receive information

A shareholder of a municipal company does not have any general continuous right of access to information about the company's affairs or documents. A shareholder has the public access to the financial statements, shareholders' register, and the articles of association. The municipality can conduct a more specific right to obtain information in the group policy but even then, it will not bind the company strictly (Ruohonen et al., 2017). According to the Limited Liability Companies Act (5:25, 2006), a shareholder has the right to present questions in the meeting of shareholders. Usually, the questions must be related to the subject of the meeting. The right to present questions does not give the right of access to the documents related to the matter. It is sufficient that the board of directors or the CEO answer the question. The board and the CEO have the right to inform shareholders about the internal affairs of the company if it is seen to be expedient. If they inform selectively only certain shareholders, they may violate the principle of equality of the Limited Liability Companies Act (1:7, 2006). Therefore, the information should not lead to unjustified advantage of certain shareholders (Ruohonen et al., 2017).

According to the Local Government Act (Section 124.1), the local authority audit committee has the right to receive information on matters that are kept secret if it deems them necessary for performing the assessment of the company. The audit committee must make a formal decision on the matter, and an individual member of the audit committee does not have the right to the confidential records. The right of access applies only to documents held by the municipality. If necessary, the municipality can use the owner's decision-making power to obtain the necessary documents from the subsidiaries. According to Ruohonen et al. (2017), the right to obtain information of the audit committee is wider than the normal elected officials but narrower than of the statutory auditor. The local authority audit committee cannot demand the information straight from the subsidiary as the auditor can. The audit committee also cannot publish any confidential information in its assessment report. The boundary between the confidential and non-confidential information may be blurred and thus the committee must be careful what information to publish. The audit committee should enquire the matter from the management of the municipal company (Ruohonen et al., 2017). The management of the company may also inform the audit committee about which documents are deemed to be confidential. The audit committee may include some of the information of the confidential documents in its assessment report if the information is written in a general way and does not reveal the confidential information.

The auditors' right to obtain information from the municipal companies is determined by the Auditing Act (2015). The auditor has the right of access to confidential documents and records if it deems it to be necessary in the auditing process. The individual auditor has the right of access to information, and the

auditee should assist the auditor in gathering information related to the audit (Kuntaliitto, 2018). The auditor is bound by an obligation to maintain secrecy.

## 4 DATA AND METHODOLOGY

### 4.1 Data

The data of the empirical part of the study consists of 10 semi-structured interviews of members of the local authority audit committee of different medium to large Finnish municipalities. Interviewing the audit committee members was chosen because they are among the rare few who have access to the confidential records of the municipality. The audit committee members were contacted through the public information found from the municipalities' official websites. The interviewees represented several different political parties.

With the audit committee members, discussions included the incorporation of municipal operations, how it has affected the audit of municipal companies, and what kind of challenges the members of the audit committee face in the audit of a municipal group. The municipalities of the interviewees had a population of at least 50 000 or more. The purpose of the size criteria was to ensure that the municipality owns possibly multiple companies. In total, there were interviewees from eight different municipalities. The interviews were conducted anonymously to ensure the interviewees could speak openly, as some of the themes might be more politically sensitive. Interviews was chosen as the method of conducting the research because, in general, it makes it easier to gather completely new information and approach less researched topics and phenomena (Hirsjärvi & Hurme, 2017).

The interviews were centred around three bigger themes: the role of the audit committee compared to statutory auditors, the adequacy of the powers and education of the local authority audit committee, and the past experiences and possible suggestions to improve the audit process. The themes were then divided into smaller sub questions that helped the flow of the interviews. These themes made it easy to conduct interviews without fully structured questionnaires. The

interviewees had the possibility to talk freely about the themes. If necessary, further clarifying follow-up questions were asked to delve deeper into the subjects that the interviewees brought up. The interviews lasted on average from 30 minutes to an hour. The interviews were transcribed in written form, from which the analysis was made.

## 4.2 Methodology

Qualitative research can be defined to be a process, where the researcher himself is the data-collection tool, a human instrument. In this way, the perspectives and interpretations related to the material develop as the research process progresses (Aaltola & Valli, 2015).

The interviews were conducted as semi-structured interviews in the form of focused (theme) interviews. Semi-structured interviews make it possible to get different types of answers even if the perspective of the interview remains the same (Eskola & Suoranta 1998; Hirsjärvi & Hurme 2017). Focused interviews (theme interviews) are one form of semi-structured interviews. In focused interviews the topics have been thought out and explained to the interviewees in advance, but the questions and their order may vary between interviews (Tuomi & Sarajärvi, 2018). According to Eskola & Suoranta (1998), the form of the focused interview is quite open, which is why the interviewee can speak freely and the collected material can be considered to correspond well to the interviewee's views. The themes of the focused interview also guarantee that the same topics have been discussed with each interviewee (Eskola & Suoranta, 1998). Thus, with these interviews it is possible to gather material with a more open framework.

According to Eskola & Suoranta (1998), interviews are the most used way to gather data for a qualitative study. The objective of an interview is to find out what the interviewee is thinking and their opinion on the matter. The interview is like a conversation which is started by the interviewer. Hirsjärvi & Hurme (1980) state that it is typical of an interview that it is 1) pre-planned; 2) initiated and directed by the interviewer; 3) the interviewer may need to motivate the interviewee and maintain the discussion; 4) the interviewer knows his / her role and the interviewee learns it; and finally, 5) the interviewee must trust that his or her reports will be treated confidentially. The advantage of interviews is the flexibility. The interviewer can correct possible misunderstandings and for example repeat the questions (Tuomi & Sarajärvi, 2018).

The place of the interview may also influence the interview, and the home of the interviewee is not always the best place (Eskola & Suoranta, 1998). However, during the making of this thesis we were in the middle of a global pandemic. Therefore, the interviews were conducted through video calls without actual face-to-face contact.

The research was carried out as a qualitative study using content analysis as a method of analysis. Qualitative research can be understood at its roughest as



a description of the material, but content analysis is also a very versatile method of analysis that can be used to capture several different styles of research (Eskola & Suoranta, 1998; Tuomi & Sarajärvi, 2018). However, when conducting qualitative research, one must be aware that qualitative research is never completely objective but is always modified by the researcher's own view (Tuomi & Sarajärvi 2018). According to Alasuutari (2011), qualitative material is characterized by its expressive richness and complexity. The interview material consists of documented situations, and for example in an interview situation, not only the answers are recorded, but also the literal form in which the interviewer presents his or her question (Alasuutari, 2011).

When conducting qualitative research, the data is often considerably narrower than, for example, the statistical data of quantitative research. In this case, the emphasis on the material and its use is quality and thoroughness, not quantity and volume (Eskola & Suoranta, 1998). In this thesis, content analysis was used to analyse the material. According to Alasuutari (2011), when analysing the material, it is especially important to pay attention only to what is relevant for the research questions and the frame of reference. The deepest purpose of content analysis is a thorough understanding of the phenomenon under study (Silvasti, 2014). Content analysis can be used to analyse the material systemically. Tuomi and Sarajärvi (2018) state that the actual interpretation of the results may be challenging with content analysis. Content analysis is textual analysis, and it used to find the meanings of the text.

With the help of content analysis, the focus was on including only the parts that are relevant to this study in the analysis. However, even though the interviewees represented several different municipalities and political parties, their opinions cannot be generalised to represent the audit committees of the country in general.

## **5 RESULTS AND ANALYSIS**

### **5.1 Background**

In the interviews I discussed three major themes with the members of the local authority audit committee: the role of the audit committee compared to statutory auditors and internal control, the adequacy of the powers, resources and education of the local authority audit committee, and the past experiences and possible suggestions to improve the audit process. In total I interviewed ten audit committee members. Five of them were either chairpersons or vice chairpersons of their audit committee. All the interviewees were also members of the city councils of the municipalities they represented.

### **5.2 Role of the audit committee compared to statutory auditors and internal control**

Most of the audit members saw the relationship between the committee and statutory auditors important and with synergistic benefits. Some of the interviewees saw the role of the committee to be like a supervisor of the activities of the auditor as the committee prepares the selection of the auditor. This selection process was thought to be one of the main responsibilities of the audit committee. The general consensus was that the auditors focus more on the technical work while the audit committee emphasizes the performance audit. This is in line with the audit committee's statutory duties as one of the tasks is to assess whether the operational and financial objectives set by the city council have been achieved in the municipality and the municipal group as discussed in section 3.1.3 of the thesis.

One committee member stated that various amendments to the Local Government Act have taken the role of the audit committee to be more focused on

the performance audit. He continued that making the evaluation report to the city council is more important than the audit committee adding supplementary comments to the auditor's report as only around three or four of the members of the audit committee were capable of understanding auditing in a technical manner.

Another interviewee stated that the role and the powers of the audit committee have changed in the recent years. He continued that many elected officials and local government officials of the municipality might still consider the role of the audit committee to be similar to the times when municipalities had elected officials as the auditors instead of professional auditors. He emphasized the importance of explaining the duties of the current audit committee to the local government officials and said that the independent role of the committee has even caused bitterness and jealousy in the municipal group management. On the other hand, one interviewee argued that the respect for the work of the audit committee has been increasing during the last decades. She said that as local authority audit committee is the only statutory committee in municipalities, it has a great role and influence on the lives of the citizens.

Other interviewee emphasized the importance of good relationships with all parties:

"In a way, personal relationships must also exist in such a way that we are not seen as a yapping dog, who is always constantly criticizing and doing things, but rather as part of that whole cooperation, we have our own role, but that we see personal relationships [as something that] all parties should have with each other " (I4)

In most municipalities the communication between the local authority audit committee and the auditors is based on meetings that are held a few times per year. However, in some municipalities the auditor was present in most of the meetings of the audit committee. In these municipalities the audit committee members were most content with the communication. In one municipality, the auditor acted as a secretary to the audit committee. Another interviewee emphasized the importance of trust between the audit committee and the statutory auditor:

"...if there is good enough trust between the two. And if the audit committee can outsource the work with confidence to the auditor and say, every six months to check it out their activities, that would be good. But if the auditor is not trusted very much and if you must constantly observe them yourself, then that responsibility is significant. I would say that the quality of that relationship is important, you must keep the relationship based on trust and the fact that the auditor also has a responsibility to report to the audit committee and that it does not only go the way that the audit committee asks for information and oversights and reports, but so that they complement each other." (I6)

Most audit committees had also communication with the internal audit units of the municipalities. The consensus was that they should be kept separate as the

internal audit is a tool and a function of the city management. The audit committee instead reports to the city council. However, cooperation between the internal audit and external audit was considered beneficial as their main goal is the same: the inspection of the city's finances and operations. One interviewee stated:

“...it is quite logical that the rather small resources that this inspection and evaluation function has, should not be wasted. So, then there is a bit of a discussion concerning what measures are taken and who does what and [how] we utilize the reporting made.” (I1)

In general, the interviewees saw the relationship between the local authority audit committee and auditors synergistic and important to the success of the external audit function. Audit committee's task was seen to focus more on the performance audit while the auditors conduct the technical work. The role of the audit committee seemed to be clear to the interviewees. This is important as according to Barrett (2002), a clear identification, and articulation of, the definition of responsibility is vital for good corporate governance. The communication with the internal audit was seen to be beneficial in the auditing of the municipality. The role of the audit committee can be seen as implementing horizontal accountability. Horizontal accountability focuses on accountability between the state's own institutions (DFID, 2006). One department can perform internal checks on other departments or agencies.

### **5.3 Adequacy of the powers, resources, and education of the audit committee**

The question of the adequacy of the powers of the audit committee raised several different issues. Most interviewees agreed that the powers were sufficient for the current duties regarding the municipality's own functions if the audit committee members can use them correctly. However, many made the point that municipally owned companies are a separate matter. Some of the interviewees thought that municipal companies should not even be under the responsibility of the audit committee as they are bound by the Limited Liability Companies Act. Some audit committee members also said that they have no rights or the ability to audit the municipal companies thoroughly. As the committee cannot demand the confidential documents straight from the subsidiaries, it needs to ask them from the ownership steering function of the municipality. Two interviewees stated that they do not even want to examine the performance and management of the municipal limited liability companies and that they should remain independent.

One interviewee stated that he could get more information about the municipal companies by googling them instead of asking from them. He continued that this leads to the problem that the audit committee members do not even know what questions to ask from the companies and therefore are unaware of

the financial activities of the companies. Another interviewee mentioned that sometimes the officials of the municipal limited liability companies do not provide the asked documents. According to her, the officials promise to get back to the matter, but they actually never do. She argued that sometimes it might be because the officials do not want to show poor performance results or bad statistics. Many of the interviewees also said that all the information they get of the companies is from the public financial statements. In all the municipalities the communication is initiated mostly by the audit committee in regularly scheduled meetings and hearings. In only two out of the eight municipalities the municipal companies contact the audit committee on their own initiative as the companies do not have a specific duty to report to the audit committee. In the hearings usually the CEO was the representative of the company and presented the overview of the situation of the company.

“ When talking about dealing with the municipality itself and the municipality’s own functions, we haven’t had problems with that. Yes, they [powers] are adequate. Instead, when talking about the activities of the municipal companies, if they expand, then the situation becomes different. And I can say that, in principle, there is not enough authority now so that many things come to the attention of the audit committee for example through a local newspaper or in some other way, but we do not have immediate access to information there.” (I4)

“ There is a big problem here. And we do not audit anything other than the functions within the municipal group. And now, of course, this incorporation to limited companies has led to the development that these big municipal companies or municipally owned companies or at least partially owned companies do not have internal audit. Not at all, at worst.” (I5)

The right to information from the municipality’s subsidiaries appears to be unclear as according to the Local Government Act (Section 124.1), the local authority audit committee has the right to receive information on matters that are kept secret if it deems them necessary for performing the assessment of the company. The audit committee must make a formal decision on the matter, and an individual member of the audit committee does not have the right to the confidential records. However, the right of access applies only to documents held by the municipality and not the subsidiaries. If necessary, the municipality can use the owner's decision-making power to obtain the necessary documents from the subsidiaries. As the municipalities transfers many of their activities and functions to limited liability companies by incorporation, it raises the question if the rights of the audit committee are sufficient regarding the inspection of these functions. A separate question to ponder in general is whether the local authority audit committee should even be responsible for inspecting the companies or if they should focus more on the municipalities’ own functions in the future.

Another interviewee, however, thought that even though it is harder to get the necessary information from the limited liability companies, it was still possible:

“ There is, of course, always a problem in this transfer of municipal functions to companies, so the problem is that it always comes with that veil of corporate secrecy. The curtain in front and that access to information is, of course, more difficult... it is therefore more difficult for citizens, it is more difficult for ordinary city councillors elected by the citizens, but of course it is true that of the citizens, the city councillors have an extended right to obtain information. However, it is true that they are restricted by this... or, if the information is confidential, it is not possible to obtain it. The audit committee has the advantage that the audit committee can obtain all information regardless of the secrecy obligation. So, if the whole audit committee wants some information, it is a pretty strong weapon, and in a way, it is sometimes necessary to remind officials that this right of access also exists.” (17)

The lack of resources given to the audit committees was raised as an issue in most represented municipalities. In six out of eight municipalities the resources either were considered too low or barely sufficient according to the interviewees. The resources that the audit committee receive is usually directly linked to the financial situation of the municipality and often the audit committee suffers from the saving programs of the public sector. One interviewee stated that the funding of the external audit function is rather small compared to the size of the city municipal group. In his municipality, the budget for the whole external audit function has been around 300 000 euros while the budget for the municipal group exceeded one billion euros. Another interviewee stated that the lack of resources affects their ability to inspect the municipal companies. He said that the optimal situation would be to have a chief of audit working for the audit committee, which would help the committee to inspect the municipal companies with more detail and care as currently they cannot focus on specific municipal companies.

One interviewee emphasized that the audit committee should always have certain amount of money reserved as ‘extra’ for unexpected situations such as sudden problems in inspecting a municipal company or a crime investigation. She said that their audit committee has had to fight for each euro and against the savings programs of the municipality.

However, the problems regarding the resources did not reflect on the education given to the audit committee members. Almost all the interviewees thought that the members of the audit committee get enough training for their duties especially in the beginning of the terms at least if they asked for it. The education was thought by many to be critical for the successful performance of the duties. According to an audit committee member from a bigger municipality, they try to also help to organise the education for the other smaller municipalities of the same region. He stated that the municipalities with bigger resources have a responsibility to help and give information to the municipalities with more limited resources. Many of the interviewees praised the national level training seminars and some hoped for more training between the audit committees of different municipalities.

The main difference between the inspection and auditing of the municipal limited liability companies, and municipality’s own functions and its own local

government enterprises (liikelaitos in Finnish) is that the municipal companies are more separated from the authority of the local authority audit committee. Before they might have had their own auditors but according to Kuntaliitto (2019), now the subsidiaries should have the same audit firm than the municipality itself. Many of the interviewees agreed that the auditing of the municipality's own functions is simple, and the information is easy to get compared with getting access to the information from the limited liability companies. When asked whether also the limited liability companies should be transferred more under the authority of the local authority audit committee, the answers varied significantly, and many thought it would be wise to consider that. However, some were doubtful if the competency of the elected officials were adequate for having greater responsibility of the audit process of the limited liability companies as the auditing of companies would require more substance knowledge than what the elected officials have. Elected officials come from different backgrounds and careers and many do not have any other education except for what is provided by the local authority audit committee.

The municipality can establish greater control and transparency also in the limited liability companies, if it wishes, through the corporate steering function of the municipality. The city council decides the principles of the ownership steering. One interviewee explained that it is possible for the municipality to exercise the right of the owner in the municipality and that in his municipality the council has increased the openness of the information of the municipal limited liability companies to the council. In practice, if the municipality wants to increase transparency of the companies, it is possible through the ownership steering even without changing the Act on the Openness of Government Activities or the Local Government Act. Therefore, the municipalities have the ability if they deem it necessary even though it requires doing it through the corporate governance and ownership steering functions.

Overall, the interviewed audit committee members saw that the resources given to the audit committees is lacking. However, the education for the audit committee members was seen to be adequate although some were worried about the access to education in the smaller municipalities. The interviewees considered the powers of the audit committee to be sufficient for the current duties. However, some saw problems with the powers when it comes to auditing the municipal limited liability companies. Most information the audit committee members got of the companies was from the official financial statements. However, even though reporting of financial information is vital, disaggregated non-financial information can also be considered critical (Shaoul et al., 2012). If the public authorities and companies use only private sector reporting standards and thus only financial information, it may raise the question whether the information given is enough to deliver external public accountability (Shaoul et al., 2012). In addition, in financial reporting it is not sufficient to only publish the information, as the way of the presentation and the location of the information affect the actual public accessibility (Shaoul et al., 2017). If the audit committee

members must search for the information in newspapers, the way of the presentation of the information does not seem to be optimal.

## 5.4 Problematic areas and experiences

The interviewees observed some common problems in the municipalities and municipal companies. One of the most common problem was people with self-interest in different positions in the municipality or the municipal limited liability companies. In one municipality, the CEO of a municipal energy company had hired a relative to work for the company and the CEO tried to hide it from the public. The same municipality had internal problems with other municipal companies too. These problems led to the increasing of costs by tens of millions of euros. In another municipality, the city had a project and used a private consulting company to aid with the planning of the project. However, one of the managers representing the municipality was also a member of the board of directors in the consulting company. One interviewee was concerned about double roles inside the municipality:

*"...when discussing the group side and the municipal companies' side, then... We find it a bit problematic that the leading city officials may be in key positions in these city-owned and co-owned companies as well, and then when on behalf of the city, bless the decisions that the companies themselves have made here on the one hand, and for this we have tried to seek the advice of lawyers and experts on this matter, and I know that there is a slightly different practice in different cities and such an overlapping organising, and the city gets either with or without merit, but in any case bad publicity and bad reputation and these people also... find themselves in an unreasonable situation where they have to defend their own behaviour from two sides" (I4)*

In one municipality the external audit used to be organised in a way in which the financial manager of the municipality was also the manager of the external audit function. The interviewee stated that the situation was corrupt as the target of the audit was a manager in the external audit organisation at the same time. The situation was changed and now the chairperson of the audit committee acts as the supervisor of the municipality's own auditor in public administration (*kaupunginreviisori* in Finnish).

Another interviewee claimed that as it is hard to ask the right questions from the municipal companies, it also means he does not know what is happening inside the companies:

*"...the fact is that if this activity is hardly monitored or viewed at the group level through any collective... through a collective group, like it is the case in ours and in many municipalities, that the local government officials who oversee the municipal companies have an expert role in these companies and sits pretty much at essentially*



all board meetings in larger companies. And so, it remains at his/her discretion quite a bit if there were any grievances or not. I also know that for example an official in charge of the municipal company or the director of the business area does not primarily inspect if the company operates [morally] correctly, but rather monitors the public interest of the owner and thereby directs the decision-making process in the board." (I5)

He continued that questionable situations in the municipal group might emerge from for example sponsorships. In his municipality, a chairperson in a municipal energy company was also an owner in the local sports team. The energy company was the main sponsor of the sports team which raised questions of self-interest of the person. He claimed that if for example an officeholder of the municipality could go through the general ledger of the companies, it could prevent malpractices.

Another interviewee agreed that especially in the sports industry officials have abused the money of the municipal companies to entertain guests. He stated that even though Finland is said to be a country with low corruption, the municipalities have problems with it. For instance, in his municipality the former municipal manager had been sentenced to prison for accepting bribes and another politician, former member of parliament, is being under prosecution.

Not all the interviewees had heard of grievances or other questionable actions in the municipal group at least in the recent past. Many thought that internal audit function has managed to prevent malpractices. However, problems with double roles or self-interest cases were the most common problems. Therefore, municipalities should pay attention to possible cases of self-interest as significant part of the accountability in public sector is in recognizing potential conflicts of interest (Smith et al., 2006).

In addition, an important aspect of good corporate governance is conformance (Tricker, 1994). Conformance consists of two main elements, firstly monitoring and supervising performance of the executives, and secondly maintaining accountability to those who have the right to expect feedback. Hence to implement the first element to municipal companies, municipalities should focus on monitoring the actions of the companies to prevent possible malpractices better, as the criminal offense threshold is higher in business than in the public sector, which can also pose risks of corruption in municipal companies (Niinimäki, 2019). Without supervising the performance of the officials of the municipal companies, citizens cannot prevent the officials from diverting money as the officials are not accountable for the use of public resources (Lambert-Mogiliansky, 2015). To enforce the second element of conformance, the municipalities should clarify whose trust the acceptance of malpractices in municipal companies violates, as municipal companies are not considered to have a certain principal whose trust would be violated by, for example, bribery (Nazarenko & Niinimäki, 2019). This way the municipal companies can maintain better accountability of their activities.

## 5.5 Improvement suggestions of the audit process

The interviewees had different suggestions regarding how to improve the audit process. Many thought that the transition to remote work during the pandemic has been a welcome addition into the work methods of the local authority audit committee. For example, one interviewee said that people have paid more attention to the meetings of the audit committee and that they have stayed present the whole duration of the meetings. Therefore, the need for better electronic materials in for instance training of the audit committee members was seen to be important. Information security was also mentioned as vital in the audit process:

*“ These electronic issues are one, which is at least what is the expertise and technology available to the audit committee in how we can utilise the electronic tools. I have liked the remote work and the remote meetings so in a certain way the improving processes streamlines the work. And they need to be tools that are so easy to use so that all members of the audit committee can use them. In other words, this is a very practical matter, and it would also make it possible, in a certain way, to gain access to even more confidential information and non-public material. Therefore, information security is a one absolutely critical issue that needs to be addressed in the coming years.” (I1)*

Two interviewees argued that the city councils do not understand the value and importance of the evaluation report made by the audit committee. The audit committee presents the results of the inspections to the city council yearly in the form of an evaluation report. The evaluation report is the audit board's view of how different parts of the municipality group have succeeded in carrying out the council's objectives (Kuntaliitto, 2018). The interviewees called for better use of the evaluation report:

*“...the city council still do not know how to use the evaluation report, for example, as a management tool fully and the fact that it should be the understanding of every person liable about what the evaluation report... what it means. And we have clarified it in such a way that we did it already the year before last when the evaluation report was submitted to the council, and back then it was usually mostly just that it is generally known and then that it must be approved by the council... We demanded in the draft decision from the council that the city government must give us the answers in a month to those questions that have been highlighted in the evaluation report. So, in a way, the city government was made more responsible that they require the branches of administration to provide answers to the issues to which the audit committee has drawn attention, conclusions, and opinions in the evaluation report.” (I8)*

*“... those assessments of the audit committee should be brought up in such a way that the city council then somehow understands what it means that if the audit committee makes observations and recommendations... it specifically means that a decision of the council has not been complied with as intended by the council and thus the council should then act thereafter.” (I9)*

However, both interviewees thought that the city councils of their municipalities are valuing the evaluation report more after being educated about the importance of the report and its applications. The other interviewee also hoped that not only the city council and management, but citizens too would also be informed about the results of the evaluation report. She was also concerned about smaller municipalities and their resources that are available when preparing the evaluation report.

Other suggestions included for example that the audit committee should be more involved or at least conscious about the planning of decisions of the city council. One interviewee suggested that the audit committee should focus more on anticipating possible problems and to make preventive measures as it is often cheaper to proactively prevent “accidents” than to just react to them. This applies to municipally owned companies as well. One way to implement preventive measures could be to instruct the audit committees to supervise the preparation of the financial statements, to inspect the chosen accounting policies and practices, the internal control systems, and the work of internal and external auditors (Audit Commission, 2006).

In general, most interviewees were content with the audit process and thought it is well established and without major problems. Many of the suggestions instead focused on the digitalization of the work methods.

## **5.6 Impact of politics on the boards of municipal companies and audit committee**

Almost all the interviewees thought that party politics have not interfered significantly with the actions of the local authority audit committee. The audit committee members, who have also been part of other committees of the municipality, stated that local authority audit committee has been the most neutral and least effected by politics of the different committees. One interviewee said that he was surprised how little the party politics was discussed in the audit committee when he started and later stated:

“...We do not want to form another small city council of ourselves because we do not have a roster for it and if we do, it means we will give up our own authority to it immediately. After that, we have two city councils in the city, one that is real and decides and the other that imagines itself to be a city council, so people have that image in their minds pretty much, you don’t want that.” (I4)

One interviewee also stated that if the chairperson of the audit committee is not strict enough, the conversations might shift into politics. He mentioned that even though there is no audience present in the meetings of the audit committee, there

are many influential members of the city council, which can lead to the temptation to try to influence others. Another interviewee, who acted as the chairperson of the audit committee, stated that new members of the audit committee might have derailed the conversation into party politics in the beginning but as the chairperson she has made clear that the audit committee should remain neutral from party politics.

One interviewee stated that in their municipality, members of one party tried to focus on their own agenda and suspicions against the municipality management using the audit committee. However, it had not yet affected the main decisions of the audit committee.

Some of the interviewees worried about the competency of the board members of the municipal limited liability companies. In Finland, the political parties nominate the members to the boards of the municipal companies depending on the relative strength of the parties and the success in the elections. Many thought that the positions in the companies' board of directors are assigned to elected officials by the parties as election promises. Therefore, many argued that the selected candidates are not always the most competent choices.

One interviewee thought that the political system does not always offer the best candidates:

*“Well, of course, it then limits the people and know-how that is available in municipal companies. And then we will have a question that when you are named in sort of with a political background, so is he/she somehow automatically a more knowledgeable person than someone else. I'm going to give you an example, a person who served for a long time as the environmental director of company Z and then when he was appointed to the board of the energy company after that, was he somehow less of an energy professional when he had a doctorate in that field and a career in company Z's environmental management and corporate management and so, but when he was appointed politically, did the know-how disappear into something? That is, in a way, there are true people with many different levels of expertise who are nominated through the political process.” (I1)*

He continued that the municipal companies should have certain people with special competence as experts in the board depending on what the business needs. And then others who know the political system and the needs of the municipality. He also said that the municipal companies have a hard time attracting experts to the boards as the salary level is significantly lower in the publicly owned municipal companies in comparison to the private limited liability companies.

One interviewee, who represented a smaller party, argued that the boards of the municipal companies are getting smaller because of increasing demands of competence and therefore the smaller parties cannot get their candidates into the boards of the companies. Another interviewee wanted to emphasize that business knowledge is not the only important skill needed in the board of directors and brought forward the importance of labour relations as an example.

Most of the interviewees thus argued that party politics did not pose an obstacle to the actions of the local authority audit committee. However, many

thought that the candidates chosen to the boards of the municipal companies are not always the best options as they are often chosen politically instead of focusing on the competence. This is contrary to private listed companies in which the members of the board are usually chosen by complimentary competency. In municipal companies the members are in fact often chosen depending on the political party the members are in (Penttilä et al., 2015). This makes good corporate governance challenging in municipal companies, as politics may interfere with the process.

## 5.7 Increased publicity or not?

The audit committee members had varying opinions on whether the Act on the Openness of Government Activities should be extended to also municipally owned limited liability companies. Two of the ten interviewees did not want to extend it and thought the current system is sufficient. Eight either agreed that the law should concern the municipal companies too or at least thought it would be a good idea to discuss about and be implemented in some level and at least in some type of municipal companies.

One interviewee argued that too much openness would endanger the competition neutrality of the municipal companies. He said that if the companies are competing against private companies in the markets, the openness might affect their competitive abilities. He also argued that if the municipal companies are competing in the markets, there should always be the chance for them to go bankrupt. Instead, he suggested that the municipalities should carefully plan which of their functions should be incorporated and which remain as public utility companies, as the former are part of the municipality and therefore under the authority of the local authority audit committee. According to him, the solution for the problem in transparency could be solved with each municipality updating their ownership steering and using the owner's decision-making power to implement specific guidelines for the companies. He also raised the problem of suppliers possibly charging too much from the municipal companies because of the confidential company secrets:

“...However, there [in municipal companies] is a turnover of hundreds of millions every year, so if they are really widely publicized, we will be in a situation where we are charged too much... so we are giving in a way, strategic information that costs that company more in tendering for contracts... and if they are very widely public, then we will kind of suffer through this as well” (I1)

Another interviewee thought that even though it is a matter of taxpayer's money, taxpayers do not have the substance competence, which requires more advanced business knowledge to understand the financials of the municipal limited liability companies. Her view was that there are elected officials and officeholders in

the board of directors of the municipal companies and that it is enough to ensure that the interests of the citizens are considered.

The other interviewees thought that it would be a good idea to discuss extending the Act on the Openness of Government Activities to at least certain type of municipal companies as the municipalities and thus taxpayers have the ownership in the companies. Many interviewees agreed that municipal companies, which offer products or services exclusively to the municipality, should have greater transparency:

“ if you think about, for example, of those companies that do 100% of their business... sell their services only to the city... of them, I do think that the principle of publicity would be the easiest to implement. Then it is another matter, if there is something else - if we are 50% or whatever - there will be certain types of problems, but like a company that is 100% serving the city, I do think it should certainly be covered by the Act on the Openness of Government Activities.” (I2)

“ In this case, the municipality has the power to extend it through its own corporate governance and rules... So, it is true that they, as the owner, can decide how far that matter will be taken forward. And I think that not all companies work by the same rules. You would have to look at it at the municipal level even. And then there can be companies like... and there are companies that are smaller that have little operational activity. I will take an example, like a parking company. We have company in which the city owns a parking company that has four to five hundred parking spaces. I do not know what inspection needs to be done there or if it is necessary to do as thoroughly as to a municipal energy company. So certainly not needed [increased publicity] to them, but somehow it [Act on the Openness of Government Activities] should be extended” (I5)

One interviewee suggested that we should have a nationwide discussion and consult experts on whether more publicity in municipal companies would be beneficial to the society and citizens. Another interviewee suggested Finland should follow Sweden’s example in applying the Act on the Openness of Government Activities to municipally owned companies. In Sweden, public access to general documents has been extended to any municipal business in which the municipality or county council has dominant position. Therefore, in Sweden the publicity act concerns also the municipal limited liability companies if the municipality exercises decision-making power in them.

To conclude, most of the interviewed audit committee members thought that more transparency and openness in the municipal limited liability companies would be welcome. Transparency can be considered public value and a norm that works against corruption and thus a vital part of effective governance (Ball, 2009). In addition, a feature of publicly owned enterprises is that the government do not always act in the best interest of the people their task is to represent (Zhou et al., 2017). Increased openness of the publicly owned enterprises thus may help monitor the government’s actions in the companies. If the policies and activities are transparent, suspicious behaviour is noticed more easily and

the public officials are more likely to be held accountable for their activities (Piotrowski & Borry, 2010). However, some of the interviewees raised questions if too much openness can be detrimental to the business of the municipal companies as many of them compete in the markets. Therefore, many agreed that a discussion of which type of companies should have more openness and in which way it would be beneficial to the society is welcomed and necessary.

## 6 CONCLUSION

### 6.1 Conclusions of the thesis

This Master's thesis studied the transparency and accountability of Finnish municipal sector and specifically municipal limited liability companies. The purpose of the thesis was to study how the accountability of the municipal companies is organised and to answer the main research questions about the role of the local authority audit committee and the challenges they face in the auditing of the municipal companies. The thesis also examined the effects of politics on the work of audit committees and the boards of municipal companies.

To achieve this goal, I studied the reasons behind incorporation of municipal functions and reviewed the key academic literature discussing the theoretical basis of corporate governance in the public sector context. Reasons for incorporating include promoting competition, improving efficiency and comparability in addition to securing market-based pricing to ensure competition neutrality. When the municipality is competing in the markets, it must choose forms of activity where the competition neutrality is secured and where it does not have an advantage compared to the private competitors. Therefore, the municipality must assign these activities to a limited liability company, cooperative, association or foundation.

The empirical part of the thesis was conducted by interviewing members of the local authority audit committee. The aim of the interviews was to find out what challenges the members of the local authority audit committee face in the audit of the municipal companies and how do the members see their role in the governance of municipalities and municipal companies. The audit committee members are among the rare few who have access to the records of the municipal companies.

The interviewed audit committee members saw the relationship between the local authority audit committee and auditors synergistic and important to the



success of the external audit function. Audit committee's task was seen to focus more on the performance audit while the statutory external auditors conduct the technical work. The communication with the internal audit was seen to be beneficial in the auditing of the municipality.

The interviewees saw the powers of the audit committee sufficient for the current duties. However, some saw problems with the powers when it comes to auditing the municipal limited liability companies. Many interviewees stated that the information they get from the municipal companies are from newspapers and public income statements. It seemed to be unclear to the interviewees if the audit committee members could even get the confidential documents from the companies as the companies are separate and independent organisational entities. This raises a separate question for general consideration: should the local authority audit committee even be responsible for inspecting the companies or if they should focus more on the municipalities' own functions such as the public utility companies in the future?

The most common problems the audit committee members had encountered were people with self-interest in different positions in the municipality or the municipal limited liability companies. For example, double roles in municipal companies and the municipal group were seen to be problematic in many municipalities. The double roles were argued to be a form of corruption and had even led to increased costs in some of the municipalities. However, most interviewees were content with the audit process itself and thought it is well established and without major problems, even though some hoped for more proactive measures in the audit process. The education for the audit committee members was seen to be adequate although some were worried about the access to education in the smaller municipalities.

The sub-research question of the thesis addressed the role of politics in the activities of the audit committee and the board of municipal companies. The interviewees claimed that party politics did not hinder the actions of the local authority audit committee significantly. However, many argued that the candidates chosen to the boards of the municipal companies are not always the best options as they are often chosen politically instead of focusing on the competence of the candidates.

Most of the interviewed audit committee members thought that more publicity and openness in the municipal limited liability companies would be welcome. However, some of the interviewees raised questions if too much openness can be detrimental to the business of the municipal companies as many of them compete in the markets. Therefore, many agreed that a discussion of which type of companies should have more openness and in which way it would be beneficial to the society is welcomed and necessary.

Therefore, the interviewed audit committee members agreed that more openness is beneficial if it does not have a significant negative impact on municipal companies. However, there are different ways to increase openness of the municipal activities. One option would be to extend the scope of the Act on the

Openness of Government Activities to municipal limited liability companies. This is the case in Sweden. Another option could be to emphasize and educate the use of ownership steering in the municipal groups. This way municipalities could increase openness locally by setting principles of publicity using the owner's decision-making power. This is possible even with the current legislation.

## **6.2 Research limitations and possible further research**

The data of the research consisted of 10 semi-structured theme interviews of the members of the local authority audit committee. Even though the interviewees represented multiple different political parties and municipalities, the interviews cannot be generalised to represent the opinions of the audit committees of the country in general. In addition, the municipalities of the interviewees had a population of at least 50 000, which means that audit committee members from smaller municipalities were not interviewed in this thesis. The opinions of the interviewees thus reflected challenges from the perspective of larger municipalities and their audit committees. Also, even though the goal of the analysis and conducting the interviews is to be as objective as possible, the author of the study is always interpreting the results and they are modified by the researcher's own view (Tuomi & Sarajarvi, 2018).

However, the aim of the thesis was not to generalize the results, but to increase understanding of the challenges faced by the various audit committees in the audits of municipal companies. Reflecting on this goal, the interviews brought more understanding on what challenges the audit committees may face in the audit process, and a variety of topics for social debate, such as different options to ensure publicity and openness to prevent malpractices in publicly owned companies.

Therefore, further research could study the effects of extending the scope of the Act on the Openness of Government Activities to the municipal limited liability companies and their competitiveness in the markets. The research could also compare the differences between partially applying more publicity to the companies and fully applying the act on them. Also, while this thesis focused on audit committees of bigger municipalities, future research could study the challenges that the audit committees of smaller municipalities face in auditing of municipal companies and group. The same subject area could also be studied with a quantitative method using, for example, an extensive survey for members of local authority audit committees. This way the study could include larger sample of municipalities and political backgrounds of the interviewees, even though the depth of the answers of individuals would not be as wide as in personal interviews. Another possible research topic could be the future role and proficiency of the local authority audit committee in auditing the municipal companies and

the municipality group if the trend of incorporating the activities of municipal functions to limited liability companies continue.

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## APPENDIX 1

### Structure of the semi-structured interviews (translated from Finnish)

Theme: The challenges the members of the audit committee face in the audit and inspection of a municipal group.

#### The role of the audit committee compared to statutory auditors and internal control

- How do you see the role of the local authority audit committee in relation to auditors?
  - o Increasing or decreasing responsibility?
- How do you communicate with the auditors?
  - o Do the auditors communicate on their own initiative with the audit committee?
- How does communication with the municipal internal audit work?

#### The adequacy of municipal internal audit powers and education

- Only a limited number of persons can access the operations of municipal companies. Do you think that you get information about municipal companies sufficiently enough as a member of the audit committee?
  - o Do municipal companies communicate on their own initiative to the audit committee?
  - o How does communication with the CEO and the board work?
- Do you think that the powers of the Audit Board are sufficient to carry out its tasks?
- Do you think that the resources allocated to the Audit Board are sufficient to carry out its tasks?
- Do the members of the audit committee receive enough training to perform their duties?
- How does an audit of municipal companies differ from an audit of other parts of a municipal group? E.g., Local government enterprise
- Should municipal companies be transferred more under the authority of the audit committee?

#### Past experiences and possible improvements of the audit process

- Have you noticed any ambiguities regarding the municipal companies or the municipal group? By this I mean, for example, unclear expenses or self-interest.
- Do you see that party politics has affected the work of the audit committee?

- Do you see that a political party is of great importance as a member of the board of a municipal company?
- How could the inspection or the audit process be improved?
  - o Increasing / decreasing the role of the Audit Board?
- Opinion on extending the Act on the Openness of Government Activities to municipal companies?
- Additional comments?