



UNIVERSITY OF ALGARVE  
FACULTY OF ECONOMICS

**CORPORATE GOVERNANCE IN MUNICIPALITY-OWNED  
ENTERPRISES: A CASE STUDY**

CARLA JIMENA CARDOSO

Dissertation  
Master in Corporate Finance

Work made under the supervision of Professor Fernando Félix Cardoso

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## **Work Authorship Declaration**

I declare to be the author of this work, which is unique and unprecedented. Authors and works consulted are properly cited in text and are in the list of references included.

Carla Jimena Cardoso



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## RESUMO

Os problemas de *governance* são cada vez mais frequentes. São numerosos os escândalos que envolvem gestores de empresas influentes, a falta de transparência na publicação de relatórios empresariais ou os indícios de promiscuidade entre entidades públicas e privadas. Estes acontecimentos intensificaram o interesse de estudar o tema numa perspetiva empresarial municipal.

O *corporate governance* é uma temática que abrange a forma como as empresas são geridas, o nível de confiança nos relatórios publicados e engloba também a relação da empresa com os seus *stakeholders*. O conceito é estudado desde há muitos anos, por diferentes investigadores, com o objetivo geral de conseguir determinar o papel do *corporate governance*.

Os *stakeholders* representam todos os intervenientes que afetam e são afetados pela empresa, estando incluídos neste termo entidades com interesses diferentes como, por exemplo, os fornecedores, colaboradores, clientes e população em geral.

Alguns teóricos defendem que o *corporate governance* é a solução para que os investidores garantam o retorno do capital investido. Outros definem o conceito como sendo um sistema que regula a administração das empresas. Opiniões diferentes sobre o conceito espelham a diversidade do que se entende por *corporate governance*.

Numa perspetiva empírica, existem diversos estudos que pretendem medir o impacto do *corporate governance*, alguns focados na *performance*.

A avaliação das políticas de *governance* praticadas utiliza, normalmente, as seguintes dimensões: (1) o conselho de administração, (2) a estrutura de capital, (3) a relação com os *stakeholders* da empresa, (4) transparência e a *accountability* e por último (4) plano legal e de regulamentação.

O âmbito das diferentes dimensões inclui:

- i. No que diz respeito ao Conselho de Administração:
  - a. Revisão e controlo da estratégia da empresa;

- b. Promoção da transparência e da ética dentro da empresa;
  - c. Inclusão ou não de membros independentes;
  - d. Estabelecimento de objetivos;
  - e. Controlo da eficiência do *corporate governance*.
- ii. No que diz respeito à estrutura de capital:
  - a. Igualdade entre os acionistas;
  - b. Nível de dispersão do capital;
  - c. Promoção do bom funcionamento da estrutura;
  - d. Atenuar os “conflitos de agência”.
- iii. No que diz respeito às relações com os *stakeholders*:
  - a. Respeitar os direitos dos *stakeholders*;
  - b. Reconhecer a interdependência dos interesses dos *stakeholders* na empresa;
  - c. Incluir a participação dos colaboradores na estratégia;
  - d. Comunicar atividades ilegais ou imorais.
- iv. Em relação à transparência e *accountability*:
  - a. Publicar relatório de contas com informação fiável;
  - b. Promover a fiabilidade da auditoria externa para confirmar a informação publicada;
  - c. Publicar possíveis riscos que possam afetar a empresa;
  - d. Revelar as práticas de *corporate governance* implementadas na empresa;
  - e. Revelar as políticas de remuneração aplicadas aos órgãos sociais.
- v. No que diz respeito ao plano legal e de regulamentação:
  - a. Assegurar a regulamentação da atividade das empresas europeias;
  - b. Definir os elementos que devem constar nos estatutos da empresa.

A definição das vertentes de cada uma das dimensões permite a correta avaliação das empresas, relativamente às práticas de *corporate governance* implementadas.

O objeto do presente estudo é, no entanto, estudar a *governance* em empresas municipais.

O conceito de *corporate governance* aplicado à realidade municipal não tem sido objeto de muitos estudos. Embora, a OECD (2011) afirme que o setor público pode beneficiar dos instrumentos aplicados no setor privado, os dois sistemas assumem-se como diferentes. De acordo com a Lei n.º 50/2012 de 31 de agosto, as empresas municipais ou empresas locais, têm como objeto a exploração de atividades de interesse geral ou a promoção do desenvolvimento regional e têm como objetivo garantir uma melhor qualidade de vida aos residentes e alcançar a autossustentabilidade.

A diversidade de interesses, entre os vários agentes, geram diferenças entre o *corporate governance* no setor público e no setor privado. Torna-se, por isso, necessário adaptar as responsabilidades e os indicadores das dimensões anteriormente descritos, à realidade das empresas municipais.

Não são conhecidas metodologias de abordagem deste tema em empresas municipais.

A relevância deste tema é, no entanto, relevante. As empresas municipais cumprem objetivos muito importantes e, no contexto empresarial do Algarve, são das empresas mais significativas, não só pelas atividades que desenvolvem mas também se as analisarmos pelos critérios ligados à sua dimensão em número de trabalhadores e em ativos.

O objeto deste trabalho, ao procurar uma relação entre o *corporate governance* e *performance*, pretende responder às seguintes questões:

- a) Como pode ser medido o *corporate governance* em empresas municipais?
- e
- b) Como podem as diferenças no *corporate governance* afetar a *performance* das empresas municipais?

Para responder a estas questões, adotaram-se as seguintes opções:

- (i) O estudo deveria centrar-se em empresas que atuassem nos mesmos setores de atividade, prestassem serviços similares, tivessem dimensões semelhantes mas com diferentes configurações a nível da estrutura capital;
- (ii) O estudo deveria avaliar as diferenças existentes ao nível das políticas de *corporate governance* praticadas nas empresas municipais escolhidas;

- (iii) Deveria ser feita uma análise à *performance* dessas empresas e analisar os seus resultados tendo em conta a natureza do modelo de *governance* seguido.

No que diz respeito ao primeiro item, optou-se por estudar duas empresas municipais que se dedicam ao abastecimento de água e saneamento de águas residuais domésticas em locais distintos do Algarve, com dimensões idênticas mas uma é totalmente detida pelo Município e outra que, sendo detida maioritariamente pelo Município no qual tem sede, tem uma forte componente de capital privado.

No que diz respeito ao segundo item, foi utilizada uma adaptação do modelo desenvolvido por Kaufmann *et al.* (2010).

Finalmente, em relação ao terceiro item, procedeu-se a uma análise comparativa de indicadores chave de *performance* segundo as metodologias seguidas por Marr (2012) e por Neves (2012).

A aplicação desta metodologia permitir compreender melhor a problemática em estudo e através da comparação dos seus resultados, extraíra conclusões sobre as questões supramencionadas.

De acordo com a análise efetuada, concluímos que a empresa com capital privado apresenta melhores indicadores de *governance* do que a que é detida exclusivamente por capitais públicos.

A análise comparativa dos indicadores chave de *performance* evidencia que a empresa com melhores resultados é, novamente, a empresa com capital privado.

As conclusões alcançadas não devem ser generalizadas. Os resultados obtidos, refletem que melhores políticas de *corporate governance* têm um impacto positivo na *performance* da empresa, o que está de acordo com os estudos e recomendações da OECD.

## ABSTRACT

This case study documents the quality on corporate governance of two state-owned enterprises and their performance. These two topics, corporate governance and performance, have been studied individually, although lately it has been evident the possible relation between them. Therefore, this study approaches both topics by evaluating quality governance within two municipality-owned enterprises and analysing key performance indicators. The field of state-owned enterprises has lack of studies on corporate governance and performance, combined. The research aims to answer “How can corporate governance be measure in municipality-owned enterprises?” and “How do differences in corporate governance may affect the performance of this enterprises?” Merging the findings of both studies provides evidence consistent with the premise that corporate governance has an impact on performance.

**Keywords:** Corporate governance, Key Performance Indicators, State-owned Enterprises, Water sector

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## ABBREVIATIONS LIST

CEO	Chief Executive Officer
CPC	<i>Conselho de Prevenção da Corrupção</i>
EBIT	Earnings Before Interest and Taxes
ECGI	European Corporate Governance Institute
<i>e.g. (exempli gratia)</i>	for example
<i>et al. (et alia)</i>	and others
<i>i.e. (id est)</i>	this is
IPCG	<i>Instituto Português de Corporate Governance</i>
KPI	Key Performance Indicators
OECD	Organisation for Economic Co-operation and Development
ROA	Return on Assets
ROE	Return on Equity
SIC - code	Standard Industrial Classification - code
SOE	State-Owned Enterprise
UK	United Kingdom
US	United States of America
<i>v.g. (verbi gratia)</i>	for example

# 1. INTRODUCTION

Latest occurrences in Portugal alerted to problems related to governance. For example problems related with managers of influent companies, lack of transparency on certain subjects and government instability, among others. This reality triggers the interest on this matter with a specific focus on state-owned enterprises (SOEs).

Corporate governance has a role in every enterprise. Consequently has been discussed among researchers and scholars.

The interest on corporate governance increased due to events that happened in the last years (Becht, Bolton, & Röell, 2005; Silva, Vitorino, Alves, Cunha, & Monteiro, 2006). This curiosity permitted a profound research on the topic, which indicated that corporate governance can be understood as a thematic that studies how companies are managed, the level of reliability of the information on financial statements and the relationship between the company and its stakeholders. All these areas are significant for the companies and for the society. By affecting the companies and the environment, corporate governance is not merely a private, but a public affair manifested through the existence of companies' regulation and guidelines (Busta, 2008).

SOEs are influenced by the country governance and sometimes by the regional governance (Andrés, Guasch and Azumendi 2011). This study will focused on the corporate governance of municipality-owned enterprises, also designed as SOEs.

Every company where the state has dominant influence, is consider as a SOE (Ministério das Finanças, 2013). These kind of enterprises have a significant role in the society and the relationship that they maintain with the stakeholders, is critical to the fulfilment of their objectives.

Our study focuses on corporate governance of SOEs, mainly on its impact in the performance of two municipality-owned companies. Our goal is to discover the differences on corporate governance with performance in SOEs.

The enterprises under observation are controlled by the Municipal Council. Both of them are located in Algarve and belong to the same sector of activity that deals mainly with water

treatment and distribution, sanitation and depollution. Their major difference is the ownership structure, because one is totally held by the Council, while the other is held in its majority by the Council leaving the rest to a private company.

In order to discover if differences on corporate governance, within these two companies, imply differences on their performance it is necessary to organise the development of the investigation. The way that was chosen to develop the study, seeks to answer two questions. The first one focuses on how corporate governance can be measure and the second question refers to the performance of the companies. In the aftermath, this questions will show evidence about the relation between corporate governance and performance.

To measure corporate governance, the methodology was developed by Bueno (1995) and Kaufmann, Kraay and Mastruzzi (2010). The first author developed the theoretical framework adopting Ansoff's research to evaluate the environment of a company. Kaufmann *et al.* (2010) developed a study to define a worldwide governance indicator. They arranged the data by evaluating a country's governance through a scale, where a lower score means poor governance and a high one means good governance.

To compare the performance of the companies, the adopted methodology was to evaluate the key performance indicators (KPIs). Marr (2012) claims that KPIs are essential to support managers on their strategy and daily affairs. Along with Marr (2012) and Neves (2007, 2012) it was possible to develop an analysis focused on economic and on the financial structure of the companies. The study focuses on analysing the turnover growth of the companies, as well as the return on assets and equity.

There are limitation along the research regarding the lack of information to generalise the findings. The fact that the study focuses on two municipality-owned companies restricts the conclusions to only this reality. Besides this limitation, the case study narrows the assumptions due to lack of information regarding the sector of activity. The assumptions that a company is in a better position than the other, requires a comparison between their results and the results of the sector. Since this last comparison is not available, it is only possible to affirm their differences.

The case study is structured as follows. Chapter two broadly describes corporate governance and examines the theoretical and empirical literature. The third chapter explains the

singularity of corporate governance within state-owned enterprises, underlining the differences of governance on both sectors, private and public. Chapter four characterises the companies, explains the methodology and analyses the results. The last chapter includes the main conclusions and suggests future research.

## **2. CORPORATE GOVERNANCE AS A DETERMINANT OF PERFORMANCE**

### **2.1 What is Corporate Governance?**

The concept of corporate governance has been discussed over the past years among policymakers and scholars. It is not exactly clear when the concept appeared. Perhaps the term was first mentioned in 1992 on the Cadbury Report, a report oriented for companies in the UK with the goal to improve the financial information and accountability (The Committee on the Financial Aspects of Corporate Governance: Cadbury Report, 1992). Morck and Steier (2005) referred to a scheme that crushed the financial system in France, as being the beginning of corporate governance. The scandal of Mississippi Company, in 1720, demanded a set of contracts and measures in order to prevent the recurrence of this events. These measures were guidelines to improve the governance of the companies.

In the study about Corporate Governance and Control, Becht *et al.* (2005) developed six explanation points, targeting the interest in the topic of corporate governance during the last two decades. The issues they had appointed were: (1) the privatization wave that affected all the world; (2) the pension fund reform and the growth of private savings, which affirms the awareness of the active investor at the time; (3) the takeover wave of the 1980's; (4) the deregulation and global integration of capital markets; (5) the 1998 Asian market crises, that spot the corporate governance in emerging markets, and finally; (6) the series of US scandals and corporate failures.

For Fombrun (2006), corporate governance is a topic that tries to explain the divergent purposes and interests between directors and investors.

Knowing what ignites the interest on corporate governance, it follows a few broad perspectives on the subject.

The definition of corporate governance can also be seen as a thematic that “deals with the ways in which suppliers of finance to corporations, assure themselves of getting a return on

their investment” (Shleifer & Vishny 1997:737). According to them, the systems of corporate governance are better in the US, UK, Germany and Japan.

Another perspective defends that corporate governance arose “whenever an outside investor wishes to exercise control differently from the manager in charge of the firm” (Becht *et al.* 2005:1). Through this argument they are mentioning agency problems, which is a problematic that corporate governance aims to reduce (Jensen & Meckling, 1976).

Despite all the research about corporate governance, the definitions from institutions like the OECD, ECGI, The World Bank and others, represent an important starting point for the description of the thematic. These institutions lead worldwide studies by fostering the knowledge about corporate governance. The development of a great deal of guidelines is aiming for an improvement in corporate governance among countries and companies. The Cadbury Report (1992), was a significant matter at the time of its implementation, even though it was oriented only for UK listed companies.

The Convention of the OECD in 1960, signed in Paris December 14<sup>th</sup>, was establish to promote a set of policies:

- i. “to achieve the highest sustainable economic growth and employment and rising standard of living in Member countries, while maintaining financial stability, and thus to contribute to the development of the world economy”;
- ii. “to contribute to sound economic expansion in Member as well as non-member countries in the process of economic development, and”;
- iii. “to contribute to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with international obligations” (OECD, 1960).

The convention had terms to clarify the meaning and the aims of itself. The governments that agreed on being part of the OECD needed to know that sound economy was essential to increase general prosperity and well-being.

The ECGI describes corporate governance as the “basis of accountability in enterprises, institutions and companies, balancing corporate economic and social goals on the one hand with the community and individual aspirations on the other” (ECGI, n.d.). Both Cadbury Report and the ECGI consider accountability as an essential topic of corporate governance.

Corporate governance can be defined as a “system by which companies are directed and controlled” (The Committee on the Financial Aspects of Corporate Governance: Cadbury Report 1992:15). The code is based in three main pillars – openness, integrity and accountability. Openness allows shareholders and others to scrutinise the companies. Integrity is about confidence on the published reports. This second pillar concerns on how reliable the financial statements of a company are, sometimes it happens that the statements do not represent the real situation of the firms. Accountability, addresses to the quality of the information that the board of directors supply to shareholders. The information must be reliable because shareholders will exercise their responsibilities according to that information.

Like the Cadbury Report, The World Bank establishes a set of pillars on which corporate governance is focused on – accountability, transparency, fairness and responsibility. The definition refers to the way that “responsibilities and rights are distributed among the board, company management, shareholders and other stakeholders” (The World Bank, n.d.). It also claims that a company’s actions mean more than having a set of written guidelines.

From a Portuguese perspective, to Silva *et al.* (2006) corporate governance arises as being a compilation of authorities and fiscal structures, both internal and external. According to them, corporate governance ensures that a company keeps its purpose through effectiveness and efficiency. The companies should pursue their goals and assume the social responsibility inherent to itself.

All the perspectives mentioned before, established the main ideas of corporate governance. To synthesise the different perspectives, corporate governance is concerned on how companies are managed, the reliability on financial statements and finally the relationship between the company and its stakeholders.

## **2.2 Corporate Governance as a determinant of performance**

To find a link between corporate governance and performance, has been a challenge for researchers and academics. On one hand, there are many studies trying to prove that corporate governance has an impact on performance. On the other hand there are others trying to prove

them wrong. These studies developed a set of different measures and indicators designed to explain the link between corporate governance and performance.

Biswas and Bhuiyan (2008) combine preceding work about corporate governance and performance. Their research, developed in German companies, result on a positive relation between good corporate governance and good performance. In a cross-country perspective, they cite works that show how improvements in governance have a positive impact on real economic activity. Regarding the market valuation, they mention that a high level of good governance implies better market valuation. Fombrun (2006) supports this argument by mentioning that investors are willing to pay more for well-governed companies. Nowadays the investor is well-informed, meaning that the relationship with stakeholders and the reliability on financial statements matter on investment decisions.

Kaufmann *et al.* (2010) developed a worldwide indicator of governance in order to discover the levels of governance in some countries. They defined six main dimensions that include the process of selection and replacement of the governments, the capacity of the government to implement sound policies and the respect of the citizens and state on the regulatory institutions. These dimensions were established in order to assure a better evaluation of governance within the countries.

By consolidating the research works of Kaufmann *et al.* (2010), Busta (2008), OECD 2011 and Brown and Caylor (2004) it is possible to extract the following dimensions of corporate governance which are the foundation of this case study: (1) Board of Directors; (2) Ownership Structure; (3) Relations with Stakeholders; (4) Transparency and Accountability; (5) Legal and Regulatory Framework.

In the following subdivisions continues a detailed explanation, for a better understanding, of the dimensions and their role on corporate governance.

### **2.2.1 Board of Directors**

Jensen (1998) affirms that decision implementation and decision control must be separated in order to limit costs. Several enterprises use a device called board of directors, to accept the separation.

A worldwide perspective by Kaufmann *et al.* (2010), defines corporate governance as the comprehension of the “process by which governments are selected, monitored and replaced”. The board of directors can be seen as the government that needs to be selected, monitored and replaced, when necessary.

The papers of Busta (2008), Brown *et al.* (2004) and OECD (2004) agree that the board has the responsibility to monitor managerial performance, to achieve a return for shareholders and to add value to the company. The board is also in charge to prevent conflicts of interest and must act defending the interests of the shareholders and the enterprise.

The Principles of Corporate Governance, published by the OECD in 2004, has provided six indicators to assist the board of directors. The first one claims that the board should act in good faith and have all information updated to audit potential investments and agreements with other parties and other interests. Secondly, the institution defends that shareholders should be treated equally and fairly. The third indicator is that high standards of ethic, should be implemented not only in the company but in the board itself taking into account the shareholders’ interest. Four, involves a set of responsibilities that guide the board for a better performance. It includes reviewing the corporate’s strategy, monitoring the performance and assuming a risk profile which will help the managers to know the level of risk that the shareholders are willing to take. Keep disclosure on nomination, election and remuneration of the board and ensure the integrity on corporate’s accounting and financial system. The fifth indicator refers to the board’s independent judgement regarding corporate affairs. The board should have independent members to guarantee quality on decision-making. The last indicator refers to the information that members of the board should have access in order to fulfil their responsibilities. To ensure quality on decision-making process, the board must have access to accurate, relevant and timely information.

Busta (2008) makes a summary of research papers dealing with the board of directors. He found that studies focus on the importance of the board and its impact on corporate governance. The development of an empirical research, confirmed that a Chief Executive Officer (CEO) substitution depends on corporate’s performance. In cases where the enterprise shows poor performance, the board will consider the addition of independent members. Regarding investor’s protection, he states that higher protection reduces the

relative importance of the investor allowing the board to focus on governance and adding value to the firm.

The empirical study of Brown *et al.* (2004) focuses on finding the link between corporate governance and performance. After defining the corporate governance indicators and the measures of performance they discover that, on average, enterprises with independent members on the board, have higher returns on equity, higher profit margins, larger dividend yields and larger stock repurchases. They also found that corporates are more valuable when the board chairman is not the corporate's CEO at the same time.

Table 2.1 illustrates the relevant information to understand the responsibilities of the board and its effects, when the board is committed to fulfil them.

Table 2.1 Responsibilities of the Board of Directors

<b>No.</b>	<b>Responsibilities of the board of directors:</b>	<b>Effects:</b>	<b>Researchers:</b>
1	The board loyalty should be intended to the company and to all of the shareholders, treating them fairly	Increases confidence within potential investors.	(OECD, 2004)
2	The board should apply high standards of Ethic	Facilitate the control of management. Some companies developed a code of conduct to prevent ethic uncertainties.	(OECD, 2004)
3	The board members should be concern about the size of the board	The size of the board affects the quality of the decision-making.	(Brown & Caylor, 2004)
4	The board should worry about the directors' assiduity on board meetings	Indicator that affects a company's performance.	(Brown & Caylor, 2004)
5	The board nomination and electoral process should be clear and transparent	Promotes transparent and clear policies. Increases confidence within potential investors and stakeholders.	(Brown & Caylor, 2004; OECD, 2004)
6	The board should include a sufficient amount of independent outside directors.	Grant independence and objectivity regarding the management.	(Brown & Caylor, 2004; Busta, 2008; OECD, 2004)
7	The board should have access to accurate, relevant and timely information	Improves board's performance.	(OECD, 2004)
8	The board should promote integrity with a transparent accounting and financial system	Increases confidence within potential investors and stakeholders.	(Brown & Caylor, 2004; OECD, 2004)
9	The board should help on solving conflicts of interests	Responsibility that could be controlled through better investor's protection.	(Busta, 2008; OECD, 2004)
10	The board should review, monitor and guide corporate's strategy	Objective to achieve better performance and protect the company from a risk that the shareholders are not interested on taking.	(OECD, 2004)
11	The board must set performance objectives, monitor effectiveness of corporate governance and be aware of every significant change within the company (capital structure, acquisitions and poison pills)	Shows an active monitoring posture of the board.	(OECD, 2004)
12	The board should align the key executive and board remuneration	Promotes fair and ethical policies	(OECD, 2004)

Source: author

### **2.2.2 Ownership Structure**

The research regarding the ownership structure has been done mostly empirically. Busta (2008) wrote a summary of some works about this topic. He discovered that ownership structure has no impact on firm value. However, he proved a positive correlation between ownership concentration and firm profitability. He also found that concentrated ownership has a negative effect on firm value. Nevertheless, these results depend on the companies that are being studied, the countries, the shareholders and the whole environment of the study.

The paper collection of Frederikslust, Ang and Sudarsanam (2008) focuses on the impact of corporate governance in Europe. The large shareholders represent an important role on continental Europe governance. In contrast shareholder dispersion is more common among US companies. La Porta, Lopes-de-Silanes, Shleifer and Vishny (2000) claim that countries with poor legal investor protection need larger investors. Ang, Cole and Lin (2000) conclude that ownership structure affects the risk that a company is exposed, having a large number of investors allows the risk sharing. In Portugal, Faccio and Lang (2002) found that widely held and family controlled companies are predominate. They argue that state control is important among large firms. Nowadays we think that these conclusions will be different.

Within the ownership structure, there has to be some guidelines to grant the well-functioning of the structure. Shareholders should be treated equally, preventing any abuse to minority or foreign investors. By issuing different kinds of shares, it allows the investor to choose the risk that he is willing to take. Big changes regarding shareholders should be approved by all shareholders through votes. The ownership structure also depends on the legal and regulatory framework of the company and country. Therefore, if the legal and regulatory framework is weak, then ownership tends to be concentrated. If ownership structure is dispersed the risk of agency costs increase. This last topic is also connected to the loyalty that managers have to the company and to all shareholders (OECD, 2004).

Mayer (2002) states that ownership structure is more related to corporate governance than with the traditional agency problems. Although in widely held firms, managers run the company in their own interest and have little interest in active monitoring.

Brown *et al.* (2004) set indicators of ownership in order to study their correlation with his measures of performance. He found a positive correlation between ownership and dividend

yield and between ownership and return on equity. This means that good a ownership structure improves the dividend yield and return on equity.

Table 2.2 summarizes the main factors belonging to the dimension of ownership structure and its goals.

Table 2.2 Factors of Ownership Structure

No.	Factors of Ownership Structure:	Goals:	Researchers:
1	Directors with more than 1 year own stock	Align the interests of the managers with the shareholders'	(Brown & Caylor, 2004; Mayer, 2002)
2	Guidelines for directors with stock ownership	Associated with company's good performance	(Brown & Caylor, 2004)
3	Identification of the shareholder with more than 50% of total shares outstanding	Identify the main shareholder	(Brown & Caylor, 2004; Faccio & Lang, 2002)
4	Large shareholders in the company's management	Identify family held firms	(Faccio & Lang, 2002)
5	All shareholders should be treated equally	Achieve equality among shareholders	(OECD, 2004)
6	Minority shareholders should be protected from abusive actions	Adds confidence into future investors	(OECD, 2004)
7	Prohibit internal trading of votes	Promotes ethics within the company	(OECD, 2004)
8	Company with dispersed shareholders	Characterize the company as widely held or not	(Faccio & Lang, 2002)
9	State as a large shareholder	To identify the company as state-owned	(Faccio & Lang, 2002)

Source: author

### 2.2.3 Relationship with Stakeholders

A stakeholder affects and is affected by a company. In this way it is important to think about the relationship of stakeholders with the firm (Bovaird & Löffler, 2009). The term stakeholders includes investors, customers, employees, creditors and suppliers of a company (OECD, 2004).

Corporate governance has the goal to create wealth in cooperation with stakeholders. In order to accomplish the goal, is crucial to recognise the stakeholders' interests (OECD, 2004). The OECD (2004) established a set of principles where the interests and rights of the stakeholders must be respected. As mentioned before, the employees are stakeholders of the company; hence it is important to maintain or develop a good relationship. A solution for conflicts that

may exist between the board and the employees, is to allow them to participate in the strategic decision-making process. To have a representative on the board ensuring the preservation of their interests, is relieving for the whole body of employees, but it can only be beneficial if information is issued regularly to stakeholders. Another principle is the necessity to have freedom to communicate unethical practices within the company. This principle may prevent the company from incurring risk that might be detriment to the company in the future.

Another study regarding employees suggests that they should be an influence in the strategy making of the company. As an example, a cooperative reached a higher level of productivity by allowing the participation of the employees on defining prices and quality standards (Shleifer & Vishny, 1997).

Creditors also need protection. That is why the OECD (2004) supports that, an effective and efficient insolvency framework, promotes confidence to future creditors.

Hopt and Leyens (2004) consider that networking with stakeholders is essential in order to balance their interests. A company is better oriented when the interests of all the involved are align.

With a different perspective, Frederikslust *et al.* (2007) alert to the possible coalitions between stakeholders that could match to go against the company's strategy.

As stated before, the rights of the stakeholders must be defended and is also important to recognize the interdependence of their interests. There is a necessity to align the interests of stakeholders (Silva et al., 2006).

The following table outlines the stakeholders' requirements and the effects they have on the company and its surroundings.

Table 2.3 Requirements of Stakeholders

<b>No.</b>	<b>Requirements of stakeholders</b>	<b>Effects:</b>	<b>Researchers:</b>
1	The rights of stakeholders must be respected	Promotes good governance	(OECD, 2004; Silva et al., 2006)
2	Acknowledge the interdependence of the stakeholders' interests	Giving the right importance to the stakeholders will make them feel appreciated	(Silva et al., 2006)
3	Align the interests of investors, managers and stakeholders.	Promote synergy among all the main characters of the company	(Silva et al., 2006)
4	Prevent coalitions between stakeholders	Avoid teams that might act against corporate's strategy	(Frederikslust et al., 2007)
5	Performance-enhancing mechanisms for employees participation	Allows the employees to participate in the firm where they work and to feel that they belong to the decision making process	(OECD, 2004)
6	Provide relevant, sufficient and reliable information on a timely regular basis	The stakeholders will assume their responsibilities and participate in the corporate if they get the right tools	(OECD, 2004)
7	Freedom to communicate about illegal or unethical practices	Allows the company to act in order to correct the bad functioning of a particular area/department	(OECD, 2004)
8	Existence of an effective and efficient insolvency framework	In case of insolvency the company has a plan to deal with the problem and the stakeholders are aware of it	(OECD, 2004)
9	Implement specific creditor rights	Keep a clear relation with creditors	(OECD, 2004)

Source: author

#### **2.2.4 Transparency and Accountability**

The European integration process has led to the priority of shareholder protection, transparency of financial information and of mechanisms of governance (Silva et al., 2006). In accordance with Silva *et al.* (2006) it is clear that the European Commission is grounded on three main pillars. The first one, is the modernization of the law of enterprises. The second is promotion of good governance rules. At last the main pillar of the Commission is transparency of financial information. There are requirements on disclosure and transparency that focus on corporate governance practices, negotiations with other parties and its financial impact on the enterprise. Disclosure on annual financial statements and governance reports is also of great matter.

The OECD understands the importance of transparency through the improvements that can be achieved, by implementing good transparency policies (OECD, 2004). Improvements regarding transparency within the company's structure, activities, policies and performance, affect the relationship of the company with stakeholders and the environment where the company operates on. However, disclosure should be cautious and the level of transparency must not harm the company. On the other hand if information is unclear, the markets do not have confidence on a given company, which could increase the cost of capital...

Disclosure is required on audited financial statements as the investor will initiate his analysis on this information. The company's objectives should be clear, as well as the business ethics and public policy. In order to evaluate the relationship of the company with the community, the policies must be clear. Regarding ownership, any special voting right and the rights of the owners should also be transparent. Disclosure on remuneration of the board and key executives promotes transparent practices. In order to keep a good practice, the company should assume and disclose foreseeable risk factors and the relationship with stakeholders to increase confidence in the markets (OECD, 2004).

The disclosed information should have high quality standards to facilitate the monitoring of the company. The annual audit, provides an external and objective assurance to the board and shareholders. It represents a reliable resource to advice the company in order to grant good practice. To keep the transparency at a high and rightful level, the channels for scrutiny of information should be provided to allow the access of relevant information (OECD, 2004).

Table 2.4 represents the resume of the requirements of transparency and accountability along with its aims.

Table 2.4 Requirements on transparency and accountability

No.	Requirements on Transparency and Accountability:	Aims:	Authors:
1	Disclosure on reliable financial statements	Increases confidence in the market	(Silva et al., 2006)
2	Disclosure on corporate governance practices	Information for future investors to analyse	(OECD, 2004; Silva et al., 2006)
3	External audit to provide an objective assurance to the board and shareholders	An independent perspective regarding the financial state of the firm, improves company's performance	(OECD, 2004)
4	External auditors should be professional and able to provide advices to the company	Achieve improvements on company's performance	(OECD, 2004)
5	Disclosure on foreseeable risk factors and on stakeholders that may affect the company	Provide useful information to the board and to shareholders without omitting any important detail	(OECD, 2004)
6	Disclosure on transactions with other parties and its financial impact on the firm	Provide detail information to the board and shareholders	(OECD, 2004; Silva et al., 2006)
7	Provide the existing channel for disseminating relevant information	Achieve a high level of transparency	(OECD, 2004)
8	Disclosure on remuneration policy of the board and key executives	Promotes transparent practices regarding remuneration policies	(OECD, 2004)

Source: author

### 2.2.5 Legal and Regulatory Framework

In accordance to European legislation, a regulation is a normative act that has general application and is binding upon the institutions, the member states and individuals to which it is addressed. A regulation is directly applicable in all member states which means that no measures are needed to incorporate the regulation into national law (The Council of the European Union, 2012).

The Council regulation on the status for a European company, has the goal to permit companies to plan and develop the reorganisation of their business on a community scale. In order to achieve its goal, consistency on the economic and legal unit of business in the community, must be ensured (The Council of the European Union, 2001).

The regulation No 2157/2001 of 8<sup>th</sup> October 2001 on the status for a European Company (SE), established a set of guidelines to be implemented in the Member States. A company, in order to be recognized as a European company, must be situated within the community territory, the capital must be divided into shares, it has to have legal personality and the employee involvement, shall be governed by the directive 2001/86/EC. Every European company shall be governed by the regulation No. 2157/2001. In cases where the regulation does not cover the issues, then the national law of the member state where the company is registered, should be adopted.

According to the directive mention before, the employees are entitled to be involved on issues that affect the company where they work at.

Regarding the structure of the company, the regulation sets two kinds of existing systems: two-tier system and one-tier system. The two-tier system has a supervisory organ and a management organ. As an alternative, the one-tier system has only an administrative organ.

The two-tier system is characterized by having managers running the company that are appointed or removed by a supervisory organ. Nobody shall belong to the management and to the supervisory organ at the same time. The supervisory organ has the responsibility to supervise the work of the managers, never to run the company itself. The members of the supervisory organ are appointed in general meetings of shareholders. Both organs must meet every three months allowing managers to report the progress and foreseeable development of the company. It is mandatory for the managers to disclose any relevant information, that may affect the company, to the supervisory organ (The Council of the European Union, 2001).

The administrative organ is the manager of the company on the one-tier system. This system shall have three members and the employee participation is regulated by directive 2001/86/EC. In order to discuss the progress and foreseeable development of the company the administrative organ shall meet every three months, too.

Both systems, the two-tier and one-tier, are required to include in the status of a company the number of members belonging to each organ. If a company permits another company or legal entity to be a member of its organs, it shall also be written on the status. The location of the company and a list of categories of transactions that require authorisation by the supervisory

organ or a discussion by the administrative organ, shall be included on the status (The Council of the European Union, 2001).

The regulation states that even after members have ceased their responsibilities, they should keep confidentiality regarding company's affairs.

Regulation No. 2157/2001 regulates European companies, therefore considering that legal and regulatory framework as a dimension of corporate governance, it is important to ensure that the law is consistent with good governance practices.

### **3. CORPORATE GOVERNANCE IN STATE-OWNED ENTERPRISES**

**(SOEs)**

#### **3.1 What is special about SOEs and its governance?**

SOEs carry out different activities that vary with the country in which they operate. These activities are also vulnerable to the diverse economic and institutional conditions. As the OECD affirms, state-owned enterprises (SOEs) represent an important share of activity and may have an important impact on the overall performance in the countries' economy. This situation alert us to the importance of SOEs. Another issue arises when the OECD claims that improvements in governance promote growth through better performance. This statement underlines the significance of governance within the companies. (OECD, 2005).

According to Bovaird and Löffler (2009) stakeholders affect the company in their own different way. It depends on the employees, shareholders or suppliers. They can also be affected by the company. For example, through changes on the board or on practices that the company decides to implement. These changes affect some stakeholders more than others.

SOEs concern about the wellbeing of the community. Fombrun (2006) argues that the asset owners care about the impact of a company in the environment and community.

Andrés *et al.* (2011) claim that the SOEs are driven by incentives that reward efficiency and transparency. In their study for The World Bank, the authors conclude that performance is related to a country's governance or even to a regional one, meaning that governance practices in Portugal may have an impact in the governance of SOEs. They also conclude that SOEs seek to achieve social goals and human capital improvements.

According to the published article of Daniel Bessa, Portugal had around 400 municipality-owned enterprises in 2012 and some of them, did not have either products or costumers (Bessa, 2012). Suggests that the regulation and supervision was not as demanding as it should be. In 2013 Portugal had 286 SOEs, less than in 2012, due to the set of policies that control the creation of these enterprises.

SOEs are owned by the state either entirely or partially. In Portugal, the enterprises are under the Public Business Sector and Public Enterprises law (DL No. 133/2013). Our research

focuses on local enterprises which are owned by the Municipal Council. Nevertheless, these are considered as state-owned companies (Christiansen, 2011).

In this point we have to clarify the difference between the governance on private sector and the governance on the state sector. The difference is grounded on five dimensions explained before: (1) Board of Directors; (2) Ownership Structure; (3) Relations with Stakeholders; (4) Transparency and Accountability; (5) Legal and Regulatory Framework.

This explanation will facilitate the overview of corporate governance practices within the companies of the case study. Considering the guidelines and responsibilities that should be follow in SOEs, it is possible to evaluate the level of corporate governance adopted by the two companies.

### **3.2 Dimensions of corporate governance for SOEs**

Corporate governance does not differ from the private sector to the public one. The OECD (2011) claims that the public sector should use tools that are valid to the private sector. However, there has to be a distinction between these sectors regarding corporate governance. Kaufmann *et al.* (2010) developed a study connecting different dimensions of governance. For instance, high levels of ethics can be achieved through better accountability and an effective government reaches a better regulatory framework. It suggests that the dimensions of governance cannot be analysed as being independent from each other.

The succeeding paragraphs will underline the differences of the dimensions when applied to the state sector.

*Board of Directors:* one of the main differences between state-owned and private enterprises is the level of involvement of the government within the companies. Even though the government is a shareholder of the company, does not mean that can intrude on the companies' strategy. Remembering what was mentioned regarding the board's independence it also applies to state-owned companies with a particular attention on political interference. Maintaining the board independency, will prevent the board's distraction regarding political influence that could result on bad performance of the company (OECD, 2011).

According to the OECD (2005) countries pursue political independence within the SOEs, aiming for a competent and well-structured board. The institution advises to be aware of the size of the board, since smaller boards permit a better discussion about the company's strategy (OECD, 2005, 2011). Regarding representation, is advisable to avoid many state representatives in order to achieve board's independence. Some countries have no state representatives on the board but they have, at least, one employee representative. In Portugal the constitutional law was not implemented, meaning that is not mandatory to have employees representatives on the board (OECD, 2005).

*Ownership Structure:* according to Andrés *et al.* (2011), SOEs with a significant participation in the private sector need to implement corporate governance policies that were design to private enterprises. They defend that the factors regarding ownership structure do not vary so much.

The state as an owner entity, still has to assume all its responsibilities and should not interfere with daily management affairs. A shareholder of a company is able to define the objectives and priorities of a company that guide the management decisions of the board. As an owner, the state should trust the independence to the board that was elected. The state, as a shareholder, must ensure the fulfilment of its responsibilities. It should also, respect the status of the company (OECD, 2011).

Wong (2009) claims that state ownership is characterised by having unclear objectives, political interference, lack of discipline and poor transparency. He defends that the state should evaluate its own performance as an owner, insulate political interference, among others.

*Relationship with Stakeholders:* Stakeholder policy should be similar to the private sector. According to Andrés *et al.* (2011), the public sector benefits, if the management imitates the stakeholder policy of private sector. Regarding what was stated before on stakeholders' relationship with the company, it is still applicable to the public sector. The OECD (2011) believes that for achieving a sustainable and financially sound enterprise, it is necessary to value and acknowledge the importance of the relationship between the company and its stakeholders. Besides the principles and guidelines mentioned before, the OECD defends that a company should have a disclosed and clear stakeholder policy as well as reliable reports on

social and environment policies. In order to maintain high ethical standards, the SOE should develop a code of ethics to set the example for the enterprises within the country (OECD, 2011).

*Transparency and accountability:* Andrés *et al.* (2011) defend that better transparency and accountability of a state-owned or a private enterprise, helps to reach good performance. According to them, it is challenging for SOEs to define performance incentives. They affirm that a management committed to achieve its objectives and goals, increases the level of accountability. By being a strategy focused on results, facilitates the definition of goals and improves the company's efficiency.

Appropriate processes of transparency and accountability will keep the state informed, allowing it to assume its responsibilities, as an owner, without interfering in day-to-day management (OECD, 2010).

*Legal and Regulatory Framework:* This dimension is regulated by the European Commission through Council Regulation (EC) n.º 2157/2001 of 8 October 2001 on the status for a European company. However, it can be adapted to each country's law. In Portugal there is a particular law, the Legal Regime of Local Business Activity that applies to all municipality-owned enterprises.

The local business activity is regulated by the law No 50/2012 of 31<sup>st</sup> August. The law considers as a municipal activity, those services that encompass water treatment, sanitation, waste management, among others. It also regulates the organization and competences of the board by defining the amount of members, its responsibilities and remuneration. These type of companies have an exclusive social object that include management of activities that concern all the public. The awareness of sustainability is clear, therefore the creation of a municipality-owned enterprise must be viable.

According to these status, the companies are constituted with a General Assembly, a Statutory Auditor and a Board of Directors.

The General Assembly as well as the board of directors can only be compose by three members.

The regulation upon the Statutory Auditors demands an opinion on financial obligation and balance, financial statements, contracts between parties, management performance and it also demands a report for irregularities.

Municipality-owned enterprises are administered under the principle of financial transparency. Consequently they must practice an organised accounting in order to comply with the community demands.

Shleifer and Vishny (1997) defend that the historic political pressures of a country, have an impact on its current governance model. Regarding law, they claim that it has a key role on corporate governance.

The following chapter introduces the study of corporate governance within the companies. The study is developed grounding its methodology on the various research papers displayed on the previous chapters.

## **4. A CASE STUDY OF CORPORATE GOVERNANCE ON MUNICIPALITY-OWNED ENTERPRISES**

The case study is focused on answering two questions: “How can corporate governance be measured in municipality-owned companies?” and “How do the differences in corporate governance may affect the performance of municipality-owned companies?” In other words, the case study will compare the differences of corporate governance within the companies and analyse them according to the performance of each company. The questions will be answer by grounding its findings on a comparison of two municipality-owned enterprises operating in the Algarve. The research method of case study is the one that fits the most to answer both questions.

The investigation of an empirical topic can be developed by using a case study. The research design should be focused on: what question to answer, what data can be collected and afterwards what is considerably relevant and finally analyse and expose the results (Yin, 2009).

According to Johansson (2003), a case study is grounded on a comparison of current situations or realities with the ones that should be actually implemented. In other words, a case study focuses on investigating a current event comparing the results with the supposedly expected situation.

The following subchapters will describe and characterise, in major detail, the steps of the case study of corporate governance in municipality owned enterprises.

A description of the companies is necessary to understand their environment and their current situation. The companies’ information is available on their own website and the development of this study did not require restricted data. The scrutinized documents are listed in appendix 7.1.

The research will be focused through the years 2011, 2012 and 2013, the last three years of activity of both companies. In order to preserve the companies’ concealments they were remained in Company X and Company Y. The following section will underline the main characteristics of each company.

## **4.1 The companies**

The current subchapter describes the companies and justifies the choice of this two enterprises.

The criteria to choose the companies should have some foundation for comparison (Neves, 2012). In this case, the main characteristic that these companies must share is the Standard Industrial Classification code (SIC-code). The fact that both companies belong in the same SIC-code, makes it feasible to compare certain objectives.

Afterwards, the choice of the companies was narrow down to the region of Algarve. The selection of this two companies is grounded on the activities that both develop, focused on their service and on the improvement of wellbeing.

Another important characteristic, to account, is the ownership structure. The selected companies must have a different ownership structure. The ownership structure is a dimension of corporate governance that is under evaluation. Therefore, the fact that the companies have a different ownership structure, is an issue that may result on differences on performance.

In addition, it was important to understand the companies and their activities. From the existing municipality-owned enterprises the known activity was, in this case, water treatment and distribution, sanitation and depollution.

Both companies were contacted and informed about the study under development. Only company X showed interest in the topic and availability to complete the gathered information.

### **4.1.1 Company X**

By scrutinizing the company, it was possible to find legal documents that clarify the company's agreement with the Municipal Council and the obligations that the company assumes to be responsible for.

The company was established through an agreement between the Municipal Council and a Private Company, signed on May of 2006. The Municipal Council owns the majority of the company while the Private Company owns a part of the shares. Nevertheless, Company X is a state-owned company. This SOE is located in a touristic area in the Algarve, consequently

is affected by seasonality. Its customers are the residents, foreigners and visitors. The company would like to become a reference on quality standard of wellbeing.

The next table will explicit the relation between these entities.

Table 4.1 Capital Structure of Company X

Capital	Municipal Council	Private Company	TOTAL
Capital €	127.500,00€	122.500,00€	250.000,00€
Number of Shares	25.500	24.500	50.000
Percentage	51%	49%	100%
Share value			5,00€ per share

Source: author

The agreement was celebrated to transfer some of the municipality's responsibilities, within a small area in Algarve, to this company. These obligations include water treatment and distribution, management of infrastructures and sanitation system and gathering of not hazardous waste.

Beneath the responsibilities, the company must be oriented to achieve economic and social balance, as well as granting the protection of the citizens without prejudice of its economic efficiency.

Company X ensures the management and maintenance of infrastructures that belong to the municipality and the construction, management and maintenance of green areas, public illumination, public parking lots and street cleaning. To safeguard the general interest of the citizens, Company X is in charge of developing events related to sports, culture and touristic promotion.

After contacting the company, it was possible to have a meeting in order to clarify the study that the company belongs to, to add information and to answer existing questions. The meeting was attended by the Chairman of the board of directors and by the Financial Director of the company. This arrangement provided the clarification on particular matters. It was possible to confirm that the board has a meeting every two weeks, where all the members are present. Regarding the body of employees, the company tries to keep a relationship of proximity, in order to allow their intervention on company's strategy. Another subject, was the openness of the board to solve conflicts of interests, since this information is barely mentioned on the documents, it was important to confirm the board's position on this matter.

To sum up, the main information obtain in the interview, was the confirmation of an independent member within the board of directors. The current President of the board was, in fact, nominated by the Municipal Council although, she belongs to an external entity that does not have an important relationship to the Municipal Council. It is also important to mention that the previous President worked in the Municipal Council as a Councillor, until 2012.

In the board of directors there is an independent member, plus an elected member from the private company and another member elected by the Municipal Council. The Municipal Council elected a member that is the President of the Local Council where company X belongs to. This election is affected by politics relationships, since the President of the Municipal Council and the President of the Local Council belong to the same party and both ran for local elections in 2013.

The board of directors is appointed or removed in general meetings of shareholders and the mandate in the board coincides with the mandate in the Municipal Council. Which means that board nomination depends, also but not only, on politics.

The company implemented an important initiative, regarding governance. In 2010, the company created a department for internal audit. This department, is independent from the board and its aim is to control and monitor the effectiveness of the company, on achieving its goals.

The company's objectives are consistent through the last years. In their reports, from 2010 to 2013, the will and effort to achieve a high quality standard of wellbeing are clear and sound. The mission of the company is to provide a service of excellence, to improve the wellbeing of the population and to become a reference for tourists and for people that value life quality. All must be achieved through economic and environmental sustainability.

#### **4.1.2 Company Y**

Company Y was founded on December of 2010 with the objective to manage the activities of general interest of water distribution and sanitation, gathering of not hazardous waste, maintenance and requalification of green areas and development of projects oriented to the environmental area.

The Municipal Council holds the full amount of the social capital of Company Y, designating the company as a state-owned company.

Table 4.2 Capital Structure of Company Y

Capital	Municipal Council
Capital €	340.000,00€
Number of Shares	68.000
Stock value	5€ per share

Source: author

Besides the objectives mentioned previously, there are other responsibilities that the company needs to assure. For example, the management of water services, including the distribution and treatment, sanitation, construction of infrastructures, are necessary to achieve company's goals and assure any reparation needed, water quality control and the responsibility to provide the suitable equipment, to the workers, to ensure the gathering of not hazardous waste and other services that the company commits on providing. Other competencies included the development of events in green areas related with recycling and renewable energies.

The board of the company is now composed by only two members, where the President of the Board is, at the same time, Mayor of the Municipal Council. This situation clarifies the dependence of the company to the shareholder.

The underlying question is the possible conflict of interests that might happen, since the President of the board is the Mayor of the Municipal Council. It is doubtful if management is guided by shareholder's or company's interest.

The mandate of the president of the board coincides with the mandate of the mayor, which indicates that the company is affected by political policies. This influence might have consequences on company's performance.

The mission of the company is focused on ensuring the satisfaction of its customer and on improving the sector of water and not hazardous waste. In order to fulfil the mission, the company must guarantee economic, social and environmental sustainability.

### 4.1.3 Summary

In order to maintain the information clear and simple, table 4.3 provides the main information about the companies, underlining their resemblances and differences.

Table 4.3 Information about the companies

<b>Company X</b>	<b>Settings</b>	<b>Company Y</b>
E - water gathering, treatment and distribution, sanitation, waste management and depollution (Direcção-Geral das Autarquias Locais, 2011; Instituto Nacional de Estatística, 2007)	<b>SIC - Code</b>	E - water gathering, treatment and distribution, sanitation, waste management and depollution (Direcção-Geral das Autarquias Locais, 2011; Instituto Nacional de Estatística, 2007)
2006	<b>Year of constitution</b>	2010
Algarve	<b>Location</b>	Algarve
State-owned company	<b>Designation</b>	State-owned Company
Public Limited Company	<b>Type</b>	Public Limited Company
51% Public Capital 49% Private Capital	<b>Capital Structure</b>	100% Public Capital
Legal Regime of Local Business Activity Commercial Company Code	<b>Law</b>	Legal Regime of Local Business Activity Commercial Company Code
Water treatment and distribution, sanitation, pollution management and area decontamination	<b>Main Responsibilities</b>	Water treatment and distribution, sanitation, pollution management and area decontamination
Management and maintenance of green spaces; Manage, build and maintain municipal infrastructures.	<b>Secondary Responsibilities</b>	Management, requalification and maintenance of green spaces; Accomplish projects regarding the natural environment of the city.
Two-tier (General assembly and board of directors)	<b>System organization</b>	Two-tier (General assembly and board of directors)
The President of the board is an independent member	<b>Board of Directors</b>	The President of the board is Mayor of the Municipal Council
Achieve excellence on their service	<b>Mission</b>	Grant a sustainable service
Be a reference of high quality standard of wellbeing	<b>Vision</b>	Reach an improvement of their services accounting with a balanced economy, society and natural environment of their city

Source: author

The resemblances are related to the kind of enterprise that these two companies are (v.g. sector of activity, designation and type). Even by operating within the same sector of activity, the companies have different specifications when describing their service.

The sector of activity “E” encompasses water gathering, treatment and distribution, sanitation, waste management and depollution (Direcção-Geral das Autarquias Locais, 2011; Instituto Nacional de Estatística, 2007). To emphasise what was mention before, the fact that both companies make part of the same sector become one of the reasons for the consistency of the analysis (Neves, 2012).

Regarding differences, the main one is recognise in the ownership structure. Company X is held in its majority by the municipality (51%) and the rest is held by a private company (49%), while company Y is totally held by the municipality. Another important difference is found in the president of the board, where in company X is an independent member and on company Y is the Mayor of the Municipal Council. There are small differences between the companies but in overall they are responsible for similar duties.

One sensitive point for the analysis was the historic information of the companies. Through table 4.3 is possible to see that company X was created 4 years earlier than company Y, which means that the analysis will focus on their last three years of activity (2011, 2012 and 2013).

After a broad presentation of the companies, is now feasible to apply and to understand the methodology. The procedures of the study are explained in the following section.

## **4.2 How can corporate governance be measured in municipality-owned enterprises?**

After describing the companies, their field and goals, it is important to introduce the applied methodology for measuring corporate governance in municipality-owned enterprises.

This method was trigger by the theoretical research of Bueno (1995), which displayed different ways to evaluate the processes of a company according to the law and criteria of the experts. The same author claims that this evaluation will allow the companies to define their strategy. Moreover, he describes the external and internal environment of the company through some indicators. To understand the influence of the topic within the company, it is imperative to classify the possible levels of impact through a scale. The author who developed tables for studying the environment of a company through a scale was Ansoff in 1979 and Bueno applied his research to develop studies that evaluate levels of disturbance and design a strategic profile of a company.

To evaluate the level of corporate policies within the companies it is necessary to adjust the methodology of the author to this case study in particular.

Another research that inspired the usage of this methodology was developed by Kaufmann, Kraay and Mastruzzi. In their recent work of 2010, they explained the applied methodology to develop a worldwide governance indicator. It was their objective, to maintain the indicator updated over the years.

This method simplifies the analysis of the information. After collecting and treating all the data, they evaluate the quality of a country's governance by measuring six dimension of governance through a scale, *e. g.* from 1 unit to 5 units with higher values corresponding to better results. After the evaluation, they rescaled the scores to range from 0 to 1. The rescaling process takes the designating score of an indicator and subtracts the minimum of the scale. This result is then divided by the difference between the maximum and minimum score of the scale (Kaufmann et al., 2010; The World Bank, 2014).

Their study shows details on the development of the worldwide governance indicators but, for this case study in particular, the beginning of the evaluation of quality governance was the most useful.

After presenting the theoretical and empirical analysis, follows the explanation of the adjustment that was necessary to implement this methodology to this case study.

#### **4.2.1 Methodology implementation**

The following subsection will describe the methodology. Its aim, is to become a tool for evaluation of quality corporate governance within companies. The study will analyse the quality of corporate governance of two municipality-owned companies and will also justify each evaluation.

For evaluating the quality of corporate governance of the companies it is essential to describe the main dimensions that will be analysed. These dimensions are the ones that had been discussed in chapter two: (1) Board of Directors; (2) Ownership Structure; (3) Relationship with Stakeholders; (4) Transparency and Accountability; (5) Legal and Regulatory Framework.

Regarding the dimension about the Legal and Regulatory Framework, there is not much to evaluate. Both companies operate in accordance with the legal regulation in Portugal. The status and contracts of each company, refer the applicable law and the recommendations that were implemented. For this reason, this dimension will not have an evaluation of quality governance at the same way as the other dimensions. The Legal and Regulatory Framework will be studied with the main goal to find the differences between the governance model in Portugal with the governance model that is recommended by the OECD and European Commission.

As mentioned, the main indicators of the dimensions are already settled on chapter two. For the experiment, it is necessary to create the scale for evaluation. The adopted scale for this case study was a Likert's scale with a range from 1 to 5 units. The analysis will follow and is important to absorb that, a low score means negative evaluation, while a higher one means positive evaluation.

The companies under observation share similarities on a corporate governance basis but they do not practice the same policies. This analysis displays the companies' position regarding the quality of corporate governance.

With this analysis, is possible to acknowledge the differences between the companies regarding corporate governance policies. It will also be possible to find the gaps between what is advisable from the European institutions with what is applied in Portugal, specifically within these two companies.

To simplify the comprehension, the analysis will be divided through dimensions and applied on both companies.

#### 4.2.1.1 Board of Directors

As previously stated, this dimension focus its attention on how management of the companies is monitor and oriented. In order to properly fulfil their responsibilities, the board should implement the guidelines to better governance that were provided by OECD and ECGI.

The evaluation was grounded in all documents and available information of companies' affairs. The findings are exhibited on table 4.4:

Table 4.4 Evaluation of quality corporate governance on the Board of Directors

	<b>1 - Board of Directors</b>	X	Y
1	The board loyalty should be intended to the company and to all of the shareholders, treating them fairly	5	5
2	The board should apply high standards of Ethic	5	4
3	Limited board size	5	5
4	Amount of independent directors	4	1
5	Board meetings assiduity	1	5
6	The board has access to accurate, relevant and timely information	5	5
7	Boards should promote integrity with a transparent accounting and financial system - be reliable	5	5
8	The board should review, monitor and guide corporate's strategy	5	4
9	The board nomination and electoral process should be clear and transparent	1	1
10	The board should help on solving conflicts of interests	4	1
11	Remuneration of the board	1	1
12	The board must set performance objectives, monitor effectiveness of corporate governance and be aware of every significant change within the company (capital structure and certain acquisitions)	5	4
		46/60	41/60

Source: author

The previous table show us the result of the evaluation on quality corporate governance regarding the first dimension. There is evidence of differences and similarities between the companies.

Both companies score the maximum on the first point under consideration. Over the last three years, the enterprises act according to their mission which is, in a general way, improving their services. Assuming a position that defends the general interest of the citizens, is a reason to consider that the board is loyal to its stakeholders and to the company. In the statements of the companies, is clear that the actions of the management must intend the improvement of the life-quality of the citizens.

Regarding responsibility number two, the companies are tie on their score. According to the recommendation of the *Conselho de Prevenção de Corrupção (CPC)* on November of 2012 the companies, in general, should have a report on Risk and Corruption Management. To have a report of corruption and foreseeable risks the companies grant a good score for the evaluation. The difference of the scores between the enterprises is founded on one initiative that Company X had implemented. By creating a body inside the company for an internal control, shows commitment for reaching better levels of ethics.

From number 3 to number 8, the responsibilities are regulated on the companies' statements. The board has a limited number of members under the 26<sup>th</sup> Article of law No. 50/2012 (Assembleia da República, 2012).

There is no law that demands independent members but according to the guidelines published by the OECD it is important for the board to have independent members. Regarding this recommendation, company X has a better score due to the fact that the president of the board of directors is an independent member. This change happened on 2013 when the change of the board had occurred. The president does not belong to the Municipal Council but was nominated and elected through the public hiring program. On the previous mandate the president belonged to the Municipal Council as a councilwoman.

Regarding board's assiduity, only one of the companies refers this issue on published documents. Company Y affirms that the in 2013 the complete board was present in every board meeting, while company X does not mention it on its statements. Although, during the meeting with company X, it was possible to confirm the board's assiduity on meetings.

The board has access to accurate, relevant and timely information according to the statements of each company. The same statements regulate the board's code of conduct by stating that the board should act with integrity and should grant transparency on financial information. It is also agreed on the companies' declarations that the board is responsible for monitoring and guiding the companies' strategy.

Concerning the obligations number 9 and 10, there is no information on the documents of the company. Company Y scores the lowest point since there is no evidence, for the public, regarding board's commitment for resolving conflicts of interests and transparency on nominating and electing the members of the board. Company X granted this information

during the meeting and through a small mention on their report on risk management. The duties of the internal audit is to monitor the conflicts of interests on hiring basis.

The remuneration of the board cannot be evaluated as being a company on the private sector since the law No. 50/2012 on the 25<sup>th</sup> article declares that only one member of the board can be compensated.

The last indicator for evaluating the quality of governance on the board of directors is related with the strategy of the company. In this indicator, the companies have a major difference which justifies the different score between them. For instance, company X has created an audit body for internal control which indicates a commitment on implementing governance policies within the company. This body was created on 2010 and their objective is to control and audit the efficiency and effectiveness of the company and is also responsible for the validation of trustful information. Company X created this audit body to promote transparency, equity and credibility. Due to this difference, company X gets a better score although it does not mean that company Y is not committed on implementing any governance policies, it means that company X is innovating and implementing good corporate governance initiatives.

#### 4.2.1.2 Ownership structure

Continuing the procedure of the previous evaluation, follows the assessment of the second dimension.

Ownership structure is one dimension of corporate governance that focuses on the relation between shareholders and the company itself. The following table displays the results of the evaluation on quality governance of ownership structure:

Table 4.5 Evaluation of quality governance in ownership structure

	<b>2 – Ownership structure</b>	X	Y
1	Disclosure on shareholders owning more than 50% of total shares outstanding	5	5
2	Identification of the largest shareholder	5	5
3	No representatives of large shareholders in the company's management	1	1
4	Equality between shareholders	4	Not applicable
5	Minority Shareholders should be protected from abusive actions	5	Not applicable
6	Company with dispersed ownership	1	1
		21/30	12/20

Source: author

The requirements, for good governance in the second dimension, aim to find out if the companies follow the recommendations from the OECD.

Before commencing the analysis is important to mention that this evaluation has an important detail. Since the parameters 4 and 5 are not applicable to company Y, the evaluation will be consider only 4 parameters. In the case of company X all the parameters will be consider.

Regarding ownership disclosure, both companies get the highest score since everything is published, as recommended and as regulated in the law.

As noticed before, the companies do not have dispersed ownership. In this situation the risk is not shared, instead is as concentrated as the ownership.

The protection of minority shareholders only applies to company X. In the status and contract of the company, is clear the rights and obligations of the minority shareholder.

This research did not find evidence of equality between shareholders on company X. The board of directors has two representatives of the state and one representative of the private company. This situation it is not prohibited, although it is also not ideal.

Continuing the research about representatives, it was found, on both companies, the existence of a representation of the main shareholder on the chair of the board. This is another situation that is not illegal but according to the recommendations and guidelines from the OECD, is a reality that could be changed.

The OECD underlines the importance on the independence of the board and defends the non-intervention of the state on daily management affairs. Some of the current policies do not permit the implementation of guidelines established by the OECD.

### 4.2.1.3 Relationship with Stakeholders

The concept of stakeholders encompasses the personalities that have an impact on the company and are affected by it, at the same time. It was previously mentioned that corporate governance aims to create wealth along with the stakeholders (OECD, 2004). In order to achieve its goal, the companies should respect the stakeholders and acknowledge their importance.

Since the two companies under observation are state-owned, their objective is focus on general interest and on the improvement of life quality of the citizens.

The following table assesses the relation that each company maintains with its stakeholders.

Table 4.6 Evaluation of quality governance on the relationship with stakeholders

<b>3 – Relationship with Stakeholders</b>		<b>X</b>	<b>Y</b>
1	Respect the rights of stakeholders	5	5
2	Acknowledged the interdependence of the stakeholders' interests	5	5
3	Provide relevant, sufficient and reliable information on a timely regular basis	5	5
4	Align the interests of investors, managers and stakeholders.	4	4
5	Performance-enhancing mechanisms for employees participation	5	2
6	Freedom to communicate about illegal or unethical practices	5	5
7	Report on corruption and risk prevention	5	4
8	Implement effective and efficient insolvency framework	1	1
9	Implement specific creditor rights	1	1
		36/45	32/45

Source: author

On this dimension, the evaluation between the companies does not vary a lot. Both of them respect the rights of the stakeholders, acknowledge the interdependence between them and publish reliable and sufficient information. The interest of the companies is to preserve a good relationship with its stakeholders. The obligation to respect stakeholders' rights appears on the status and contracts of the companies as well as the obligation to publish reliable and sufficient information. The acknowledgment of the interdependence is declared on the companies' report of good practices.

To arrange the interests of the investors, managers and stakeholders can be a difficult process. The concern around this alignment, implies the implementation of processes that assess the satisfaction of stakeholders. Even by being aware of this subject, the companies must frequently assess the satisfaction of stakeholders.

Employees are a vital feature of the companies. A solution to keep them satisfied with the strategy and future of the company, is to enhance their participation on decision making procedures. Company X appears to be more committed to this solution than company Y. According to the information published by company Y there is one employee that belongs to the decision making process but no more information was found about the subject. On the other hand, it is possible to see that company X, has interest and initiative to include the body of employees to the strategy and decision making process. This information was published on the report of Risk Management of company X.

In order to fight against fraud and corruption there has to be freedom to advert the responsible body regarding illegal or unethical actions inside the company. Both companies get maximum score due to the implementation of the recommendation approved by the *Conselho de Prevenção de Corrupção (CPC)*, that aims to prevent corruption and infringements.

The last two indicators of governance had the lowest score on both companies. These two recommendations intent to build a good relation with its creditors and investors. By having an insolvency framework, the company notifies what implications have to stakeholders and designs a process that works the best way possible for all the parties involved. To conceive a report on creditor's rights, suggests that the company practices transparent policies and stimulate equality among the creditors. The indicators are a recommendation from the OECD (2004).

#### 4.2.1.4 Transparency and Accountability

This fourth dimension is of great importance to increase the confidence of stakeholders. It is also claimed by the OECD that better transparency and accountability improves performance.

The following table displays the evaluation of quality governance regarding transparency and accountability.

Table 4.7 Evaluation of quality governance on transparency and accountability

		X	Y
1	Disclosure on Reliable Financial statements	5	5
2	Disclosure on Corporate Governance practices	4	4
3	External audit to provide an objective assurance to the board and shareholders	5	5
4	External auditors should be professional and be able to provide advices to the company	5	5
5	Disclosure on Foreseeable risk factors and on stakeholders that may affect the company	5	5
6	Disclosure on transactions with other parties and its financial impact on the firm	5	5
7	Disclosure on Remuneration policy	5	5
		34/35	34/35

Source: author

Table 4.7 illustrates the result of the evaluation of quality governance on transparency and accountability for the two companies under observation. Both companies end up with a good score, which suggests that regarding this dimension the companies have good corporate governance practices.

The indicators 1, 3, 4 and 5 are described on companies' status and report on Risk Management. Company X and company Y practice disclosure on financial statements, external audit and its qualification. Every time that is possible the companies oblige themselves to disclose any foreseeable risk factors that may affect stakeholders as well as the company.

The practices on corporate governance are disclose but the information available is not detailed. For this reason both companies are evaluated with 4.

In cases where the company is involved with other parties the information must be disclosed. This indicator is fulfil by the companies since is require by the law n. ° 50/2012.

Regarding the last indicator on transparency and accountability, both companies apply the public administration remuneration policy.

#### 4.2.2 Analysis of the results

The previous subchapters explained and displayed the methodology that attempts to measure the level of quality governance of the dimensions. After the implementation of the methodology it follows the analysis of the results.

Table 4.8 displays the results of the previous experiment. Through this table is possible to compare the scores of the companies.

Table 4.8 Results of the evaluation of quality governance within the dimensions

<b>Dimensions</b>	<b>Company X</b>	<b>Company Y</b>
1 - Board of Directors	43/60	41/60
2 - Ownership Structure	21/30	12/20
3 - Relation with Stakeholders	36/45	32/45
4 - Transparency and Accountability	34/35	34/35

Source: author

The comparison of scores concludes that company X has better quality governance on board of directors, ownership structure and relation with stakeholders. Regarding transparency and accountability both companies score the same high result.

A different conclusion can focus on Portuguese law and its regulation on governance policies. The premise assumes that the Portuguese law regulates the dimensions in a dissimilar way.

Table 4.9 Average results of the evaluation

<b>Dimensions</b>	<b>Company X</b>	<b>Company Y</b>
1. Board of Directors Monitor and control management Loyalty to the shareholders and company Guide corporate's Strategy	71%	68%
2. Ownership Structure <sup>1</sup> Disclosure on shareholders identity No representatives of large shareholders in the company's management	70%	60%
3. Relation with Stakeholders Respect the rights of stakeholders Freedom of communication (corruption and illegal practice) Alignment of interests	80%	71%
4. Transparency and Accountability Disclosure on Reliable Financial statements and on foreseeable risks Disclosure on remuneration policy Report of an external statutory auditor	97%	97%

Source: author

For instance, table 4.9 indicates that the scores on the first and second dimension, on company Y, do not reach seventy percent of the recommended governance responsibilities or requirements. Since it happens on one of the companies, is possible to conclude that company X applies better policies of corporate governance. On the third and fourth dimension both achieve more than seventy percent of the score. It is still evident that company X reaches a better result than company Y on the third dimension.

This research is not flawless and the conclusions are arguable. These assumptions are only valid for the two companies under the investigation. In order to generalise the conclusions a study for all the municipality-owned companies should be developed.

The conclusions are only valid for the comparison of these two specific companies. On the other hand the regulation of municipality-owned enterprises is clear and mandatory, which

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<sup>1</sup> This dimension is evaluated according to the applicable parameters on both companies. Company X is evaluated under 6 parameters and reaches a score of 21 out of 30 (70%). In the case of company, is evaluated under 4 parameters and reaches a score of 12 out of 20 (60%).

implies that, if some companies have better governance than others is because they choose to implement extra governance policies that are not obliged within the law.

Another weakness is the lack of general information in order to compare the findings to the sector of activity or to the expected situation regarding quality of corporate governance. The comparison between the companies is not sufficient to claim that the enterprises have good or bad quality governance; is only enough to report the differences between them. However, the research adapted a model to evaluate the quality of governance in municipality-owned enterprises answering the question of this case study: “How can corporate governance be measured in municipality-owned enterprises?”

### **4.3 How do differences in corporate governance may affect the performance of municipality-owned enterprises?**

In order to support the findings in the qualitative analysis, another method will be applied. Marr (2012) enhances the importance of Key Performance Indicators (KPIs) by claiming that managers do not have useful information but a significant amount of data, which does not help the management process. The same author defends that the analysis of KPIs is more than numbers. To have a complete analysis, the analyst should consider what is behind the ratio, like employees, customers and suppliers.

This method is focused on a ratio analysis. In accordance with Neves (2007), ratios are a tool to simplify data, by transforming the data into comparable information between companies or between companies and their sector of activity. The same author claims that analysis through ratios is only meaningful when there is a foundation for comparison. The fact that both companies have the same SIC-code and that both develop similar activities, is the foundation for the benchmark.

The published reports and financial statements of both companies have the information needed to develop this methodology. There was no request for special information.

The implementation of the methodology and the description of the results intend to be clear. In order to present a clear methodology, the following subchapters display the obtained results and the analysis of both companies continues afterwards. For the analysis, a set of KPIs were used and the formulas are displayed on Appendix 7.2.

The chosen KPIs reflect the economic analysis and the financial structure analysis. The first one is focused on revealing the economic situation of a company. Measuring the structure of the costs, along with profit margins, is possible to analyse the economic situation of a company. For the second part of the analysis, the measures are related to financial aspects, like the financial structure and equilibrium, as well as the return on assets and equity (Neves, 2007).

### 4.3.1 Economic Analysis

According to (Marr, 2012), companies' aim is, in a broad way, to reach profit. This analysis focuses on measures that provide information regarding profit and return. Tables 4.10 and 4.11 present the results of this analysis for both companies.

Table 4.10 Results of the economic analysis - Company X

Indicators	Company X			
	2010	2011	2012	2013
Turnover Growth Rate	3,58%	-1,02%	15,82%	-2,41%
Operating Profit Margin	0,89%	2,95%	2,02%	2,34%
Gross Profit Margin	74,28%	74,38%	75,25%	77,91%
Net Profit Margin	0,7%	1,15%	0,13%	0,67%

Source: author

Table 4.11 Results of the economic analysis - Company Y

Indicators	Company Y			
	2010	2011	2012	2013
Turnover Growth Rate	-	-	10,3%	-1,46%
Operating Profit Margin	-	6,47%	8,69%	5,44%
Gross Profit Margin	-	76,08%	75,56%	77,42%
Net Profit Margin	-	0,14%	0,1%	0,03%

Source: author

The analysis begins by studying the turnover growth rate of the companies. This measure can show evidence of volatility in the income of the companies. Companies with consistent turnover growth rate are considered attractive to all investors (Marr, 2012).

For instance, company X shows volatility when in 2010 presents a positive growth rate and in the following year a decrease. In 2012, the turnover reaches the maximum (7,86 M) of the

observed years and in 2013 there is a slight decrease of -2,41% on the income. There is no absolutely conclusion of the analysis, although is evident that company X shows some volatility on turnover growth rate.

Company Y was created in the end of 2010, which means that there is not an important amount of information regarding turnover. In 2012 there was an increase of 10,3% in comparison with 2011, although the growth rate decreased to -1,46% in 2013.

By analysing the EBIT (Earnings Before Interest and Taxes) of the companies with their turnover, is possible to measure the operating profit margin. This measure can show how much of the sales is consumed by the operational costs of a company, more specifically, the measure shows “how much money a company makes on each dollar of sales” (Marr 2012: 17).

Starting again with company X, is feasible to affirm that in 2010 the result is moderately low (0,89%), which means that the operational costs of the company consume most of the turnover. In 2011, when measuring the operating profit margin the result is better (2,95%) than in the year before. The following year registered a slight decreased and in 2013 reaches 2,34%. This is not the best result, although better than the year before.

In company Y the results of the operating profit margin are higher than the ones found in company X. In 2011, the company showed a result of 6,47% meaning that operational costs of the company consumed 93,53% of the turnover. The following year presents a higher result than in 2011, although in 2013 the operating profit margin is lower than in 2011.

The analysis continues on gross profit margin of the companies, this measure shows what is left after deducting the costs of goods sold (Marr, 2012). In company X, the return on gross sales has a range from 74% to 78% between the years of 2010 and 2013. The results show that the expenses related to the provided services of the company do not reach 30%, of turnover, in the years under observation. In company Y the interval is narrower than in company X. From 2011 to 2013 the range is from 75% to 77%, which leads to same conclusion as before, that the expenses related to the provided services of the company do not reach 30% of turnover, in the years under observation.

Studying the turnover, operating and gross margin requires on net profit margin. This last KPI measures the profit of a company on a euro in revenue, which can also tell if the company

is being well managed. A low net profit margin could indicate high operating costs and a fragile position. If the costs increase or in cases that revenues decreases the company starts to make losses. This key indicator is useful for comparisons between companies in the same sector (Marr, 2012).

The net profit margin of company X follows the tendency of the operating profit margin. The results are low even by noticing an increase from 2012 to 2013. The key indicator shows that if company X has a decrease in revenues could lead to a negative net profit, a situation that is not desirable.

The situation of company Y is similar, since both companies display low net profit margin. Although company Y does not show a net profit margin that follows the tendency of the operating profit indicator, it shows a decreasing tendency very close to zero which is a very fragile situation for this company.

So far, the analysis suggests that company Y generates more profit than company X on operating matters. Although company Y shows a decreasing tendency on this measure, while company X do not vary in a significant way. Regarding gross profit margin both companies have similar results. Concerning net profit margin, the companies show low results although when comparing one to another, company X reaches a better margin than company Y. The next subchapter continues the analysis on financial structure.

### 4.3.2 Analysis of financial structure

According to Neves (2012), the analyses of the financial structure focuses on financing resources and on the ways this resources are placement. There is not an absolute result for a perfect financial structure, although there are guidelines for analysing the financial equilibrium. For example, the equity of a company should be superior to the debt to ensure financial equilibrium and the debt should be of medium or long-term. Another guideline is to ensure that non-current assets are covered by permanent capital, in order to support a sound financial structure.

The following tables display the indicators under observation and the results for both companies.

Table 4.12 Results of the analysis of financial structure - Company X

Indicators	Company X			
	2010	2011	2012	2013
Financial Autonomy	11,77%	20,48%	19,7%	18,43%
Working Capital	-1.027.767	-1.370.189	-1.784.406	-1.892.893
Fund Require for day-to-day Transactions	-1.043.038	-878.692	-1.687.208	-1.470.946
Treasury	15.271	-491.497	-97.198	-421.947
ROA (Return on Assets)	2,26%	4,7%	3,73%	3,94%
ROE (Return on Equity)	14,96%	8,98%	1,2%	6,09%
Financial Leverage Effect	9,16	3,46	1,48	1,87

Source: author

Table 4.13 Results of the analysis of financial structure - Company Y

Indicators	Company Y			
	2010	2011	2012	2013
Financial Autonomy	54,09%	0,65%	0,66%	0,7%
Working Capital	-8 969 296	-7 205 029	-8 908 472	4 766 359
Fund Require for day-to-day Transactions	-9 019 225	-7 364 424	-8 521 269	3 712 362
Treasury	49 929	159 394	-387 203	1 053 997
ROA (Return on Assets)	-	2,35%	3,09%	1,97%
ROE (Return on Equity)	-	7,76%	5,11%	1,8%
Financial Leverage Effect	-	4,18	4,75	5,24

Source: author

The financial autonomy measures how much of the assets are financed by equity. When the financial autonomy of a company is too low means that the equity finances a small part of the assets. The opposite means that the company is financed mainly by equity, with almost no debt.

For company X the results on financial autonomy are stable between the years of 2011 and 2013, reaching in average 19%. In 2010, the company displays a low result on financial autonomy of 11,77%. Most of the 81% of debt refers to short-term financing that belongs to suppliers and creditors. The bank debt reaches 25% of total liabilities in 2013.

In the case of company Y the results do not reach 1%, which means that the company relies on debt to finance its assets. The rest 99% are considered, mainly, in “other payable accounts” of non-current liabilities that in 2013 reached 24 million euros, which is superior to the non-current assets. Regarding bank debt, company Y does not approach the bank as company X, since the bank debt in 2013 reaches only 0,1% of total liabilities.

Company X has more weight of short-term financing than company Y. On the other hand, company Y displays a high amount of non-current liabilities when comparing with its non-current assets, an amount that is superior in nearly 4,5 millions of euros, which is inextricable.

When mentioning financial equilibrium, working capital is a topic that requires attention. Working capital measures, in its essence, the current assets minus current liabilities (Marr, 2012). Neves (2012) claims that through the analyses of working capital is possible to realise the financing part that intends to finance the day-to-day transactions. Having a negative working capital means that short-term debt is financing long-term assets, which does not result on a sound financial structure.

The fund required for day-to-day transactions measures the difference between the day-to-day demands with the resources to cover those demands. Having a negative fund, implies that a company is able to cover day-to-day demands with day-to-day resources. This last conclusion is included in the treasury, where the result is expected to be positive in order to support one of the guidelines that state that non-current assets should be finance by non-current resources (Neves, 2012)

Considering company X, it displays a negative working capital and a negative fund required for day-to-day transactions. Although the last one is not negative enough to cover the working

capital in order to achieve a positive treasury, during the years from 2011 to 2013. By having negative working capital along with negative fund and treasury, company X is not in financial equilibrium.

Examining company Y results on different situations for its financial equilibrium. For instance, in 2012 the company displayed a negative working capital and fund leading to a negative treasury. In contrast, during the year 2013 the working capital and fund became positive resulting on a positive treasury. Such phenomenon is only explicable by restructuring short-term debts held in company, in 2013. With a deeper analysis is possible to understand that company Y rather finance its assets with debt than with equity, which highlights the company's dependence to its main supplier.

Return on Assets (ROA) ratio measures the performance of the total capital invested in the company (Neves, 2007). In addition, the companies are interested in maximise the income with the assets they own, therefore ROA is a measure of a company's efficiency to use its assets (Marr, 2012).

Analysing company X, shows that its ROA is always above 2% during the observed years. It reached the minimum value in 2010 (2,26%) and the maximum in 2011 (4,7%). In the following year, the ROA was lower (3,73%), when comparing to 2011, although in 2013 there is a slight increase to 3,94%.

Company Y displays a result on ROA with an increasing tendency on the first two years although in 2013 decreased to 1,97% from 3,09% in 2012.

By comparing the results of both companies it is feasible to affirm that company X has more stability than company Y. Company Y has much more assets than company X, although company X is able to achieve better return on the assets. The results show that company X is more efficient on using its assets than company Y.

Return on Equity (ROE) measures the return that a shareholder ensures with his investment and allows the comparison with rates in the capital market and with cost of financing. This ratio is affected by the financing policy that each company assumes (Neves 2012, 2007). The benchmark of this ratio is only useful when the companies under observation apply the same accounting policies, regarding historical cost or fair value (Neves, 2012). Since both

companies developed their reports according to the historical cost is possible to continue the benchmark on this ratio.

Studying company X, it was possible to discover a tendency for a decreasing ROE from the years 2010 (15%) to 2012 (1,2%). In 2013, the company reached 6% of its ROE, a significant increase from 2012. Even with a decrease on turnover the company reached a net profit higher than in 2012.

Company Y shows a decreasing tendency on its ROE. In 2011 displays a ROE of 7,7% and in 2013 of 1,8%. The results are not encouraging for the equity owners, since the net profit is decreasing over the years, the return decreases along.

The analysis of Financial Leverage Effect will reveal if the debt is a perk or a disadvantage for the company (Neves, 2012). If the result is superior than 1 it means that the debt is a benefit for the company (Neves, 2007).

By analysing the financial leverage effect on company X, is possible to conclude that from 2010 (9,16) to 2012 (1,48) the company had a decreasing tendency. In 2013, the leverage effects increases to 1,87. When applying the financial leverage effect on company Y, the results are quite different from company X. It shows an increasing tendency. Both companies achieve a financial leverage effect superior than 1.

Concluding the analysis of financial structure, is possible to affirm that company X represents better results on ROA and ROE than company Y, in 2013. On the other hand, company Y seems to have a relationship with the main supplier very critical. The suppliers are, actually, supporting, now and in the future, the activity of the company. Regarding working capital, on company X, is negative due to the difference between the payment and receiving periods. Company X displays a receiving period much sooner than the payment one, which affects the working capital.

Although the results of both analysis, economic and financial structure, are not as conclusive regarding the companies' performance. they show evidence on the assume strategy of each of the companies, where company X is willing to take on debt and company Y finance its assets by keeping a high debt to its main supplier. Consequently, the connection to the Municipal Council is clearly higher on company Y than in company X.

## 5. CONCLUSIONS

The attempt to answer two different questions in order to find evidence for the relation between governance and performance, result in several conclusions that require a cautionary discussion. The succeeding paragraphs will incorporate the results of both methodologies to explicit the relation between performance and governance.

The conclusion requires a recapitulation of what was previously mentioned. The development of the case study was divided by two different methodologies. One focused on corporate governance and the other one focused on performance. The characterisation of the companies was essential to better understand the assessment of the study.

To sum up, the companies share the SIC-code that encompasses water treatment and distribution, sanitation and depollution. Beside these activities, they are, also, responsible for green areas. The ownership structure that each company has is an important fact that justifies the choice of these two companies. By comparing a company totally held by the municipality, with another one held by the municipality, in its majority, and by a private company, permitted the evaluation of the impact of corporate governance on the companies.

After introducing the companies, the methodology was implemented following the study developed by Kaufmann *et al.* (2010), where its goal was to find a worldwide governance index. The results request a discussion to analyse the diverse perspectives.

The findings on the dimensions of board of directors, ownership structure and relationship with stakeholders indicate that company X has better governance policies than company Y. The results could also indicate that the Portuguese law regulates these dimensions without recognising the complete set of recommendations previously established on chapter two. Since both companies comply the Portuguese law and the fact that company Y does not reach the same results as company X, it leads to the conclusion that company X chose to implement better practices. Regarding transparency and accountability both companies had high scores, which can demonstrate that the Portuguese law covers most of the recommendations.

Regardless what composes the Portuguese law the findings show that company X has better corporate governance than company Y on the studied dimensions. Nevertheless, the findings

in this case study incite the development of a similar investigation but this time applied to bigger scale, since the conclusions are only valid for this case study.

To claim that a company practices good corporate governance, it would be necessary to compare its results to the average ones in the sector. For researchers it is also interesting to find out the differences of corporate governance within the sectors, being as interesting, if not more, to decipher the reasons behind those findings.

Another possible research would be the study on the different impacts of each dimension to the company. In other words, it would be useful to develop an econometric model to create, eventually, a corporate governance index.

The applied methodologies should be more sophisticated to achieve an evaluation on quality governance as accurate as possible. Improvements on the used techniques should have a positive impact in the outcome.

The first question of the study was answer by demonstrating that corporate governance within two municipality-owned companies can, in fact, be measured.

Currently, the enterprises are managed under several theories, beliefs, law enforcements and others. To prove that policies of corporate governance can improve a company's performance could be an important advance in the scientific field, which leads to the following part of the case that studies the performance of the companies.

The implemented methodology for the study of performance is grounded on the work developed by Marr (2012) and Neves (2012). The authors established a set of indicators that become useful by turning financial data to information. The chosen indicators show evidence on companies' efficiency to assure profit and return. The analysis on financial equilibrium is also an important topic, since it gives information on the companies' position regarding unpredictable happenings.

Assessment on companies' performance seems to indicate that the company with private capital has better balance on performance.

To provide closure on the link between corporate governance and performance, is necessary to highlight that the company with better quality corporate governance shows a performance

better balanced. Future research could corroborate this conclusion or not, since the study is only focus on two state-owned companies.

In overall, both questions were answer. The fact that company X displays better results on quality governance and performance might be the proof of the existing relation between both concepts.

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## 7. APPENDIX

### Appendix 7.1 – Companies’ documents

Consulted documents of Company X:

- Statutes of the company
- Equity Structure
- Contract with Municipal Council
- Financial Report, 2010
- Financial Report, 2011
- Financial Report, 2012
- Financial Report, 2013
- Plan for Risk Management

Consulted documents of Company Y:

- Statutes of the company
- Contract with Municipal Council
- Financial Report, 2010
- Financial Report, 2011
- Financial Statements, 2011
- Annex to Financial Statements, 2011
- Financial Report, 2012
- Financial Statements, 2012
- Annex to Financial Statements, 2012
- Financial Report, 2013
- Financial Statements, 2013
- Annex to Financial Statements, 2013
- Report on good practices of Corporate Governance

## Appendix 7.2 – Implemented Formulas

$$\text{Turnover Growth Rate} = \frac{\text{Turnover in period t} - \text{Turnover in period t-1}}{\text{Turnover in period t-1}}$$

$$\text{Operating Profit Margin} = \left( \frac{\text{Operating Profit}}{\text{Turnover}} \right) \times 100$$

$$\text{Gross Profit Margin} = \left( \frac{\text{Turnover} - \text{Costs of goods sold}}{\text{Turnover}} \right) \times 100$$

$$\text{Net Profit Margin} = \left( \frac{\text{Net Profit}}{\text{Turnover}} \right) \times 100$$

$$\text{Financial Autonomy} = \frac{\text{Equity}}{\text{Total Assets}}$$

$$\text{Working Capital} = \text{Current Assets} - \text{Current Liabilities}$$

Fund Require for day to day Transactions

$$= (\text{Inventários} + \text{Contas a Receber} - \text{Shareholders}) - (\text{Current Liabilities} - \text{Bank debt} - \text{Shareholders})$$

$$\text{Treasury} = \text{Working Capital} - \text{Fund Require for day to day Transactions}$$

$$\text{Return on Assets} = \left( \frac{\text{EBIT}}{\text{Total Assets}} \right)$$

$$\text{Return on Equity} = \left( \frac{\text{Net Profit}}{\text{Equity}} \right)$$

$$\text{Financial Leverage Effect} = \left( \frac{\text{Total Assets}}{\text{Equity}} \right) \times \left( \frac{\text{Profit Before Taxes}}{\text{Operating Profit}} \right)$$