

Presentation by the Supreme Audit Office, Czech Republic

This paper sets out the SAO's experience of auditing privatisation in the Czech Republic. It explains the legislative framework for privatisation and for the SAO's audit of privatisation (Section I); the findings of the SAO's audits (Section II); and provides a case study of the privatisation of spas in the Czech Republic (Section III).

I. Position of the Supreme Audit Office (SAO) in the process of privatization in the Czech Republic

I.1 Privatization methods, their legislative framework and SAO's involvement in audits of the privatization process in the past years.

Transfer of property to other legal and natural persons was the decisive systemic change in the overall transformation of Czech economy to market economy after 1989. Property transfers can be grouped as follows:

- a) Restitution of property to mitigate post-1948 wrongdoings
- b) Privatization of small businesses in services, commerce and other than agricultural production – the so-called “Small Privatization”
- c) Privatization of large property units – the so-called “Large Privatization,” including coupon privatization
- d) Sale of assets as part of liquidation of state-owned enterprises
- e) Transfer and sale of land and agricultural assets.

To carry out privatization, three entities were established: the Ministry for the Administration of National Property and Its Privatization (closed down at 30 June 1996 and its privatization powers were assumed by the Ministry of Finance), the National Property Fund for other than agricultural assets, and the Land Fund for the purpose of privatizing assets that serve agricultural original production. The powers and competencies of the aforementioned institutions were stipulated by appropriate acts. The two funds are non-governmental, legal entities, whose assets are not those of the state and are not part of the state budget.

a) Restitution of property

Restitution of property was aimed at mitigating the consequences of wrongdoings caused from 1948 to 1989 to natural persons, private legal persons and municipalities by the removal of their ownership rights to real estate and moveable things. The terms of the restitution process were governed by:

- Act No. 403/1990 Coll., on the mitigation of the consequences of certain wrongdoings concerning property;
- Act No. 298/1990 Coll., on the regulation of certain property relationships of the monastic orders, the congregations and the Archbishopric of Olomouc;
- Act No. 87/1991 Coll., on the out-of-the court rehabilitations;
- Act No. 229/1991 Coll., on the regulation of ownership relationships to land and other agricultural assets.

Restitution proper consisted of giving back real estate and moveable things to the original owners, the so-called beneficiaries. The so-called obligor, i.e. the holder of such things at the time the aforementioned restitution acts came into force, had to give the property back. In lieu of things that were not possible to give back or which ceased to exist, the obligor had to provide the beneficiary with corresponding material compensation, or the relevant state administrative authority made financial compensation.

The SAO's audit powers were quite limited in this type of privatization since potential disputes between the beneficiaries and the obligors were under law in the jurisdiction of courts, whose powers the SAO was not competent to interfere with. Nevertheless, the SAO did get involved in audits of restitution of properties.

b) Small privatization

Small privatization was concerned with the transfer of ownership to, or the sale at public auctions of, moveable things and real estate constituting whole operating units in the sectors of service, commerce and other-than-agricultural production, to which state-owned enterprises, budgetary & contributory organizations, and the erstwhile National Committees enjoyed the right of management at 1 November 1990. The objective was to set up conditions for the emergence of small and medium-sized privately owned businesses.

Small privatization was regulated by Act No. 427/1990 Coll., on the transfer of the state's ownership to certain things to other legal or natural persons. The scope of privatized assets was determined by the Ministry for the Administration of National Property and Its Privatization. Public auctions were organized by County Privatization Commissions, set up solely for that purpose. Only natural persons who happened to be citizens of the then Czechoslovak Federative Republic or legal persons, whose partners were composed exclusively of such natural persons, could become lawful owners.

As small privatization was carried out prior to the establishment of the SAO, the Supreme Audit Office was not involved in auditing it. Over 22 thousand operating units for the starting price of CZK 21 bn were put up for sale. The proceeds amounted to approximately CZK 30 bn, i.e. 143% of the starting price, on average.

c) Large privatization

The transfers of assets under large privatization took place through the National Property Fund on the basis of submitted privatization projects. The first Large Privatization legislative step was the adoption in 1990 of the Lawful Measure by the Presidency of the Federal Assembly of the Czech and Slovak Federative Republic No. 364/1990 Coll., on the handling of assets entrusted to state-owned enterprises; it prohibited such enterprises from transferring state-owned assets without the government's consent. This measure was aimed at the prevention of reduction in value of the privatized assets, and it was incorporated into successive privatization acts.

The terms of large privatization were regulated by Act No. 92/1991 Coll., on the conditions of transferring state-owned assets to other persons. The subject of privatization, pursuant to this Act, were those assets of the state to which the right of management had been enjoyed by state-owned enterprises, state-owned financial institutions, state-owned insurance companies and other state-owned organizations, including their property stakes in the businesses of other legal persons, as well as the conditions for transferring the state's property stakes in such businesses. Such transfers went to Czech or foreign legal and natural persons. The assets were an aggregate of moveable things and real estate. Chiefly the following served as Large Privatization methods:

- Public auctions;
- Tenders;
- Direct sale to a previously determined owner;
- Transformation of a state-owned enterprise into a joint-stock company;
- Free-of-charge transfer of assets to municipalities, health and retirement insurance funds, banks and savings institutions.

From the launch of privatization through the end of 2002, the National Property Fund transferred in restitution and sold assets totaling CZK 181.4 bn for a total of 14.4 thousand units; of this, free-of-charge transfers and restitution, including additional purchases, amounted to CZK 71.8 bn; direct sales, CZK 67.8 bn; tenders, CZK 33.4 bn, and public auctions, CZK 8.4 bn.

Furthermore, the National Property Fund founded 1.9 thousand joint-stock companies, with assets of CZK 752.7 bn nominal value. By the end of 2002, it sold shares whose nominal value was CZK 172.1 bn, 68% of which were shares sold directly to foreign or domestic parties. It transferred, free-of-charge, assets worth CZK 443.0 bn, nearly 80% of which were transfers of assets under coupon privatization.

A set of economic, technical, property, temporal and other data about the property to be privatized, the so-called privatization project, was used as the foundation for a privatization decision. The Ministry for the Administration of National Property issued binding guidelines on how to put together a privatization project. The entity to be privatized had to produce compulsorily a privatization project, and each party interested had an opportunity to submit its own project and propose a method of privatization. The ministry that had originally founded the enterprise handed over all privatization projects, accompanied with its opinion, to the Ministry for the Administration of National Property, which either made a decision, or forwarded a proposal to the government for approval. Direct sales to a pre-determined owner were all subject to government approval. In addition, the government in the course of the privatization process issued an entire set of resolutions that regulated the approval process of privatization projects.

Once a privatization project had been approved, the Ministry for the Administration of National Property released the privatization project to the National Property Fund for implementation. Under law, the National Property Fund had a responsibility, among other things, that the property privatized would be transferred to other legal and natural persons in compliance with the approved scope, price and method of privatization. The privatized property was transferred by the founding ministry to the Fund at a date appointed by the Fund. The Fund also continued to organize public auctions and tenders.

A special Large Privatization event was the transfer of the state's asset stakes (shares) to citizens after the transformation of state-owned enterprises into joint-stock companies. All citizens over 18 permanently residing in the Czech Republic could participate in this so-called coupon privatization, using investment coupons (securities). One could purchase these coupons for an administrative fee of CZK 1000. Coupon privatization was executed via the Coupon Privatization Center in two waves. SAO did not audit coupon privatization.

In auditing the financial management of entities prior to privatization, SAO competencies were, and continue to be, very limited in the area of how the state's asset stakes are handled by the successor joint-stock companies, as is demonstrated further below. SAO has repeatedly in these audits pointed out the absence of an act on state property. In auditing the procedures undertaken by the authorities in charge of the Large Privatization process, SAO has been restricted primarily to the formal aspect, since under the law, privatization decisions cannot be reviewed even by courts. The government has had to date the power of selling a privatized entity directly to a pre-selected interested party, which in certain cases has considerably interfered with the privatization process' transparency.

d) Liquidation of state-owned enterprises

Liquidation of state-owned enterprises has been regulated by Act No. 111/1990 Coll., on the state-owned enterprises. Assets were not privatized in the process of liquidation by the National Property Fund; rather the sale was organized by a liquidator appointed by the founder. In the liquidation process, there was much more freedom in the handling of state-owned property, as we can see below. Liquidation was supposed to be a procedure of winding up the activity of a state-owned enterprise whose assets had been privatized under Large Privatization methods. SAO audits noted that some founders sold in the framework of liquidation even large units of property.

SAO faced no obstacles with regard to audit powers. Pursuant to the state-owned enterprises act, each liquidator was to proceed in the management of liquidation in the most cost-effective way. Audits revealed different attitudes to cost-effectiveness on the part of the founder of the state-owned enterprise and on the part of the SAO. Here too, the negative absence of an act on state property was noted.

e) Transfer and sale of land and agricultural assets

The transfer of land and agricultural assets has been regulated by Act No. 229/1991 Coll., on the adjustments of ownership relationships to land and other agricultural property. Privatization also went on by privatization projects approved by the Ministry for the Administration of National Property. In these instances, the powers of the National Property Fund were executed by the Land Fund. Within the framework of privatization, the Land Fund was engaged in:

- The management of real estate pursuant to the Land Act. At the end of 2001, it administered some 770 thousand hectares of agricultural land and other assets at the net-book value of CZK 8.5 bn. The Land Fund rented out, exchanged, sold and assigned assets;
- Restitution claims pursuant to the Land Act. This involved compensation in the form of shares and bills of exchange, real estate transfer (real estate worth CZK 7.2 bn was released through the end of 2001), transfer of substitute land, and financial recompense;
- Transfer of assets under privatization projects using Large Privatization methods. From the launch of its activity through the end of 2001, the Land Fund implemented 9 thousand privatization projects – worth some CZK 30 bn – as direct sales, free-of-charge transfers, tenders and auctions, but the proceeds amounted only to CZK 11.3 bn. The low purchasing price was impacted mainly by delays in sales, as demonstrated below.

The Land Fund is not a state fund. It was founded by law practically as an entity governed by private law. It manages real estate, as already said. There was never any elaboration of the term “management.” To SAO rebukes concerning insufficient records of the assets under its management, the Land Fund frequently opined that it had to account only for its assets and it was never appointed to keep records on the state’s real estate, which it only manages. The Act on state property has improved this situation in part only, since the Land Fund got a number of exemptions.

I.2 Audit opportunities under the current situation in privatization in the Czech Republic, and the applicability of the procedures of the INTOSAI Working Group for Privatization-related Audits.

a) The biggest restriction on the audit of privatization has been the inadequate range of SAO audit powers in auditing the state’s asset stakes in joint-stock companies, even where the state holds a full 100% of shares. Privatization in the Czech Republic is in a phase where the sale of entire state-owned enterprises or portions thereof has been practically completed. Currently, it is the state’s asset stakes in the joint-stock companies that are being privatized. In the end of 2002, the National Property

Fund had in 189 joint-stock companies asset stakes whose nominal value in shares was CZK 138.3 bn, of which 21 were strategic joint-stock companies whose shares were nominally worth CZK 120.7 bn. Apart from that, the state held the so-called “golden” share in 49 companies. Additional shares are owned by the Czech Consolidation Agency.

The powers of the Supreme Audit Office have been laid down by Act No. 166/1993 Coll., which, inter alia, has stipulated that the SAO exercises powers of audit over:

- The management of state property and the financial means collected under law to the benefit of legal persons save for funds collected by the municipalities or the regions under their respective separate authority;
- The Czech Republic’s final account of state;
- The performance of the state budget of the Czech Republic;
- The management of funds provided from abroad to the Czech Republic and of funds, for which the state has assumed guarantees;
- The issuance and amortization of public securities;
- The awards of public procurement.

This audit control is exercised by the SAO over the organizational units of the state and over legal and natural persons. It verifies whether the activities subject to audit are in compliance with the legal regulations; it checks on their material and formal accuracy, forming an opinion as to whether they are purposeful and cost-effective. Facts thus checked are subject to be audited by the SAO, regardless of any secrecy’s type or degree.

However, when auditing those privatization results involving the sale of shares, the SAO runs into a problem of auditing powers when it needs to have access to the necessary financial ledgers of the joint-stock companies so that it could assess the accuracy, cost-effectiveness and efficiency of the privatization process. Pursuant to the commercial code, the commercial assets of a joint-stock company refer to all of its assets, and the joint-stock company is accountable with its entire assets for breaches of its commitments, while shareholders do not guarantee the company’s commitments. Only the value of shares figures as state-owned property, while the handling of such values needs to be considered management of state property, and not of the joint-stock company’s property. Not even in cases where the state owns a majority share (over 50 %) can it be termed direct auditing of the financial results of a non-state-owned business entity. The audit powers as stipulated by the SAO Act do not recognize such a power. Under the current legislation, privatization can be audited with respect to the joint-stock companies only:

- Using the privatization projects and documents held by the relevant ministries and funds. This is not the best way. No audit can obtain a complete answer to the privatization process’ cost-effectiveness and efficiency;
- Indirectly, using documents available to the owner or the shareholder, e.g. the National Property Fund. This method of audit has been proven inadequate. In 1994, SAO powers were expanded to include auditing of assets assigned to the National Property Fund. The SAO carried out a 1996 audit aimed at the management by the Fund of such assets. In checking on the handling of shares, the SAO encountered the fact that the available financial ledgers of the joint-stock companies intended for the state’s representatives at general meetings or supervisory boards were inadequate for forming an accurate assessment of a certain stage of the privatization process. The assessment of these, furthermore, ran into objections from the Fund, since the pieces of information were intended for the shareholder, or a supervisory board member and not for the SAO, where the Fund was not the sole shareholder of a company;
- Indirectly, applying the fact that the joint-stock company is a recipient of state subsidies. However, SAO can obtain only certain pieces of information dealing with the use of such subsidies and not to the financial results as a whole.

In the area of privatization of state property, including the sale of portions of moveable things or real estate managed by state entities, there are no such problems with auditing powers on the scale the SAO faces in respect to the joint-stock companies, provided the state property will not be, prior to privatization, transformed in their entirety or part into commercial companies. SAO is currently preparing an audit of the sale of Czech Railroads assets earmarked to offset its payables.

The expansion of its powers over the financial results of assets assigned to the National Property Fund was taken up by the SAO in 2002 when an audit of the Fund's management of receivables was included in the audit plan.

b) The recommendations by the INTOSAI Working Group are particularly useful in the audit of:

- the objectives of selling an enterprise in relation to the broader economic intentions,
- the temporal course of privatization,
- valuation of the privatized assets prior to sale, including the proposed and the used methods of sale,
- the residual responsibility for the payables and receivables associated with the privatized accounting unit,
- the volume of funds spent on privatization.

In agreement with the objective of the INTOSAI Working Group, the SAO emphasizes auditing prior to the sale of assets, i.e. an audit of preventive and economic nature. The objective of such audits is to limit the probability of the inception of low efficiency and low cost-effectiveness of privatization.

In some instances, the SAO Act does not allow for application of INTOSAI Working Group procedures, e.g. collaboration with another state administrative body when the SAO Act only modifies international cooperation.

II. The SAO's experience with privatization-related audits

II.1 The focus of audits

To date, the SAO has wrapped up 32 privatization-related audits. The number of audits spread over the privatization years in the Czech Republic corresponded to the course of privatization where massive privatization of state-owned assets was taking place up to the mid-1990's; for the most part, the state's asset stakes in joint-stock companies, as already mentioned, are being privatized now. More than one-half of the privatization-related audits (17) were carried out by SAO during the 1993 to 1995 period. Four audits were completed between 1998 through 2002.

The audits were mostly concerned with the procedure followed by the responsible authorities in the privatization process, regarding adherence to the legal regulations in force. The audited persons were invariably the Ministry for the Administration of National Property (and later the Ministry of Finance), the National Property Fund and the founding ministries concerned, which were, for the most part: the Ministry of Industry & Trade, the Ministry of Agriculture, and the Ministry of Health. Apart from that, the audits focused on:

- Pre-privatization financial management by privatized entities;
- Observance of set rules and procedures in the delineation of the assets, and the records thereof in the accounting system, of the privatized entity;
- The accuracy of transfer of assets from the founder to the National Property Fund, and further to the acquirer;

- The procedure followed by the National Property Fund in the sale of shares, the handling of the state's asset stakes, and the holding of tenders;
- The lawfulness of releasing a real estate property pursuant to the mitigation of wrongdoings act;
- The financial management by state-owned enterprise in the course of their liquidation;
- The financial management by the so-called "residual companies," which are enterprises whose assets were mostly sold in the course of privatization.

A special group of audits were those that were aimed at the observance of legal regulations and set procedures in selling land, restituting land or compensating for lawful restitution claims that could not be recovered. Here the audited entity was the Land Fund. SAO carried out four audits of this nature and is in the process of completing yet another one.

As regards the number of privatized entities that were audited, the audits may be split into two, approximately equal groups:

- Audits dealing with privatization of a single entity or two;
- Audits of 6 and up to 44 privatized entities founded by a certain central authority, and by certain privatized sectors.

II.2 Serious audit findings with concrete examples

Summed up below are the findings from all the privatization-related audits the SAO has carried out to date. The findings concerned not only deficiencies on the part of the parties to privatization, but also some deficiencies in the privatization-regulating legislation. Select characteristic examples are included.

a) The entity privatized did not keep its accounting ledgers conclusively and accurately in respect of its assets, valuation included, so that its assets were incorrectly delineated. The value of assets was not supported by proper stock takes of assets & payables. The authorities responsible for the privatization process failed to check whether the assets being transferred reflected the actual situation and, in some cases noted, they did not even find out whether it was permissible to privatize all the assets being transferred. For example:

Example 1: A state-owned fishery enterprise

The SAO in auditing a state-owned fishery enterprise's transformation into a fishery joint-stock company noted:

- Illegal transfer of state-owned assets worth some CZK 350 m into a joint-stock company. The founder did not notice in the privatization project a transfer of land of the aforementioned value, although the state-owned enterprise had no right to manage that property. It was real estate that was not supposed to be privatized pursuant to the large privatization act through the National Property Fund, but rather pursuant to the land act through the Land Fund;
- Illegal transfer of assets, which according to the legal regulations in force could have only been owned by the state. They included water streams, basic forestry land and natural landscape worth some CZK 1.5 m;
- Inaccurate valuation of a site of cultural heritage, whose value was cut through depreciation by CZK 64.6 m. The legal regulations in force do not allow for depreciation.

Objective supervision over asset transfers was not provided as the state (the founder) and the National Property Fund were represented at the signing of a transfer of assets hand-over protocol by the same individual.

Another audit established that a state-owned enterprise (a horse racing establishment) stopped keeping its accounting system altogether. The amount of assets set aside for privatization was therefore untrustworthy.

- A founder founded a state-owned enterprise, whose basic assets were, according to the founder's deed, worth CZK 221 m. This fact was never recorded in the commercial register;
- Three years later, a part of the assets were privatized as a deposit into a joint-stock company. Assets totaling CZK 64.3 m were transferred to the National Property Fund. For the remaining part of the state-owned enterprise, CZK 1.8 m worth of assets were entered into the commercial register. The reason of the CZK 155.0 m difference, compared with the founder's deed, could not be determined by the audit as the necessary documents were totally missing;
- In the records on the hand-over of assets to the joint-stock company, the assets were worth only CZK 1.7 m. The necessary documents were again missing so that it was impossible to resolve this additional decline in value.

The Ministry for the Administration of National Property approved in this case the relevant privatization project, although it was advised by the founder about the insufficient delineation of assets to be privatized and potential subsequent complications in the implementation of the privatization project. The joint-stock company concerned was later in bankruptcy proceedings.

b) The privatized entities (state-owned enterprises or farms) did not manage the state-owned assets in a thrifty manner; rather, they executed transfers of assets without the government's consent; entered into disadvantageous lease agreements; or were not forceful enough in collecting their receivables. Such cases were accompanied by the founder's inadequate supervision over the financial management. The absence of an act on state property, which the SAO had been clamoring for over a long period, was negatively demonstrated in these instances.

One provision of the large privatization act stipulated that no privatized entity was allowed to sell assets outside its customary field of management without the government's consent. This provision was to prevent the reduction of the value of assets prior to privatization. The SAO noted breaches of this provision in a huge number of cases with respect to the entities audited. E.g., a privatization-related audit of entities under a single founder revealed violations of the aforementioned provision in 16 out of the 22 state-owned enterprises that were subsequently privatized. For the most part, violations concerned sales of automobiles, which were sold for prices that were lower than the appraisal value, as the legal regulations would have it. In other instances noted, state farms sold, without the government's consent, entire herds of cattle worth tens of millions crowns.

Example 2: A spa

During a privatization-related audit at a spa facility, the SAO found out that the state-owned spa did not account for an investment loan of CZK 85 m and related interest. For the purpose the loan was given, the spa spent only CZK 42.5 m. The loan was to be repaid over 4 years, the spa kept on putting off the repayment and the interest grew. The bank assigned the receivable shortly before the repayment period was up to a private person against a payment. The total value of the assigned receivable, appurtenances included, amounted to CZK 120.4 m. The assignee paid CZK 117.3 m for it.

The government discussed the problematic privatization effort at the spa in the following year, and it agreed that the National Property Fund would pay the spa's receivable and that the spa was going to be privatized through a tender. This prevented the sale of the spa to the creditor, who wanted to resolve the settlement of the debt in this way. The National Property Fund paid CZK 140 m to the creditor and the debt was supposed to be settled. But even after the settlement the creditor continued to raise additional demands, which the spa acceded to even without any proper documents, the founder presented to the Government these demands as proven, and the National Property Fund paid up without adequately checking upon the matter. The total payments the National Property Fund made to the creditor thus went up to CZK 329.0 m. As a portion of the debt was paid by the state-

owned spa, the outcome of the case was such that between them the National Property Fund and the state-owned spa expended a total of CZK 357.0 m for a loan of CZK 85 m.

c) Privatized entities disposed of and liquidated unneeded state-owned assets in a non-conclusive manner, which reduced the value of the assets transferred under privatization.

Under large privatization procedures, the privatization projects earmarked so-called ‘assets not needed for doing business.’ The total value of the enterprise to be sold was then lowered by these assets’ accounting value. Such assets were to be liquidated and the profit from such liquidation constituted revenue to the National Property Fund. Some privatized entities had no records of such liquidation of ‘assets not needed.’ One privatized entity in the area of music industry had no records of liquidating unneeded books and sheet music worth CZK 2.5 m, by which sum the accounting value of the assets being transferred was reduced.

d) The entities audited, the obligors, wrongly released assets under the out-of-court rehabilitation act.

The so-called obligor, who usually happened to be the statutory representative of a state-owned enterprise, released assets on the basis of a restitution claim. The right to recognize a restitution claim rested entirely with the obligor and if he honored the claim, nobody reviewed his decision. Only the courts had jurisdiction if a party with an interest in the matter filed a suit.

Example 3: Luxury hotels

During its audits, the SAO encountered that two luxury hotels in downtown Prague were restituted. Both hotels were classed pub and restaurant establishments and as such they got nationalized pursuant to the act in force back in 1948 since they employed, at any time since 1946, more than 50 employees. The audit established that the obligor released the hotels despite the fact the number of the employees in the said years met the law-stipulated nationalization clause, and therefore the hotels were not supposed to be restituted (one hotel employed 70, and the other up to 230 employees).

e) The National Property Fund in some cases did not follow an approved privatization project or a government resolution, and did not assign all payables to the assignee, set a disadvantageous price of the shares being sold, or accounted belatedly for receivables from the buyers.

It was noted in one audit that the Ministry for the Administration of National Property approved in a privatization project the sale of one state-owned enterprise in a tender. The National Property Fund consequently held a tender but the winner withdrew. The Fund then sold the state-owned enterprise to a cooperative, which never took part in the tender. The fund also reduced the purchasing price by CZK 19.6 m, which were the payables of the enterprise being sold. In another case, the National Property Fund did not include in a purchase agreement any arrangements, as stipulated by the privatization project, concerning the assignment of payables worth CZK 33.3 m.

Another audit noted that the National Property Fund set the price of shares to be sold by the accounting value at the end of the calendar year instead of at the date of sale. The price set in this manner was lower by CZK 44.7 m.

f) In the course of privatization, the large privatization act and the state-enterprise act never stipulated any clear-cut definitions of the powers individual central authorities should exercise. The liquidation process was thus entered even by entities for which a privatization project had been approved or which was already submitted to the National Property Fund for implementation. The entities concerned were under liquidation and were sold on less favorable terms than would have been the case if the approved privatization project were followed.

This observation was made by the SAO in two audits dealing with the privatization of two state-owned enterprises of domestic commerce (Examples 4 and 5).

Example 4: Major department store

- The Ministry for the Administration of National Property approved the privatization project (a tender) for one major department store in a medium-sized city;
- The National Property Fund conducted the tender and chose the winner bidding a CZK 100 m purchasing price;
- The founding ministry exercised its powers pursuant to the state-owned enterprise act and called for liquidation of the entire state-owned enterprise, which included the department store, and did not transfer the property to the National Property Fund for the sale to the winner of the tender. The relationship between the state-owned enterprise act and the large privatization act was delineated only after 4 years of privatization, stipulating that for liquidation the founder had to have consent from the Ministry for the Administration of National Property;
- The National Property Fund recommended to sell the department store as part of liquidation to the winner of the tender for the stated price of CZK 100 m, including debt, encumbrances, etc.;
- The liquidator asked the Ministry for the Administration of National Property for an exemption for direct sale as part of liquidation, which was stipulated by the large privatization act. Without such an exemption, the liquidator was obligated under the law to call a tender for the sale of the assets. Under liquidation, the ministry's consent was all that was needed for a direct sale to a pre-selected buyer, while in the process of privatization the government had to approve any direct sale. The purchasing price was not set by the liquidator in his application, nor by the ministry when granting the approval;
- The liquidator concluded a contract with the tender's winner, according to which the purchase price was not to be less than CZK 80.1 m. In the contract, the liquidator being the seller did not stipulate any protective measure, which would prevent the buyer to dispose of the property prior to paying the purchasing price;
- The buyer sold the department store for the same price;
- Neither the original buyer nor the new owner honored the payables totaling CZK 80.1 m for the purchase of the department store and demanded the payable be reduced. The founder, too, wanted a reduction of the payable but the liquidator did not concur and insisted the full price be paid. The founder removed the liquidator and appointed a new one;
- The new liquidator agreed that a contract on the assumption of the debt between both companies be signed, and pursuant to the contract, the new owner of the department store owed money;
- On the same day, the liquidator concluded a contract on reducing the receivable by CZK 34.8 m as based on an expert opinion. At the same time, he slashed the price by a further CZK 12.2 m for payables that the new owner paid but which originally had to be paid outside of the purchasing price. All in all, the department store was sold for CZK 33.0 m instead of CZK 80.1 m.
- An expert appraised the department store itself at CZK 27.0 m. For the purpose of establishing a lien for a bank, another expert appraised the department store at CZK 73.0 m.

On the basis of the audit above, the SAO audited the procedures at other state-owned enterprises of domestic trade. It was noted that similar methods were applied in other cases as well:

Example 5: Trading companies

- The government approved a privatization project to sell a state-owned enterprise consisting of department stores in Prague to the winner of a non-public tender for CZK 102.5 m. The founder subsequently decided to liquidate and so the assets were never transferred to the National Property Fund. The liquidator asked the Ministry for the Administration of National Property for a direct-sale exemption to the aforementioned party for CZK 102.5 m, and the ministry agreed. The liquidator, however, fixed the purchasing price in such a way that the buyer paid only CZK 10.3 m and for the remainder of CZK 92.2 m he assumed the state-owned enterprise's payables with the Consolidation Bank. He would be obliged to assume them in case of a sale under large privatization upon paying the full purchasing price. The income for the state was thus lower by CZK 63.2 m. The SAO's audit powers made it impossible to find out whether the buyer actually paid the Consolidation Bank for the payables.
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- When the largest state-owned enterprise of domestic trade in Prague was being privatized, the Ministry for the Administration of National Property rejected the sale of the enterprise to a company for CZK 2.2 bn. The ministry decided that the state-owned enterprise would be privatized in such a way that portions of the state-owned enterprise would be turned into a joint-stock company and other separate portions would be sold off in a tender (a large warehouse facility) and in public auctions (16 operating units).
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- Subsequently, only the joint-stock company was privatized. The founder, without proper economic reasoning, resolved to liquidate the rest of the enterprise. The aforementioned company that wanted to purchase the entire enterprise for CZK 2.2 bn acquired in the course of liquidation and privatization into its sole or majority ownership some 60% of the original assets for CZK 545 m, i.e. 25% of the price it originally offered to pay. It did not acquire the assets in tenders or auctions, as the ministry approved at first in the privatization project. Under liquidation, it obtained in direct sale, with the ministry's consent, the warehouse facilities and two department stores. Under further privatization, it obtained, again in direct sale approved by the government, 50.3% of shares of the joint-stock company founded. There were other parties interested to buy said real estate and shares.

g) Audits examining the liquidation methods of state-owned enterprise noted the considerably wasteful attitudes taken by liquidators who paid disproportionate prices for services rendered and significantly chipped away at revenue from liquidation.

Using money from the sale of assets, the liquidators paid for services rendered during liquidation, hiring various legal and professional assistance, as they deemed fit. The liquidators were not subject to the rules of tenders in seeking out such services. If the founder did not oversee them sufficiently, the only restriction liquidators had to cope with was the actual property itself. Liquidators paid for, among other things:

- The liquidator of the already mentioned domestic trade state-owned enterprise paid CZK 18 m to a natural person for legal services related to recovery of receivables, while the receivables amounted to CZK 5.5 m;
- Another trio of liquidators of three state-owned enterprises paid out, with the consent of the founder, CZK 60 m to one company for recovery of receivables, but the recovery amounted to just 50% of the sum paid to the liquidators.

h) In auditing the activities of the Land Fund, deficiencies were noted repeatedly. As already stated, the cause was also in the ambiguous regulation of the Land Fund's powers.

The SAO repeatedly noted that the Land Fund did not keep complete records of the state-owned land under its management, not even 9 years after the land act came into force. Thus, the Land Fund did not enter into its accounting ledgers the entire property transferred from the military forestry farms, leased out unrecorded parcels of land whose area totaled 33 million square meters, and it even leased out land in excess of 2 million square meters, which were not under the Land Fund's management, but rather owned by the state.

The Land Fund did not complete the approved privatization projects approved by government resolutions. It had to accept back assets and repeat a tender with respect of one entity, because contrary to the decision by the Ministry for the Administration of National Property it included in the assets for the first tender also assets worth CZK 3.0 m not exploitable for business purposes. This caused a considerable delay in the selling process and depreciated the property. Under the repeated tender, the property was sold for a price that was lower by CZK 13.0 m. Another audit noted that the Land Fund did not hand over to the assignee certain subdivisions worth CZK 2.2 m earmarked for construction, which were listed in the privatization project. While implementing privatization projects, the Land Fund authorized representative happened to be a person who at the same time was the statutory representative of the assignee.

Furthermore, SAO audits noted that in managing real estate the Land Fund overstepped its powers set by the land act when satisfying restitution claims:

- The Land Fund provided compensation totaling CZK 14.8 m for livestock and fixed assets to persons who did not meet the lawful prerequisites; furthermore, it provided real estate worth CZK 12.2 m, which did not serve the purpose stipulated by law. Pursuant to the land act, the original owner of fixed assets and livestock is entitled to compensation if, inter alia, the condition is met that he would provide for the operation of agricultural or forestry production. The compensation was to be used towards the operation of these productions.
- The Land Fund transferred real estate at prices that did not correspond to prices appraised by experts in expert opinions, or at prices set by Land Fund employees who were not empowered to do so. In this manner, the prices were fixed for land parcels totaling 1.8 million square meters.
- Until 1998, the Land Fund left it up to the beneficiaries to pick up substitute land, which could not have been released under the law. Consequently, land that was considered more attractive market-wise for other than agricultural activity (construction of gas stations, hotels, etc.) was given out. In respect of the meeting of restitution claims, it was further noted that in many cases such claims were subject to speculative purchases. The beneficiaries' claims were honored after a considerable delay, whereas some assignees did not have to wait long.

i) The links of the large privatization act to the commercial code were insufficient indeed. Accordingly, the legal assurances of tenderers were circumscribed in a major way if assets were to be privatized through a tender. The problem arose when a party interested in a privatized property met all the conditions required of the winner as arising under the commercial code, but the property concerned was not assigned to the winner due to a privatization decision made pursuant to the large privatization act during or after the tender. The winner is not entitled to an appeal nor to compensation for costs incurred in respect of the tender. Privatization decisions are not subject to the general provisions on administrative proceedings. The decisions cannot be reviewed by courts. This instance will be dealt with in detail in the case study below.

Summary

The audit findings listed here are serious. It must also be mentioned here that the deficiencies accompanying privatization in the Czech Republic were, in a sense, the price paid for the scope and speed of the privatization process with which it was put into operation. Prior to 1989, there was practically no private property in the Czech Republic. The Supreme Audit SAO has no powers to deduce personal accountability from the audit findings, nor can it impose any penalties. Individual cases pointing to criminal activity have been communicated to the bodies active in criminal proceedings for further investigation.

III. “Financial management of state-owned assets in the process of privatizing healthcare facilities, including the state’s asset stakes transferred to the National Property Fund”: A Case Study

In 2000, the SAO conducted an audit of the financial management of state assets in the process of privatizing healthcare facilities, including the state’s asset stakes transferred to the National Property Fund

The objective of the audit was to check out the privatization process of state-owned spas, concentrating on the correct procedures taken by the state’s central administrative authorities in the course of privatization, and on the implementation by the National Property Fund of approved privatization projects. The period under review was from 1994 through 2000.

The persons audited:

Ministry of Health, the founder of the state-owned spas,
Ministry of Finance, the approving body in the privatization process,
National Property Fund (hereinafter only the “Fund”), which was responsible for the implementation of approved privatization projects,
Státní léčebné Spa Darkov, s. p., Karviná (hereinafter only “Spa Darkov”), and
Státní léčebné lázně Janské Lázně, s. p. (hereinafter only “Spa Janské Lázně”).

The audit was carried out from January through October 2000. A total of ten SAO auditors, from the transport, industry and economy section, from the state budget section, and from two regional sections, were involved. SAO member Ing. Jiří Kalivoda was in charge of the audit and drafted the audit report on the basis of audit protocols. The audit report was approved by the SAO College in January 2001.

I. Introduction to the issues under review

The audit followed up a 1995 SAO audit that primarily checked on compliance with the legal regulations concerning privatization of state assets at organizations founded by the Ministry of Health, among them 5 state-owned medical spas. Furthermore, it tallied with a 1998 SAO audit of the financial management of state assets at the Státní léčebné lázně Třeboň, s. p. (hereinafter only “Spa Třeboň”).

The audit primarily checked on the privatization process at Spa Darkov and Spa Janské Lázně and on the degree of thriftiness exhibited by these state-owned enterprises in managing the state-owned assets in the period after the commencement of the privatization process at the two spas. With respect to Spa Třeboň, only certain aspects in the process of privatization of the spa were verified per motion filed by the Budget Committee of the House of Representatives of Czech Republic Parliament.

In the Czech Republic in 2000, there were 13 separate state-owned spa facilities, whose founder was the Ministry of Health, plus 47 non-state-owned ones, in operation. The more than three times higher proportion of medical capacities at the non-state owned spa facilities was a result of

privatization, primarily in 1992 to 1994. By November 1998, when the Czech government suspended privatization of select healthcare facilities, some 80 % of spa facilities had been privatized.

Spa Darkov, Spa Janské Lázně and Spa Třeboň were founded in 1990 as state-owned enterprises by the then Ministry of Health and Social Affairs, and proposed for privatization in 1993 or 1994. The basic privatization projects submitted by the management boards of these state-owned enterprises were approved. On the basis of the projects, the spas were supposed to be sold to a pre-selected acquirer. The spas were placed in the category of privatized healthcare facilities with a firmly fixed scope and structure of healthcare services.

The decisions to privatize Spa Darkov and Spa Janské Lázně were issued by the Czech government in its resolutions of June 1996 and June 1997, respectively.

Spa Třeboň was supposed to be privatized according to the project submitted by the organizer (Ministry of Health) and the acquirer was supposed to be picked up through a tender. The decision to privatize Spa Třeboň was issued by the Ministry of Finance in August 1996.

II. The process of privatization of state-owned medical spas: The findings

1. The procedures proposing to privatize Spa Darkov, Spa Janské Lázně and Spa Třeboň lacked any concept.

At the end of 1997, the Ministry of Health initiated a review of the decisions to privatize certain healthcare facilities, medical spas included. It demanded that they continue to operate for the time being as state-owned enterprises. It eventually changed the decisions to privatize the aforementioned medical spas, facilitated by a large privatization act provision, which stipulated:

“The privatization decision may be changed by the body empowered to issue it only in cases when, after the decision had been made, serious facts do subsequently come out which were not known at the time the privatization decision was made and which would have had a substantial impact on the original decision-making process concerning privatization.”

Substantiating the change, the Ministry of Health listed as the principal reason that the privatization experience at the working and highly specialized healthcare facilities, accompanied by the high debt burden and the requirement to preserve the scope of health care on offer simply did not give any guarantee for the preservation and further development of the existing activities.

a) With respect to Spa Darkov and Spa Janské Lázně, the reasons, as formulated by the founder, for changing the privatization decision were apparent prior to the issuance of the decision to go ahead with privatization. The Ministry of Health stated that in particular:

- More than 95 % patients treated were covered by health insurance,
- Demands on the treatment of adults exceeded the facilities’ capacity,
- Continuation of the current activities at both spas was in the public interest,
- The activity of both spas was not subsidized by the state,
- Privatization would necessarily hike up the price of medical treatment for the insured,
- Private owners may tend to look for wealthier clients and activities that are less cost-intensive.

On the basis of the supporting documents submitted by the Ministry of Health, the Czech government by an April 1999 resolution cancelled all decisions to privatize healthcare facilities that had not been implemented by that time and all the proceedings that had preceded such privatization

decisions. Begun in 1995, the privatization process at Spa Darkov and Spa Janské Lázně was never completed and both spa facilities remained state-owned enterprises.

b) With respect to Spa Třeboň, a tender was announced for the sale of the spa. On 28 November 1997, the National Property Fund notified the winner that his bid was chosen. Although on 6 February 1998, the Minister of Finance asked the Fund's Executive Chairman that the executive committee "make no conclusion, if at all possible," the executive committee of the Fund evaluated on 9 February 1998 the materials for the implementation of the tender and resolved:

- To agree to the conclusion of a purchase agreement with the tender's winner and transfer the assets of Spa Třeboň to the Fund at 16 February 1998;
- To conclude with the acquirer a conditional withdrawal from the purchase agreement at the date of the remittance of the purchasing price;
- To forgive debts encumbering the Spa Třeboň assets.

Prior to this, the Ministry of Health submitted on 4 February 1998 to the Czech government a proposal to execute free-of-charge transfer of the Spa Třeboň assets to the City of Třeboň. These were the reasons:

- The assignment of assets to the City's ownership will take away arguments from the critics of the not entirely "happy" privatization effort and the case will not be politicized;
- Due to the court judgment that a receivable of CZK 111 m has to be paid to the creditor, Spa Třeboň's account was attached, which put the very existence of the entity into jeopardy.

Further to its decision of 9 February 1998, the Fund asked on 11 February 1998 the founder to transfer the privatized assets at 16 February 1998. At the same time, the Fund advised the Ministry of Health about the guarantees on the remittance of the purchasing price. The Fund stated it considered documents submitted by the winner of the tender to be a sufficient guarantee for the financial coverage of the purchasing price bidden at CZK 301 m, with the proviso that the guarantees for CZK 189 m would be covered by a mutual bank guarantee as requested by the Fund on 10 February 1998 from the financial institution concerned.

On 16 February 1998, the Fund advised the Ministry of Health that the assets of Spa Třeboň had not been transferred and stated that by doing so the Ministry of Health as the founder of that state-owned enterprise was in breach of the large privatization act.

Even after this notice, the founder did not transfer the assets to the Fund.

Upon suggestion by the Ministry of Health, the Czech government subsequently adopted a resolution on the matter on 18 February 1998, concerning the progress of privatization of state-owned enterprise Spa Třeboň. It ordered the ministers of finance and health, respectively, to submit to the Czech government a paper proposing further privatization steps at Spa Třeboň, and the minister of finance and the chairman of the Fund's presidium not to take irreversible actions in the privatization efforts at Spa Třeboň.

With regard to the further privatization steps at Spa Třeboň, there the Ministry of Finance, which had issued the privatization decision and was empowered to alter it, and the Ministry of Health, which was the spa's founder, both entertained differing ideas.

Being the authority to modify the privatization decision, the Ministry of Finance stated it was unaware of any serious facts to necessitate changes in the privatization method of the assets of Spa Třeboň, or of any new fact that would substantiate free-of-charge transfer to the City of Třeboň. It did not recommend that a new decision changing the privatization method be issued prior to the potential cancellation of the tender.

The Ministry of Health opined that the tender had to be cancelled, primarily on these following grounds:

- Privatization took a long time and the tender’s result was no guarantee that the purchasing price would be paid, since the winner did not demonstrate solvency or furnished sufficient guarantees covering the purchasing price;
- There was a risk of depreciation and subsequent liquidation of Spa Třeboň by selling off the real estate due to an inability to repay the bank loan from the spa’s financial results;
- Due to the court judgment that a receivable has to be paid to the creditor, Spa Třeboň’s account was attached, which put the very existence of the entity into jeopardy;
- City of Třeboň gave an unambiguous guarantee of adhering to the privatization terms; because of its own assets, it would be a stable owner, and it wanted to assure 100% utilization of the bed section for Czech patients;
- City of Třeboň undertook preliminarily to subsequently repay the amount owed to the creditor from the future income of the spa.

The Ministry of Health in its opinion did not state the fact that the Fund on 9 February 1998 resolved to forgive debts encumbering the Spa Třeboň assets.

Overriding the differing opinions of the Ministry of Finance and the Ministry of Health (and their different legal standings in the privatization process of Spa Třeboň), the Czech government in its April 1998 resolution concerning the progress of privatization of State-Owned Medical Spa Třeboň, ordered the Fund to cancel the result of the last round of the tender to sell Spa Třeboň, and ordered the Minister of Finance to modify the privatization method of these assets to free-of-charge transfer to the City of Třeboň. Further, it approved the transfer, including the privatization terms. One of these was that the City of Třeboň would refund to the Fund the amount already paid for Spa Třeboň.

On the basis of the aforementioned resolution of the Czech government, the Ministry of Finance executed in June 1998 the change in the privatization decision from the tender method to the method of free-of-charge transfer of moveable things and real estate to the City of Třeboň.

2. The course of privatization of Spa Darkov, Spa Janské Lázně and Spa Třeboň was accompanied by much confusion that exerted a negative impact on privatization of these entities.

a) As requested by the Ministry of Health, Spa Darkov produced in September 1995 a basic privatization project. It failed to follow the binding guidelines on how to compile a privatization project pursuant to the appropriate decree. Certain data were not given, or they were imprecise or incomplete, in the basic privatization project. Thus:

- Spa Darkov did not fill out a form specifying the assets, which are to be left in the state’s ownership (in this case, the wells of natural mineral water of healing properties),
- Financial security given in the relevant form was inconclusive,
- The privatization project listed land worth CZK 6 m and measuring some 150,000 square meters, which pursuant to the act regulating the ownership relationships to land and other agricultural assets had been transferred to the management by the Czech Republic Land Fund.

Still, the basic privatization project was accepted by the Ministry of Health and submitted by the then Ministry for the Administration of National Property and Its Privatization (hereinafter only the “Ministry for Privatization”) in May 1996 to the Czech government for approval. The Ministry for Privatization, following the decision to privatize Spa Darkov as issued by the June 1996 Czech government resolution, asked the Ministry of Health to ensure updating the required documents to render them compliant with the government-approved Principles of further privatization procedures

under the large privatization act. The Ministry of Health failed to do so, although, pursuant to the aforementioned Principles, the entity to be privatized had to furnish updated documents within 14 days of receipt of the privatization decision and to submit them to the founder. Having reviewed them, the founder would then deliver them immediately to the Ministry for Privatization. It was not until March 1997 that the Ministry of Finance, to which powers in that area had been transferred by law effective 1 July 1996, requested of the Ministry of Health a speedy submission of the updated documents. According to a written communication from Spa Darkov, the updated privatization project was sent to the Ministry of Health as late as September 1997.

The Ministry of Health, however, did not even then forward the updated privatization project to the Ministry of Finance, stating that it had been executed just in one hardcopy and submitted to the appropriate Deputy Minister for approval. He did not approve the project and did not refer it for further proceedings.

Therefore, the privatization project could not be forwarded by the Ministry of Finance to the Fund for implementation. No purchase agreement could be concluded by and between the Fund and the selected acquirer. Spa Darkov thus joined the entities subject to the November 1998 resolution of the Czech government suspending privatization of healthcare facilities, by which, on an initiative of the Ministry of Health, privatization of those healthcare facilities, for which no agreement had been yet concluded between the Fund and the acquirer concerned, was suspended from 1 December 1998 through 30 April 1999.

b) As requested by the Ministry of Health, in September 1995 Spa Janské Lázně submitted a basic privatization project. Certain data required by the binding guidelines for the compilation of privatization projects as enforced by the relevant decree were altogether missing from the privatization project or listed in an insufficient manner. For example:

- Remodeling & refurbishing costs of assets paid from the operating funds,
- Lease agreements for 166 apartments were not shown,
- There was no mention of a promised loan to pay for the purchasing price and no reference to the blocking of a deposit to secure the down payment on the purchasing price
- The lease arrangements of a major facility of accommodation were omitted.

After many discussions, the basic privatization project was accepted, even with the aforementioned deficiencies, and in May 1997 it was submitted to the Czech government for approval. Upon the decision to privatize Spa Janské Lázně, issued by the Czech government's June 1997 resolution, the Ministry of Finance asked for the updated privatization documents.

Within the meaning of the government-approved Principles of procedures to complete privatization under the large privatization act, the entity to be privatized had to furnish updated documents within 14 days of receipt of the privatization decision and to submit them to the founder. Having reviewed them, the founder would then deliver them immediately to the Ministry of Finance. Spa Janské Lázně, however, handed over the updated documents as late as February 1998, although the privatization decision from the Ministry of Finance was received in July 1997 and the founder's request for submission of documents in August 1997.

The Ministry of Health, which at the time was already seeking a revocation of the privatization decisions concerning select healthcare facilities, spas included, held up the updated documents, and handed them over to the Ministry of Finance as late as May 1998 after having been invited to complete privatization in the standard manner. In June 1998, the Ministry of Finance forwarded the documents concerned to the Fund for the implementation of direct sale to the designated acquirer, with whom the Fund in the same month, on 15 June 1998, concluded an accord concerning the payment of 10 % of the net-book value of the assets and the provision of a document on funds to pay

for the remainder within 90 days of the signing of the accord. The designated acquirer failed to comply with the commitments and the Fund extended the deadline by another 45 days.

The designated acquirer, however, did not meet his commitments even then and the privatization efforts at Spa Janské Lázně were consequently suspended on the basis of the November 1998 resolution of the Czech government.

c) With respect to the sale of Spa Třeboň, the Fund called for in October 1997, pursuant to the large privatization act and the commercial code, a repeated tender for the most suitable bid to conclude an agreement on the sale of the privatized assets of Spa Třeboň. The Fund stipulated in the terms of reference that the winner would have an obligation to furnish within 30 days of receipt of notification on the acceptance of his bid a document attesting to the financial coverage of the balance of the purchasing price (minus the bond paid); it reserved the right to assess such a document and set the possibility of extending an additional time limit for submitting of or supplementing the document, and it set the obligation to sign within 60 days of the winner's fulfillment of the aforementioned duty an appropriate agreement on the sale of the privatized assets.

On 28 November 1997, the Fund notified the winner that his bid was selected. Within the deadline stipulated by the terms of reference, the winner submitted on 18 December 1997, with regard to the document on the financial coverage of the CZK 301 m purchasing price, a bank's promissory note, which was not recognized by the Fund as a sufficient one. A new deadline of 31 January 1998 was set. By that deadline, the winner furnished only bank promissory notes, including the bond, totaling a mere CZK 112 m; as of the deadline he failed to furnish a document that would guarantee payment of the purchasing price in full. Upon evaluating additional documents submitted by 9 February 1998, the Fund on the same day resolved to enter into a purchase agreement with the winner (conditional withdrawal from the purchase agreement at the date of the remittance of the purchasing price) and to have the assets of Spa Třeboň transferred to the Fund at 16 February 1998.

The Fund's decision, however, was never implemented due to the Czech government's resolutions adopted in February 1998 and April 1998, and following upon that, due to the subsequent modification of the privatization decisions executed in June 1998 by the Ministry of Finance. Spa Třeboň was transferred on the basis of an agreement on free-of-charge assignment to the City of Třeboň in July 1998.

Using the example of this case, the Supreme Audit Office pointed out a certain legislative loophole. The legal regulations on privatization did not stipulate how the Fund should proceed if the tender pursuant to the Commercial Code was ended but no assets were transferred to the Fund. The Fund sent on 22 May 1998 to the winner a "Notice on the cancellation of the award in a tender." The Fund stated there that the award in the tender was cancelled in compliance with the April 1998 government resolution. At the same time, the Fund advised the winner that the bond had been refunded to the appropriate account.

III. Findings in the area of financial management of state-owned assets

1. In June 1997 Spa Darkov provided, after the launch of privatization, an unauthorized guarantee using state-owned assets for a loan, interest included, of some CZK 11 m to a natural person.

The loan was provided to the wife of a top Spa Darkov employee to remodel a real estate property. In this matter, a complaint on the suspicion that a crime might have been committed was filed in 1998 with the bodies active in criminal proceedings.

2. It was noted during an audit at the Ministry of Health that the liquidator of state-owned enterprise Státní léčebné Spa Třeboň "in liquidation" sold via a purchase agreement of July

2000 to the City of Třeboň a total of 11 land parcels (total area of some 500,000 square meters), where the natural deposits of peat of healing properties are located.

These deposits of peat happen to be natural resources declared by a Ministry of Health measure to possess healing properties. Pursuant to the care for the people's health act, natural curative resources are owned by the state and for that reason they were, within the meaning of the respective provision of the privatization act, removed from the privatization intentions regarding Spa Třeboň.

3. In some cases, funds earmarked for the operating activity at Spa Darkov and Spa Janské Lázně were wastefully spent:

a) On the basis of a lease agreement, in 1997 Spa Darkov purchased an automobile whose total acquisition price was about CZK 1.5 m. The new general manager at Spa Darkov terminated the lease agreement earlier, after 8 monthly installments totaling more than CZK 900,000, as there was no need for the automobile. After the lease agreement was reconciled, Spa Darkov was refunded less than CZK 300 thousand. Spa Darkov thus spent more than CZK 600 thousand in a wasteful manner.

b) In December 1995 Spa Janské Lázně purchased one-half of a hotel, for which they had a 5-year lease agreement since March 1995. At the same time, Spa Janské Lázně extended the lease period for the second half of the hotel to 10 years. In July 1996, Spa Janské Lázně purchased the second half as well and terminated the lease relationship. The purchase agreement did not correctly account for the rent of CZK 11 m paid in advance for the full period of the lease. Spa Janské Lázně thus wastefully paid a sum of nearly CZK 800,000.

4. In the accounting (and records) of assets certain accounting act provisions were breached, resulting in distortions of some data in the privatization projects.

a) Spa Janské Lázně did not account on the "Land" account for 29 land parcels (as noted) whose total area was nearly 10,000 square meters), to which the Spa had the right to manage, but did account in the account for 2 (as noted) land parcels, to which the Spa had no right to manage.

b) The opening balances of certain balance-sheet accounts (short-term receivables and trade receivables) as disclosed by Spa Darkov in the annual financial statements at 31 December 1997 did not match the closing balances at 31 December 1996.

c) Spa Darkov did not account in its off-balance sheet accounts (pursuant to the chart of accounts and the accounting procedures) for land under the management by the Land Fund and for the real estate they used and that was leased from natural and legal persons totaling at least CZK 5 m. Nor did the Spa account for the guarantee for the CZK 11 m loan to a natural person, as mentioned above. Further, Spa Janské Lázně did not account in its off-balance sheet accounts for the leased hotel, land and internal furnishings included.

IV. Summary and assessment

The audit checked on the privatization process at Spa Darkov, Spa Janské Lázně and Spa Třeboň (in respect of Spa Třeboň only the procedures taken by the Ministry of Health, Ministry of Finance and the National Property Fund, especially since 1998, were focused on). At Spa Darkov and Spa Janské Lázně, the financial management of these state-owned enterprises with the state-owned assets in the period after the launch of privatization in 1995 was checked.

The privatization process at the aforementioned state-owned spas went on without any strategy. In regard to Spa Darkov and Spa Janské Lázně, the privatization process that commenced in 1995 was stopped in April 1999 immediately prior to the implementation, and all the steps taken up to that date were nullified. The reason was a change of opinion on the part of the Ministry of Health

regarding privatization of certain health facilities, which the Ministry of Health proposed for privatization. Privatization of Spa Třeboň was completed because in 1998 the Czech government, upon suggestion from the Ministry of Health, ordered the Ministry of Finance to modify the privatization decision from a tender to free-of-charge transfer to the City of Třeboň; in its decision-making process, the Czech government took into account the differing opinions held by the Ministry of Health and the Ministry of Finance, respectively.

Although the tender to sell Spa Třeboň had been formally legally concluded by delivering an announcement to the winner that his bid was selected, the Fund cancelled the award in the tender on the basis of the April 1998 resolution by the Czech government.

In the implementation of the decision to privatize Spa Třeboň and the subsequent modification, there occurred a clash between the procedure pursuant to the privatization act and the procedure pursuant to the commercial code. The modification of the privatization decision pursuant to the large privatization act was made at a time when the tender was ended that had been called in accordance with the large privatization act and the commercial code. Such a procedure makes it considerably harder to carry out an efficient audit and to assess the legality of the procedure's course. In addition, the SAO pointed out to the fact that according to the legal regulations delineating the privatization process, the decisions concerning privatization are not subject to the general provisions on administrative proceedings, nor can such decisions be reviewed by court. The procedure with respect to privatization of Spa Třeboň resulted in a negative impact on the financial management of the Fund. The figure put on the loss is at least CZK 200 m.

The submission to the Fund of the approved privatization projects for implementation was time and again put off both by the applicants and by the Ministry of Health, which in the cases of Spa Darkov and Spa Janské negatively impacted also their respective management of the state-owned assets. The parties submitting approved privatization projects disregarded the period set for the updating of the projects (Spa Darkov by more than a year and Spa Janské Lázně by nearly six month). That period turned out to be even longer due to the administrative delays on the part of the Ministry of Health in the end of 1997 and in 1998. The Spa Darkov privatization project was never handed over to the Fund for implementation, that of Spa Janské Lázně as late as June 1998, although the privatization decisions were approved by the Czech government in June 1996 and June 1997, respectively. The implementation of privatization at the state-owned medical spas was being postponed also because at the privatization project approval stage an insufficient degree of attention was paid to the financial standing of the purchasing price by the presumed acquirers (assignees).

The state authorities involved did not give a proper consideration to the state-owned assets, which pursuant to the constitutional or special acts can be only owned by the state. This audit noted that in breach of the law, there were transferred to the City of Třeboň such parcels of land with the deposits of peat, which, being natural resources of healing properties, were supposed to remain the exclusive property of the state.

Prague, 14 March 2003

Written by the Privatization Working Group and by SAO member Ing. Jiří Kalivoda