

**Privatization**



**Effectiveness Audit:**

**Objectives and Vehicles**

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# State Property Structure



# Uses & Acquisitions Program

## Objectives:

- Income to be generated by state property (federal budget revenues)
- Appreciation of assets
- Influence on markets

# Privatization Program

## Causes and Objectives

- Lack of manageability
- Developing competition
- Attracting investments
- Generating revenues from the divestment of state-owned assets

# Restructuring State Property

	2002	2003	2004
State-owned enterprises	9 846	8 820	
Stockholding companies with state interest	4 222	4 035	
Properties sold:			
plan	1 126	435	719
actual	185	187	

A total of **749** enterprises in federal ownership were privatized during 1998-2002.

# Restructuring State Property (continued)

**2000** state-owned enterprises and **500** predominantly majority stockholdings should remain under state ownership by the end of 2008.

Reasons:

1. Inherent inefficiency of state-owned enterprise management
2. Low ROE of minority/non-controlling federal shares

# Limitations and Risks:

1. Increasing burden on the Government in its role of stockholder.
2. Stock market destabilization as a result of oversupply of liquid state-owned assets.
3. Feeble attraction of minority stock as an investment.
4. Premeditated bankruptcy of privatized companies.

# Limitations and Risks (continued):

5. Missed fiscal revenues.
6. Wrong choice of buyer.
7. Shrinking investment in the real sector of the economy.
8. Restrained economic growth.

# Privatization: Speed vs. Quality

## Auditing the privatization strategy

1. Non-marketable minority stock quickly sold out (Dutch auction, sales without starting prices).
2. Liquid minority shares placed on the stock market. E.g., with several shareholder groups.

# Privatization: Speed vs. Quality (continued)

## 3. Disposal of majority stock to generate maximum proceeds:

- ✓ Due diligence
- ✓ Stimulate the upsurge of liquidity (consolidate assets and financial statements, ensure transparency of corporate reporting and organization)
- ✓ Expert review by state audit institutions of presales procedures and asking prices

The state property management and privatization model existing in Russia for the last 10 years has proven to be inefficient. Low budget revenues from property uses and privatization, unauthorized disposal and misappropriation of state assets.

The Government has proposed a new model for state property management based on two keystones:

1. The structure of state property should match the functions of the state alongside with a consistent policy of privatization, restructuring and liquidation of redundant property.
2. State property management and privatization should be based on medium-term programs. Under systematic state control.

This model suggests the following:

1. A Federal Property Classification by statutory management objectives for each asset based on the need to carry out the activities and tasks of the state.

Eventually, the composition of state property elements should fit the activities of the state, and the property should be efficiently operated.

Property necessary for the state to carry out its activities may be transferred on concession terms. Concession arrangements allow attracting private investment into the public sector and improving the quality of goods and services.

2. A 3-year Federal Property Management and Privatization Program will be adopted, including a Uses Plan, an Acquisitions Plan and a Privatization (divestment) Plan. The development of this Program must be rigidly connected with the federal budgeting process.

The Uses Plan includes:

- goals and objectives of the state in its capacity of property owner;
- preparation of operational programs for state-owned enterprises and corporations;
- appreciation of assets;
- influence on markets;
- a forecast of federal property earnings and a justification of the associated running costs.

The Acquisitions Plan envisages new property to be acquired by developing new projects through state investment and civil law acquisitions.

The Privatization Plan should envisage:

- objectives, including inadequate asset manageability, encouraging competition, attracting investments;
- proposed methods for the divestment of state property;
- a forecast of revenues, as well as validation of expenditures, since a presales audit, for instance, is an expense.

This slide shows quantitative structural changes in state property. In the beginning of 2004 - 8,820 state enterprises and some 4000 stockholding companies with state equity interest. At that, almost 85 percent of stockholdings represent minority or non-controlling stakes. Amidst inadequate and inefficient asset management which creates real risks of loss of state-owned assets the Government intends to reduce the number of state-owned enterprises from 9 to almost 2 thousand by the end of 2008. And retain not more than 500 out of over 4000 stockholdings under state ownership.

The eventual outcome of this strategy cannot fail to arouse misgivings.

Firstly, not more than 190 assets succeeded selling in one given year.

Furthermore, there are substantial macroeconomic limitations as follows:

- increasing burden on the state in its role of stockholder in the event of massive transformation of state-owned enterprises into stockholding companies;
- destabilization of the stock market as a result of excess supply of state-owned assets;
- short-received budget revenues;
- feeble attraction of minority stock as an investment;
- premeditated bankruptcy of privatized companies;

- shrinking investment in the real sector of the economy;
- restrained economic growth.

In auditing the effectiveness of a privatization strategy, the degree of liquidity of a divested asset can be used as a key criterion.

Closing of a deal is admittedly a success in low-liquidity divestitures. Regardless of the sales price.

A maximum sales price could be adopted as a criterion for the disposal of liquid minority interests in the presence of several structured shareholder groups.

The maximum sales price, with growing investment and business value in the long run, will also serve as a criterion for the disposal of controlling equity interests or complex multi-entity properties.

Auditing the effectiveness of a state property privatization program entails a review of the risk matrix, mitigation plans and risk management.

Risk matrices and mitigation plans should typically be developed by the relevant state authorities and managers of state-owned corporations.

An audit undertaken by state audit institutions should, in turn, review:

- risk matrices and the relevant mitigation plans;
- mitigation plans and risk management.

Let us provide a few examples.

<b>RISKS</b>	<b>Risk Management</b>
1. Feasibility and justification of state property privatization	<ul style="list-style-type: none"> <li>- Privatization Plan and current equity share of the state;</li> <li>- Manageability of the entity;</li> <li>- influence on markets, delivery of strategic and social goals;</li> <li>- ROI history (budget strains);</li> </ul> <p>adequate level of decision-making required to privatize entities (federal law, President, Government).</p>
2. Asset stripping, depreciation of assets	<ul style="list-style-type: none"> <li>- control over the incorporation of subsidiaries and related companies;</li> <li>- ensuring control to retain state interest, including parent stakes in the subsidiaries;</li> <li>- control over dividends from preferred stock;</li> <li>- control over major deals and related party transactions.</li> </ul>
3. Premeditated bankruptcy	<ul style="list-style-type: none"> <li>- control over borrowing, bankers' bonds, debt transfer, etc.</li> </ul>

- existence of contract management procedures

adequate internal controls, controls on receivables and contractor performance.

Applying rules as necessary to comply with the Sarbanes-Oxley Act:

- responsibility of the Main Board Audit Committee;
- transparency and reliability of financial statements;
- enhanced responsibility of external auditors;
- responsibility, including criminal responsibility, of company management for false financial reporting and fraud;
- management responsibility to ensure adequate internal controls. For example, the COSO model includes the internal control environment, risk matrix/appraisal, control procedures (management action to mitigate risks), inter-corporate communications and monitoring – assessment of internal controls.

4. Validity of privatized

assets' market value

- audit of the state of assets;

- transition towards a single share for vertically integrated companies;

- management motivation at privatized enterprises;

- controls on generated revenues;

- controls on investment, audit of investment efficiency;

- dividend policy.

Let us also note a key point in the Privatization Effectiveness Audit. It is an independent expert review performed by a state audit institution of the sales price set by the Government.

The sales of major and strategically important state-owned assets must only be effected after a state audit institution has issued its independent opinion on presales procedures and finalized its expert review of the starting price.

Finally, to complete the Privatization Effectiveness Audit:

- audit legal compliance with the established procedures for the disposal of state assets;
- review buyers' performance of their obligations;
- confirm receipt of cash by the federal budget;
- verify validity of expenses associated with presales preparation and disposal of state-owned assets.

The Privatization Effectiveness Audit must cover:

- feasibility justification for the divestment of federal stockholdings (strategic and social significance of state participation, size of the equity interest, dividend history, potential sales proceeds, etc.);
- status of the assets of the privatized company. This procedure is necessary to prevent misappropriation of assets and profits. It entails a detailed review of founders' activities, an audit of business and financial relations between parent and daughter (related) legal entities;
- audit of the equity capital structure of the privatized company. This is especially necessary for so called vertically integrated (holding) companies. The problem is that holdings often lose control over the subsidiaries (e.g., if dividends on preferred stock are irregular) eventually leading to a significant reduction in the sales price and lost federal budget revenues.

To prevent this situation, and for the parent company to effectively manage its subsidiaries, the strategic mistake of the 1992 privatization model must be rectified by introducing a single share. Obviously, in some cases this will lead to a reduction in the size of state equity interest, but will also stimulate the upsurge of liquidity, encourage competition in stock trading and, consequently, increase federal income. We should also consider the state's possibility to increase its stake in the subsidiaries during the transition to a single share by acquiring shares on the open market, and by investing assets under federal ownership, for example, land on which the subsidiaries are located;

- further, the above must be followed by an expert assessment of the Government's starting price to be performed by an independent appraiser. It is, therefore, necessary to legally prescribe that any disposal of federal

shares of companies with a consolidated book value (including the assets of the subsidiaries and related companies) of, say, more than 5 million times the minimum income threshold may be effected by the Government only upon an opinion of the Accounts Chamber of the Russian Federation with respect to the audit findings on the presales procedures and starting price review.

With that, the disposal of shares of stockholding companies appearing on the list of strategic enterprises must be in compliance with the above procedures regardless of the book value of fixed assets of such enterprises;

- audit of legal compliance with the established procedures for the disposal of state equity interests;
- verification of buyers' performance of their obligations, including payment for the shares;
- receipt of cash by the federal budget; justification of seller expenses (i.e., of the Russian Federal Property Fund).