Executive summary of the public audit report

FINANCIAL RISK MANAGEMENT IN STATE-OWNED ENTERPRISES AND PUBLIC ESTABLISHMENTS

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ABBREVIATIONS AND DEFINITIONS

'Diversification' means a resource allocation strategy to reduce risks. Diversification requirements in the area of finances apply to institutional investors by indicating the limits of investment in certain securities and assets. The basis of diversification is the assumption that the value of different assets is changing in opposite directions[1].

'Issuer' means a private company or a government institution (Ministry of Finance, central bank) which issues money or securities[2].

'Financial resources' means the share in monetary expression allocated to fund economic development. Sources of financial resources include sources of monetary funds, securities, money market funds (money), grants, subsidies, and other non-repayable sources of funds[3].

'Financial engineering instrument' means the instrument provided for in Article 44 of Regulation No. 1083/2006[4]. Financial engineering instruments are implemented under agreements on the implementation and funding of financial engineering instruments. The final beneficiary of the financial engineering instrument is a natural or legal person funded by the manager of the financial engineering instrument implementing this instrument.

'Guidelines' means the Financial Risk Management Guidelines for State-Owned Enterprises.

'Credit rating' means an opinion regarding the creditworthiness of an entity, a debt or financial obligation, debt security, preferred share or other financial instrument, or of an issuer of such debt or financial obligation, debt security, preferred share or other financial instrument, issued using an established and defined ranking system of rating categories[5]. The bank credit ratings mentioned in this report are long-term borrowing credit ratings.

'Monetary resources' means company assets expressed in the form of money.

'State-owned enterprises' means state enterprises, public establishments, joint-stock companies, and private limited liability companies the major ownership of which (50 per cent of shares and 1 share) belongs to, or has been established by, economic entities attributed to the government sector[6].

[1] Glossary of the daily Verslo žinios (Business News), accessed at http://zodynas.vz.lt/Diversifikavimas.

[2] Glossary of the daily Verslo žinios (Business News), accessed at http://zodynas.vz.lt/emitentas.

[3] Martinkus B., Žilinskas V. Ekonomikos pagrindai [Fundamentals of Economy]. Kaunas, 2001, 524 p.; Gineitienė Z., Korsakaitė D, Kučinskienė N, Tamulevičius J. Verslas. Vilnius, 2003. P. 153–155.

[4] Rules for administering and funding finance engineering instruments approved by Order No. 1K-334 of the Minister of Finance of the Republic of Lithuania of 24 October 2008, par. 3.

[5] Regulation (ECOLOGICAL STATUS) No. 1060/2009 of the European Parliament and of the Council of 16 September 2009 on credit rating agencies, Art. 3(1)(a).

[6] Ministry of Finance, Ministry of Economy. Financial Risk Management Guidelines for State-Owned Enterprises, 2012.

According to the Procedure for exercising the property and non-property rights of the state in state-owned enterprises adopted by Resolution No. 665 of the Government of the Republic of Lithuania of 6 June 2012, public establishments are not assigned to state-owned enterprises.

EXECUTIVE SUMMARY

It is relevant for the state to ensure efficient management not only of public monetary resources but also of other financial resources related to the government sector, i.e. those of state-owned enterprises.

The issue of efficient financial risk management has become particularly relevant after the bankruptcy of bank Snoras in 2011, which caused loss of funds for 34 state-owned enterprises, state-owned joint-stock companies, and private limited liability companies. The amounts lost exceeded LTL 207 million[7].

In order to improve the management of state-owned monetary resources, Financial Risk Management Guidelines for State-Owned Enterprises were developed in 2012 at the initiative of the Ministry of Finance, based on international best practice examples[8]. The purpose of the Guidelines is to recommend key principles to be applied for the formulation of the financial risk management policy of state-owned enterprises.

The Financial Risk Management Guidelines encouraged enterprises to regulate their financial risk management: 55 per cent of the audited enterprises which had corporate documents on financial risk management in place approved these documents following the publication of the Guidelines.

The objective of the audit was to assess the application of financial risk management instruments by state-owned companies, i.e. to see whether:

- financial risk management principles have been established;
- the financial risk management procedure has been followed;
- financial risk is managed in the absence of a financial risk management procedure;
- the Law on Public Procurement[9] is observed when purchasing banking and financial services;
- the pledging of accounts and rights of claim is an effective fund protection instrument in case of the bankruptcy of the credit institution;
- the publicly available data on the credit risk indicators of commercial banks is sufficient to evaluate the credibility of the bank.

The audit was conducted at the Ministry of Finance, Ministry of Economy, Public Procurement Office, 29 state-owned enterprises, joint-stock companies, private limited liability companies, and public establishments. Information was gathered from nine ministries[10] to the governance area of which the audited companies belong. The state-owned companies, joint-stock companies, private limited liability companies, and public establishments were surveyed on the application of public procurement when purchasing banking and investment services.

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[7] According to the data of the Governance Coordination Centre as of January 2014.

[8] Department of Finance Canada. Financial Risk Management Guidelines For Crown Corporations. Accessed at http://www.fin.gc.ca/activty/pubs/frmcc-grfse-eng.asp

[9] Law of the Republic of Lithuania on Public Procurement, 13 August 1996 No. I-1491 (version No. X-471 of 22 December 2005).

[10] Ministry of Environment, Ministry of Energy, Ministry of Culture, Ministry of Transport and Communications, Ministry of Health, Ministry of Education and Science, Ministry of Justice, Ministry of the Interior, Ministry of Agriculture.

The audit covered the period 2012-2013, data of the year 2014 was also used to analyse changes.

The following public audit conclusions and recommendations were drawn upon the assessment of the audit findings.

CONCLUSIONS

1. When managing monetary resources and conducting other financial transactions necessary for ensuring their business activities, state-owned enterprises are exposed to financial risks; however, the assessment of 29 enterprises during the audit found there is insufficient management of the financial risk in the state-owned enterprises, with too little emphasis laid on the development and implementation of the financial risk management policy:
   1.1. 31 per cent of the audited enterprises within the governance areas of the Ministers of the Interior, Agriculture, Health, Education and Science, Finance, and Culture do not have any corporate documents on financial risk management. Two enterprises within the governance areas of the Minister of the Interior and the Minister of Education and Science failed to approve financial risk management documents even after they had lost almost LTL 17 million due to the bankruptcy of bank Snoras.
   1.2. The financial risk management process is not regulated in almost half of the enterprises:
      - persons and/or units to be responsible for the preparation and submission of investment proposals and decision-making have not been designated in 48 per cent of the audited enterprises;
      - no accountability to the senior management for investment has been provided for in 44 per cent of the enterprises.
   1.3. 28 per cent of the enterprises have not determined the financial instruments for investing their temporary idle funds.
   1.4. Financial risk management limits have been set only in enterprises which have an approved financial risk management document.
   1.5. The enterprises have not been sufficiently diversifying their financial resource: 31 per cent of the audited enterprises have not been diversifying, or have been inadequately diversifying, their financial resources by economic entities.
2. It is not clear how to apply the Law on Public Procurement in managing financial risk and purchasing banking and investment services, therefore, enterprises do not always follow the requirements of this law.
3. The Law on Public Procurement and the Methodology for Estimating the Value of Public Procurement do not indicate how the purchase value should be estimated when purchasing banking and investment services and generating revenue. Therefore, the enterprises have not been classifying investments in fixed-term deposits as services subject to the provisions of the Law on Public Procurement, or choosing a wrong method of procurement.
4. It is difficult for enterprises to evaluate changes in the condition of banks and the credibility of commercial banks in due time because it is not always clear whether the credit risk

indicators are relevant: not all credit risk indicators of the bank are publicly available and not all banks indicate the credit rating and/or the date of its approval.

RECOMMENDATIONS

To the Government of the Republic of Lithuania and ministries[11]

In order to ensure better financial risk management in state-owned enterprises:

1. To inform the enterprises assigned to the governance area of the Government of the Republic of Lithuania and ministers about the audit findings and to obligate them to prepare financial risk management documents or to review and, if necessary, to revise the existing ones in the light of the recommendations provided in the Financial Risk Management Guidelines for State-Owned Enterprises.

To the Public Procurement Office

Given the fact that the functions of the Public Procurement Office include monitoring the compliance with the Law on Public Procurement, providing methodological support on public procurement issues and developing recommendations necessary to implement the law:

1. To prepare, in cooperation with the specialists of the Ministry of Finance and the Ministry of Economy who developed the Financial Risk Management Guidelines for State-Owned Enterprises, recommendations to guide the state-owned enterprises on how to implement the Financial Risk Management Guidelines without breaching the provisions of the Law on Public Procurement, including the planned direct lending to the Ministry of Finance which will take out loans on behalf of the state.
2. To revise the regulation of the estimation of the purchase value when purchasing banking and investment services, including cases when the enterprise receives income upon the acquisition of such services.

[11] Ministry of Environment, Ministry of Energy, Ministry of Finance, Ministry of Culture, Ministry of Transport and Communications, Ministry of Health, Ministry of Education and Science, Ministry of Justice, Ministry of Economy, Ministry of the Interior, Ministry of Agriculture. Other ministries, Ministry of Foreign Affairs, Ministry of Social Security and Labour, and Ministry of National Defence, will be informed about the audit findings and recommendations by a letter of the National Audit Office.