



Executive summary of the public audit report

RETURN OF STATE-OWNED ENTERPRISES TO THE STATE

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ABBREVIATIONS & DEFINITIONS

GLR – Government of the Republic of Lithuania

MFRL – Ministry of Finance of the Republic of Lithuania

MERL – Ministry of Economy of the Republic of Lithuania

SETB – SE 'Turto bankas' (until 30/09/2014 was called SE 'Turto fondas', SPF)

GCC – Governance Coordination Centre. It's a governance coordination office of the state controlled enterprises in the SE 'Turto bankas', which carries-out the functions envisaged in the guidelines on property and transparency

IRS – Institution, which represents the state

SCC – state controlled companies (state enterprises or state controlled companies)

SOC – state owned company (public limited liability company (**AB**) or private limited liability company (**UAB**), which's shares or a part of shares grant more than 0.5 of votes in the General Meeting of the Shareholders and which belong to the state based on the right of ownership)

SE – state enterprise (the company, which is established from the assets of the state or transferred to the state by following the procedure fixed in the laws, belongs to the state based on the right of ownership and uses and disposes of the assets transferred to it or acquired on the right of trust)

SCC portfolio – the compendium of all Lithuania's SCCs

Collegial governance body – the SCC board

Supervisory board – the collegial supervisory body of the company

SA – special authority

IAS – international accounting standards

OECD – Organization for Economic Co-operation and Development

The guidelines of OECD – OECD Guidelines on Corporate Governance of State-Owned Enterprises

Special obligations – the functions carried-out by the SOC, which the company would not take-up on a commercial basis or would take-up for a bigger price than the established one and those obligations, which are vested to the companies to be carried-out as the decisions of the shareholder/owner, i.e., the state

Property and transparency guidelines – guidelines

Property guidelines – the 06/06/2012 Resolution No.: 665 by the Government of the Republic of Lithuania 'Regarding the Confirmation of the List on the Rules of Implementing Property and Non-monetary Rights in The State Controlled Companies'

Transparency guidelines – the 14/07/2010 Resolution No.: 1052 by the Government of the Republic of Lithuania 'Regarding the Confirmation of the Guideline List on The Ensuring of The Transparency of the State Controlled Companies' Activities

Capital Asset Pricing Model – the valuation model of the capital assets used to calculate the price of own capital

ROE – return on equity. This is the financial indicator of the use of the invested by the shareholders capital. It's calculated by dividing the net profit from all of the equity capital

Normalized ROE – an indicator, which shows how effectively the own company capital is used, i.e., how much of the net profit goes to each euro of the company's own capital by eliminating atypical deals, tax paid to the state, the impact of overpricing the real property etc.

Net profitability – a financial indicator, which is calculated by dividing the net profit from the net turnover

Cross-financing – financing means when loss-making activity is financed from the income received from gainful activities

Literature – various descriptive articles from Lithuania and foreign countries, which indicate acceptable or achievable values of financial indicators.

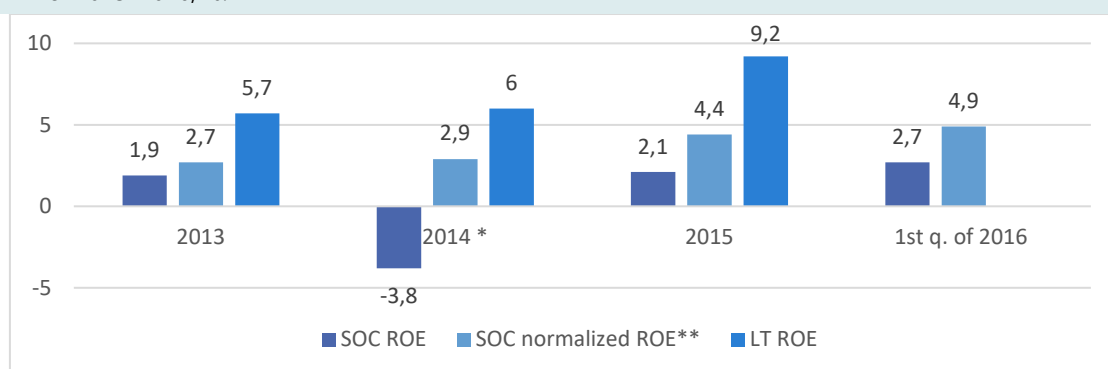
SUMMARY

State owned companies occupy a significant part of the country's economy, they are economically, strategically and socially important. They generate about 3% of GDP, about 41 thousand of people work in this sector and the paid dividends could constitute a significant part of budget's income. For Lithuania it is really important, that the activity of SOC would be effective and ensure optimum return on capital, properly carry-out strategic projects of the state, aim for social and political objectives, which would reduce the social disjuncture and serve for the betterment of the people.

Based on the data of the 1st quarter of the year of 2017, the state of Lithuania was the owner or primary shareholder of 118 SOCs and the accounting value of the used assets was 9.3 B EUR. Based on legal form, all SOCs are divided into state enterprises and state owned companies: public and private limited liability companies, which take-up activities in various important branches of economy - energetics, communications, forestry etc. They create a significant economic value and contribute towards the economic development of the country, implementation of social and employment policy; also, these companies are the treasure of all taxpayers of Lithuania.

The primary indicator, which shows the added value created by the assets of SOC, is the return on equity (see Fig 1). It, due to objective reasons (decisions of the regulator) and management quality of SOCs, is quite lower than the indicator of return on equity of Lithuanian companies¹.

Fig 1. The indicators of SOCs and Lithuanian companies return on equity in the 1st quarter of the years of 2013–2016, %.



* Negative value in 2014, because the overpricing of assets with the market value in the energy sector had an impact on it.

** See the definition of SOC normalized ROE in the chapter 'Abbreviations & Notions'.

Source – State Audit Office according to the data from GCC

The SOC dividends and profit instalments paid to the municipality's budget for the year of 2013 was 17.2 M EUR, i.e., 0.24% of all budget's income, in the year of 2014 it was 74.8 M EUR or 1% and in the year of 2015 it was 111.1 M EUR or 1.4%.² If the return on equity of SOCs would be the

¹ To the common ROE indicator of Lithuanian companies all public and private ROE indicators of all legal forms (AB, UAB, SE, ME) are included, except for companies carrying-out individual activities and natural persons. See: <http://osp.stat.gov.lt/statistiniu-rodikliu-analize?portletFormName=visualization&hash=c9c18cb9-27c8-4c80-8dc8-54b1de4e1e33>.

² https://finmin.lrv.lt/uploads/finmin/documents/files/LT_ver/Vaiklos_sritys/Biud%C5%BEetas/Biud%C5%BEeto_vykdymas/Valstyb%C4%97s_biud%C5%BEeto_vykdyimo_duomenys/2013_m_.pdf;
[https://finmin.lrv.lt/uploads/finmin/documents/files/LT_ver/Vaiklos_sritys/Biud%C5%BEetas/Biud%C5%BEeto_vykdymas/Valstyb%C4%97s_biud%C5%BEeto_vykdyimo_duomenys/Metinis\(internetui\).pdf](https://finmin.lrv.lt/uploads/finmin/documents/files/LT_ver/Vaiklos_sritys/Biud%C5%BEetas/Biud%C5%BEeto_vykdymas/Valstyb%C4%97s_biud%C5%BEeto_vykdyimo_duomenys/Metinis(internetui).pdf);

average of return on equity of the companies of Lithuania, then the sum of dividends and profit instalments to the state budget could be about 4% of all budget's income, i.e., 300–350 M EUR.

The SOC activity must be effective, based on clearly suggested objectives of shareholders and owners, as well as transparently determined principles of the execution of non-commercial functions. Because the state must aim to achieve not only the return on finances, but also carry-out the activity benefiting the society, the IRS, upon assessing special functions of the SOC, should balance the expectations of public interest and return on finances. In accordance to the property guidelines, all of SOC are divided into groups in accordance to the objectives, which the state aims to achieve: 1A (aims to achieve the increase in business value and the profitability of dividends or profit instalments), 1B (aims to achieve the increase in business value, the profitability of dividends or profit instalments and the ensuring of strategic interests of the country) and 2 (aims to achieve the implementation of social and political objectives, as well as profitable activity). The list of SOC is laid down in the Annex No.: 12.

The Ministry of Economy is the object of the audit. The Ministry forms the policy on the increase of competition related to SOC in the country and is responsible for organizing, coordinating and implementing this policy. The audited term is 2013-2015. In certain cases, we use the sources and data of previous and later periods.

The purpose of the audit is to analyse the created system for the control of state owned companies and evaluate what kind of return they give to the state:

- does the SOC management policy lets generate an appropriate return to the state;
- is transparent and responsible management of SOC ensured;
- has the state clearly defined the objectives, which it aims to achieve.

CONCLUSIONS

The state, in order to increase the transparency and effectiveness of the activity of state owned companies, at the audited period improved the governance of these companies based on the good governance principles. However, we missed consistently formed and higher governance standards, which suite the company governance policy. The Lithuania's membership in OECD is one of the most important priorities of the state for the proximate period. There was progress made in carrying-out the governance reform of SOC and implementing the OECD recommendations, but, if Lithuania wants to finish the membership process by the year of 2018, it is not enough to limit oneself with it:

1. the mechanism, which must ensure the state owned companies ownership policy review, does not work in practice, a consistent review of ownership policy is not carried-out, it is not clear how the objectives, which the state aims to achieve, should be carried-out, there are no detailed criterions to choose a legal form and not always an effective execution of special obligations is ensured. The regulation of SOC activity constitutes suppositions to differently interpret the provisions, and in practice does not ensure a uniform and correct application. The Ministry of Economy has prepared an action list, according to which the OECD guidelines

[https://finmin.lrv.lt/uploads/finmin/documents/files/6%20sk_%20\(%C5%BEemyn\)%202015%20KV%20VB%20SB%20%20pajamos%20grafikai.pdf](https://finmin.lrv.lt/uploads/finmin/documents/files/6%20sk_%20(%C5%BEemyn)%202015%20KV%20VB%20SB%20%20pajamos%20grafikai.pdf).

would be implemented, however a part of those means is already late to be implemented (sub-chapters 1.1, 2.1, 2.2, 2.4, 3.1, 3.2).

2. The status of Governance Coordination Centre can't ensure the independence of the functions, which are being carried-out, because the Centre is an office in the company, which is owned by the state. Which is why there are limited possibilities to carry-out the implementation of governance policy and the functions of a coordinating institution (sub-chapter 1.2).
3. State owned company activities indicators are determined inappropriately. Parts of strategic documents are poorly prepared, there are many imperfections in them, inappropriate objectives and goals are affirmed and the indicators for achieving these objectives are unclear. This does not constitute suppositions to create target value for consumers and optimal return for the owners of the companies (sub-chapter 2.2).
4. The determined variable part indicators of the monthly wage paid to the managers of the companies are not ambitious and they are not related to the company's results. The companies are making losses, however, the variable part, which depends on the implementation of the company's goals and achieved results, is paid to the manager. The manager simply receives the variable part of the monthly wage, because the determined indicators do not incite the manger to work effectively (sub-chapter 2.2).
5. At the moment, civil servants constitute a majority in the boards of state owned companies. Independent and experienced members should work in them. The legal regulation constitutes the means to consistently increase the number of natural persons in the boards, meeting the independency criterions. This is in conformity with the OECD recommendations for Lithuania. However, there is no obligation envisaged in the Republic of Lithuania Law on the Adjustment of Public and Private Interests in the Civil Service to declare their interests. Which is why, there is a risk of public and private interests adjustment (sub-chapter 2.3).
6. The transparency of activities of the state owned companies is not ensured. The companies differently interpret the provisions of Transparency guidelines and what kind of data they should make public on their websites. Which is why the subject-matter of the disclosed information does not ensure the quality and publication of the information. The information on the websites is publicized in fragments and not in full (sub-chapter 2.4).
7. The Law on Charity and Sponsorship doesn't have common principles for allocating aid and detailed rules on how the state owned companies must organize the provision of it. Which is why, the means are created to provide the aid irrationally and non-transparently (sub-chapter 2.4).
8. From the 128 SOCs, which were active in Lithuania in the year of 2015, 93 of them or 73% of them were classified to the category of small companies. These kind of companies have limited means to more effectively use human and finance resources, attract managers having a high qualification and form professional boards with independent members. The Government in the program's implementation plan has envisaged to optimize those SOCs, which carry-out the same or similar activities (forest stewardships and road maintenance companies) (sub-chapter 2.5).
9. A part of state owned companies objectives are determined unclearly and this allows for the institutions representing the state to differently interpret the assignment of companies to the groups envisaged in the Property guidelines (1A, 1B and 2). A correct, clear and transparent assignment of companies to these groups is important, because the objectives

of the state depend on it, whether the state wants to ensure strategic interests, implement social and political objectives or gain return on finances (sub-chapter 3.1).

10. The institutions representing the state do not always make sure, whether the implementation of social and political objectives vested as special obligation to the state owned companies is the most effective choice and whether other market participants would be able to do it. The data about the carrying-out of special obligations is not informative enough. Which is why it is difficult to analyse activities and to determine what part in proportion to the whole activity of the company the state financed obligations constitute. This creates the conditions for irrational use of funds (sub-chapter 3.2).
11. Not in all cases the state owned companies effectively carry-out special obligations. When implementing these obligations, the expenses from the activity exceed the generated income. Which is why, every year the companies suffer approximately 50 M EUR of losses. Many companies compensate them from gainful commercial activity. There is no unified mechanism for supervision of expenses and compensation of them. This has an effect on the SOC activity results (sub-chapter 3.2).
12. A large part of state owned companies do not meet the return on finances indicators established for them. In the years of 2013-2015 for all 1A and 1B group companies a unified (no less than 5%) average target annual capital price was determined. This did not incite the competition of the companies and did not motivate to achieve bigger return indicators. Only 40% of companies did meet this indicator. From the year of 2016, the target annual capital price for each company categorized in 1A and 1B groups is calculated separately, but without expert evaluation. Capital Assets Pricing Model, which is used to calculate the price of the capital, has limited capabilities without expert evaluation, because the situation in the SOC, the objectives in the strategy, specific activities etc. are not evaluated thoroughly (sub-chapter 3.3).
13. In the year of 2017, a new dividend payment procedure became valid. The primary objective of which is to incite SOCs to try to achieve the return on capital and a bigger income by increasing the turnover and decreasing expenses as big as possible. However, the expenses of the companies with regulated activities are supervised and the profitability of them is limited. Which is why there are doubts on whether or not the new order in all of the cases is just (sub-chapter 3.3).

RECOMMENDATIONS

The Supreme Audit Institution, in order to identify the problems inherent in all the companies and institutions acting in the public sector, also carried-out the audits for municipalities' controlled companies governance, activity, the establishment of public enterprises and governance. The audit results show that there are no clear criterion for choosing the legal form, state owned companies, municipalities controlled companies and public institutions often carry-out similar activities, there is lack of state view on what kind of public services the state must provide and what services it could transfer to the market, municipalities etc. Which is why it is important to systematically evaluate the regulation of the activities of companies and institutions and comprehensively review the governance policy of companies and institutions.

There are means envisaged in the program's implementation plan of the Government of the Republic of Lithuania regarding the transparency of state owned companies' activities, the increase of return to the society, the centralization of companies' governance by differentiating the policy shaping from the governance of state enterprises. By carrying-out the consolidation process of the companies, the unification and centralized governance of forest stewardships and companies carrying-out road maintenance is envisaged. The means are intended to be carried-out until the end of 2018.

Upon providing recommendations on effectiveness of state owned companies' activities, transparency and the increase of return to the society, we paid regard to the prepared drafts of the statutes of law on the development of legal regulation and the means planned to be implemented in this sphere, which are mentioned in the Government's program. In order for the means to be implemented at the envisaged scope and for them to have a planned result, we shall monitor the fulfilment of these means.

We recommend for the Government of the Republic of Lithuania:

In order to achieve a better regulation, implementation of SOC governance policy and the regular property policy review:

1. To determine the objectives of the state and to envisage their need, scope and the terms for fulfilment (1st conclusion).
2. To determine the criterion, according to which each of the state owned company would be transparently and objectively classified to an appropriate group (1A, 1B and 2), in accordance to the target objectives of the state (1st and 9th conclusions).
3. To ensure the Governance Coordination Centre coordination activity's independency, when it is implemented for carrying-out the SOC governance policy (2nd conclusion).
4. To ensure the fixing of obligation for the members of the state owned companies boards to declare their public and private interests (5th conclusion).
5. To ensure the spread of unified information about the activity of state owned companies in such a way, which would allow analysing, evaluating and comparing the data (6th conclusion).
6. To determine a detailed procedure for providing aid, which would encompass common principles and procedures for the provision of aid (7th conclusion).
7. To additionally carry-out an expert evaluation when Capital Assets Pricing Model is used to calculate an average target annual capital price of each state owned company (12th conclusion).

We recommend to the Ministry of Economy of the Republic of Lithuania:

8. To establish common principles of control mechanism for the carrying-out of special obligations (1st, 10th and 11th conclusions).

It is expected that the conclusions and recommendations of the audit shall incite to comprehensively review the state owned companies governance policy, help the Seimas and Government to carry-out the innovative standards of the companies' governance standards, which meet the needs of society and are related to the development of the country.