



Governance and Disposal of State Owned Enterprises



Performance Audit Report



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Proper operation of state owned enterprises significantly affects sustainable economic development of a country. Hence, it is rather important achieve efficient governance of the enterprises, considering economic policy of the country and best present practice.

A considerable part of enterprises currently owned by the state is either not operating or not profitable. Audits conducted in several state owned companies has revealed deficiencies of internal control systems, drawbacks of strategic planning and misuse/inefficient spending of public funds.

The State Audit Office studied governance system of state owned enterprises in regard of efficiency and effectiveness. Based on the results of conducted analysis, recurring shortcomings were identified and relevant recommendations were issued to remedy them.

30.01.2015

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2015

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Glossary and Definition of Terms

The Agency/NASP – LEPL National Agency of State Property

The Ministry, MoE – The Ministry of Economy and Sustainable Development of Georgia

SOE's – State Owned Enterprises (enterprises where the State owns more than 50% of shares)

SAO – the State Audit Office of Georgia

The Public Registry – National Agency of Public Registry

The Fund – The Partnership Fund

OECD - Organization for Economic Cooperation and Development

LEPL – Legal Entity under the Public Law

Executive Summary

Due to non-existence of establishment criteria and management policy for state owned enterprises (SOE's), enterprises with no exceptional significance had been founded over the last 20 years (until 2011). This led to the number of 1129 SOE's by the year 2012.

In order to manage and dispose of these enterprises, LEPL *National Agency of State Property* (the Agency, NASP) was formed in 2012 under the *Ministry of Economics and Sustainable Development*. Elimination, going bankrupt, merging, privatization of SOE's and transferring them to local municipalities started approximately the same time. As a result, by October 2014, there were 344 enterprises left. The most profitable and economically important enterprises are owned by the *Partnership Fund*. 310 SOE's (about 75% of which are not operating) are managed by the *Agency*, and the rest of the enterprises are transferred to various Ministries and entities of public or private law.

The State Audit Office of Georgia (SAO) has studied the process of management and disposal of SOE's and assess its effectiveness and extent of proper functioning. For this reason, SOE management regulatory framework and issues of accountability, transparency, remuneration, privatisation and dividend mobilisation process were studied. The Audit covers period from 01.01.2012 to 01.11.2014.

Studying and analysing the regulatory documents of the enterprises has revealed that the policy and strategy of the state, as a managing partner, with clearly defined vision and goals, is not established, therefore, criteria for establishing SOE's is not developed and implemented and the list of significant enterprises is not defined. Moreover, there is no corporate governing code for SOE's, which would lay out main principles and basics of managing the enterprises.

Analysis of the existing situation has revealed that the management system of SOE's is decentralized. Reporting and performance appraisal system are not comprehensive and uniform. Therefore, there is no aggregate data about the assets and performance of the enterprises. Notably, The SAO have discovered 75 state owned enterprises, which are not in the records of the NASP, as a result of comparison between the databases of registered enterprises in the *Agency* and in LEPL *Registry of Commercial and Non-commercial Entities* under the *National Agency of Public Registry* and LEPL *Revenue Service*.

It is worth noting that effective and fair remuneration and incentives system is not developed for the enterprises' employees, which is important due to the materiality of wage expenses and low profitability of the SOE's (approximately one third of the enterprises are at a loss).

Assembly of the Commission, which is a decision-maker for profit distribution of cost-effective enterprises is not regular (in the audited period the Commission have assembled only once, in 2013). Hence, state dividends are determined with a delay. Moreover, there are no measures for timely mobilization of the dividends that are to be transferred to the budget, which decreases the benefits the state derives from them.

The following Performance Audit report reviews the existing circumstances of the SOE management system and as a result of comparing it with the selected criteria, presents the corresponding recommendations, elaborated from conclusions of conducted study and analysis. Taking these recommendations into consideration would be reasonable, in order to improve the present situation.

1. Introduction

Enterprises incorporated with equity participation of the state, the so called State Owned Enterprises (SOE's) define the stability of various sectors of the economy and may substantially contribute to the sustainable development of the country.¹ Apart from their great economic importance, some SOEs have essential social impact on the society.² There are 344 state owned enterprises in Georgia, as of October 2014.

Effective management of SOEs is a substantial challenge for most countries.³ Authorities, both at central and local levels, should try to introduce a corporate governance system⁴, which ensures gaining maximum economic and social benefits from the SOE's⁵. Necessity of implementing reforms in the referred sector has been conditioned by high public interest and problems associated with the management of SOEs at OECD member states⁶. Such problems are for instance: excess political interference in the operation of SOEs, passive and inefficiently performing bodies in charge (Supervisory Councils and Management Boards), insufficient transparency, poor accountability system , etc.⁷.

Due to all above-mentioned, fundamental reforms were carried out in old as well as new member states of OECD. During the process countries came across multiple challenges. For the authorities it was the most difficult to balance between active implementation of a partner's authority and excess interference in the operation of SOE's; improvement of the accountability systems and ensuring transparency of SOE operation turned out to be difficult⁸.

Along with international standards, the present Report elaborates on the challenges faced by various countries of the world and reforms implemented to overcome them. Comparative analysis of practices followed in Georgia and other countries has resulted in a more clear presentation of problems, identification of their root causes and elaboration of applicable recommendations.

¹ OECD; *Comparative Report on Corporate Governance on State Owned Enterprises*; 2006, p. 27

² Sodali and Governance Consultants S.A.; *The Importance of the Corporate Governance in State Owned Enterprises (Paper presented for CAF – Latin American Development Bank)*; 2012, p. 1.

³ OECD; *Guidelines on Corporate Governance of State Owned Enterprises*; Paris, 2005, p. 3.

⁴ Corporate governance guidelines for SOE's includes binding and/or mandatory norms, basic principles and fundamentals of managing SOE's

⁵ Sodali and Governance Consultants S.A.; *The Importance of the Corporate Governance in State Owned Enterprises (Paper presented for CAF – Latin American Development Bank)*; 2012, p. 1.

⁶ Organization for Economic Cooperation and Development

⁷ OECD; *Comparative Report on Corporate Governance on State Owned Enterprises*; 2006, p. 2

⁸ OECD; *Comparative Report on Corporate Governance on State Owned Enterprises*; 2006, p. 2.

1.1 Audit Purpose and Main Question

Audit aim is to assess SOE governance system, identify the reasons behind existing problems and set up solutions to remedy them. Hence, the audit should respond to the following main question:

- › **How sound and effective is the governance system for State Owned Enterprises?**

Audit procedures have been developed to find answer to the audit question and attain the audit goal. The procedures have been applied to study and assess main issues related to SOE governance.

Particularly, the State Audit Office has examined regulatory framework of the SOE governance system and status of implementation of corporate governance principles; analysis of justification of management right distribution among various authorities in charge has been carried out and the issues of accountability and transparency of the activities of the SOE's, as well as the issue of remuneration of SOE workers.

State Audit Office has evaluated privatization process of shares/stocks and assets of SOE's in regards with efficiency. The report also discusses pertinence and timeliness of dividend collection process.

1.2 Audit Criteria

OECD guidelines on issues related to SOE management were used as main criteria of audit.⁹ 34 countries of the world come together under OECD. Representatives of these countries developed a document on the grounds of their shared knowledge and experience. Guidelines are preferred and recommended for implementation both for member and non-member countries. Document clearly indicates that guidelines presented in it may be an effective tool for solving various dilemmas and complex problems.¹⁰ In addition, guidelines suggest alternative approaches in a number of instances depending on the organizational setting and level of development of a country, which makes it easier to wisely apply the referred document and adapt it to the Georgian reality.

Apart from the referred document, findings indicated in the present Report are based on another most significant document of the same organisation,¹¹ which was published

⁹ OECD; *Guidelines on Corporate Governance of State Owned Enterprises*; Paris, 2005

¹⁰ OECD; *Guidelines on Corporate Governance of State Owned Enterprises*; Paris, 2005; p. 3.

¹¹ OECD: *State Owned Enterprise Governance Reform: An Inventory of Recent Change*; 2011

6 years after the guidelines were issued (in 2011) and which elaborates on the reforms implemented both in old¹² and new member states¹³ and discusses how the practical issues arising during the process were dealt with. Same kind of document was issued by OECD in 2006 as well.¹⁴

The above mentioned 3 documents have been used as a criteria for the analysis and assessment of status of implementation of main corporate governance principles. It covers the following core issues:

- › State, as a partner – division of authority among the governing agencies;
- › Transparency and accountability;
- › Remuneration.

Apart from the above mentioned documents, legislation of various countries of the world, best international practice, reports of various institutions and scientific papers were also used as criteria of audit.

1.3 Audit Scope

Performance Audit of SOEs covers the period from 2011 to 1st November 2014.

Following main issues were subject to the scrutiny and analysis by taking into account the audit questions:

- › Establishment and Assessment Criteria for SOE's;
- › Implementation status of corporate governance principles;
- › Privatization of SOE shares and assets;
- › SOE profit distribution.

Discussions presented in the present Report apply solely to state owned enterprises.

¹² In particular Finland, Sweden, Germany, the UK, Poland, Switzerland, Korea, France, Belgium, Hungary, Portugal, Italy, New Zealand, etc.

¹³ Estonia, Slovenia, Chile, Israel

¹⁴ OECD; *Comparative Report on Corporate Governance on State Owned Enterprises*; 2006

2. Establishing and Implementation Status of Corporate Governance Guidelines for State Owned Enterprises

SOE's should be founded to fulfill special tasks the government is not able or not willing to do itself. So they have to follow a specific strategy – in total and as well every SOE itself – they have to achieve measurable objectives and produce exactly defined goods or services or have to gain money.

In addition to that a proper SOE organization minimum needs a legislative framework, well distributed management functions, a transparent and accountable structure or an remuneration and bonus system.

2.1 Criteria for Establishment of State Owned Enterprises are not developed

We may deem various types of regulations to be incorporated in the legislative framework of SOE Operation and namely the following:

- › Legal instrument that should regulate the market, ensure its viability, competitiveness and common playground for state and private companies¹⁵.
- › State, as a partner within SOE's should have a policy and strategy, which will clearly define its vision and aspirations towards such SOE's. It should also define its role and ways to implement its functions. Strategy should also regulate the following¹⁶:
 - Criteria for establishing SOEs, justification for selecting this form rather than non-commercial NGOs, legal entities of public law (LEPLs) or other organizational forms;
 - Criteria defining the strategically important SOEs that are to be maintained under the state governance¹⁷.
- › Corporate Governance Code for SOEs, which are mandatory for execution and/or will be reflecting major principles and principles of corporate governance as recommended norms¹⁸.

¹⁵ OECD; *Guidelines on Corporate Governance of State Owned Enterprises*; Paris, 2005, p. 18

¹⁶ OECD; *Guidelines on Corporate Governance of State Owned Enterprises*; Paris, 2005, p. 23

¹⁷ OECD: *State Owned Enterprise Governance Reform: An Inventory of Recent Change*; 2011, p. 10-12; The Government of the Republic of Slovenia; *Policy of Corporate Governance on State Owned Enterprises*; Ljubljana, 2009. p. 9

¹⁸ E.G.: *Public Corporate Governance Kodex des Landes Baden-Württemberg (Deutschland)*; 2007; *Public Corporate Governance Kodex des Österreichs*; 2002

Strategic Vision and Criteria for the Establishment of SOEs

No legal instrument is available in Georgia that would regulate the management issues in relation with SOEs or would define policy in the area concerned¹⁹. Particularly:

- › There is no available list of strategically important SOE's of the country; Vision, goals and role of the state is not defined for SOE management
- › Criteria for the justification and possibility of incorporating SOEs as entrepreneurial subjects are not defined. OECD has defined the criteria for theoretic basis of SOE incorporation. The following may be deemed as the referred theoretic basis (criteria):
 1. Market stimulation – it may be required for the economy to ensure the supply of certain goods and services when private sector is less interested in the operation at the referred niche of the market (i.e. private sector having no desire or interest in producing the referred goods or services).
 2. Need to produce such goods or render such services that are in high demand and towards which public has high expectations to be financed by the State and risk exists that they may not be provided adequately solely by the private sector. Such are education, healthcare, etc.
 3. Threat of having excess production or service delivery of such goods that will have a negative side effect²⁰ (e.g. pollution of environment);
 4. When political or economic environment in any field is not safe (it implies open conflicts, territorial or criminal actions, excess taxation, tightened regulations, risk of bankruptcy of banks and unstable relations with suppliers or consumers²¹). In such conditions State cannot promise investors that stable business environment is created, thus leading to the reduced investments²².

¹⁹ SOE's are subject to the Law of Georgia on Entrepreneurship, though other special regulations are not developed, as mentioned above.

²⁰ Negative production externality – A negative effect on the environment, society or economy of the country, formed as a result of production of certain goods. In this case, arised costs are not paid by the producers of goods/service providers and are paid by the third parties, which include any individual, organisation, property owner, or resource that is indirectly affected. It is Calculated as the difference between actual production costs and costs of society

²¹ <https://www.pilgrimgroup.com/news.php?id=140>

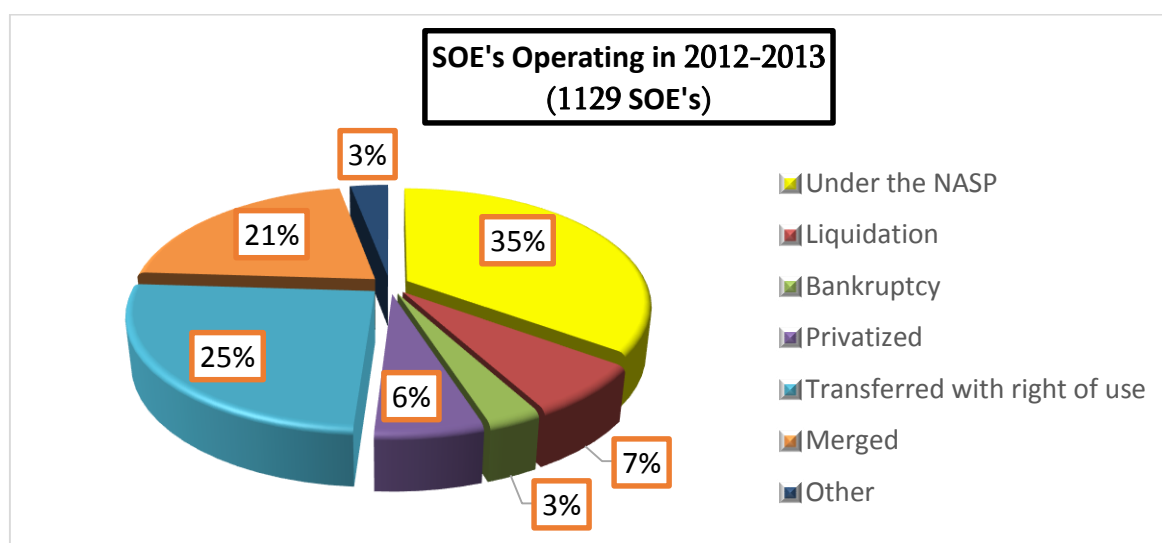
²² The Corporate Governance of Commercial State Owned Enterprises of Ireland, Dublin 2009, p. 12; OECD, Corporate Governance of State-Owned Enterprises: A Survey of OECD Countries, Paris 2005, p. 20–1.

Local Reality in Georgia

Due to lack of a clear vision and establishment criteria, SOE's without any strategic or commercial importance were being incorporated over the last decades and, as a result, by 2012, there were 1129 SOE's in the country.

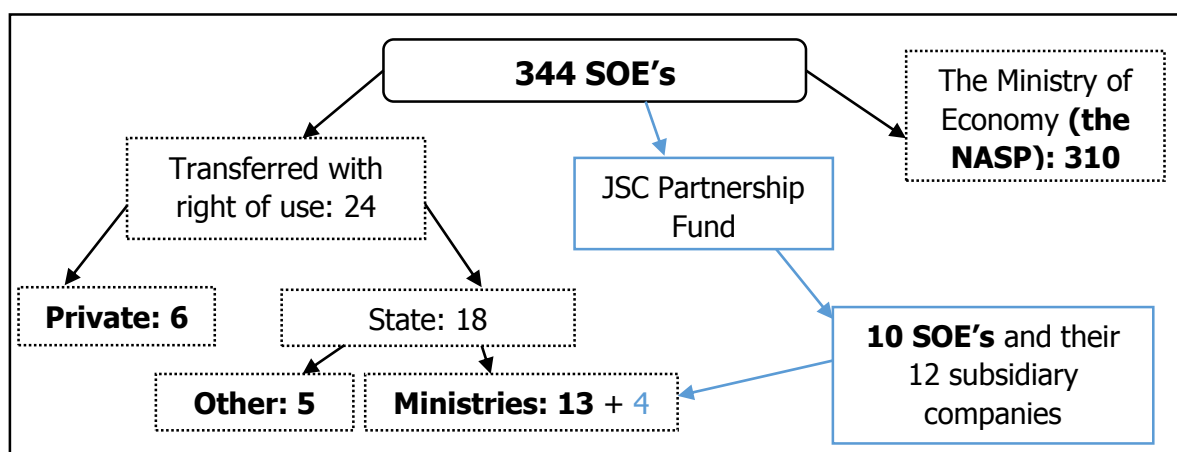
Since 2012, National Agency of State Property (hereinafter - NASP, the Agency) started liquidation, bankruptcy and merging procedures for non-profitable, overindebted and idle SOE's; some were transferred with right of use to private entities, some others were privatized. This process is to be considered positive.

Chart 2.1.1²³: SOE's Operating in 2012-2013 (1129 SOE's)



As a result, as of October 2014, there are only 344 state owned enterprises left.

Scheme 2.1.2: Management system of State Owned Enterprises²⁴



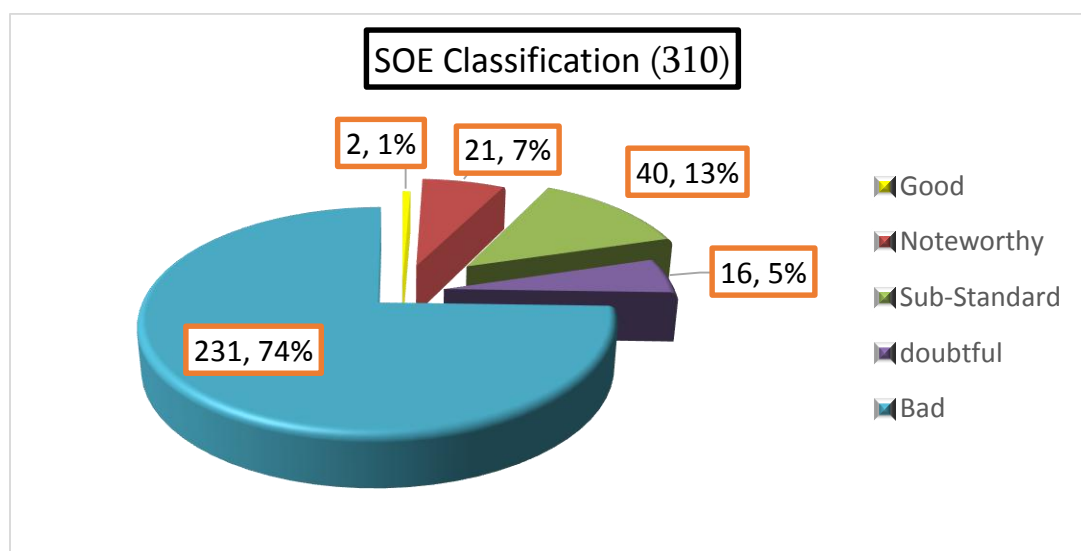
As the scheme above shows, 310 out of existing SOE's is governed by the Agency. 228 of these SOE's do not operate at present. 75% of the remaining enterprises have

²³ Report of State Audit Office of Georgia about annual state budget execution report 2013

²⁴ The table only concerns state owned enterprises, other non-profit legal entities and enterprises owned by local self-government units, autonomous republics and LEPL's

financial difficulties. The Ministry of Economy has assessed the SOE's and ranked them in 5 categories shown on a chart below.

Chart 2.1.2: Classification of SOEs under the Management of the National Agency of State Property



The Agency fulfils partner's rights at the SOE's, makes decisions about the amendments in their capital and other important issues²⁵. Strategically most important and financially potent SOE's are possessed by JSC Partnership Fund. The main purpose of the Fund is to support and promote investments on initial stages of investment projects by contributing to them (financially, co-investing in equity, subordinated loans, etc.).

As already mentioned, shares of some SOE's are transferred with the right of use to various legal entities²⁶. At present, 17 SOE's are managed by several Ministries, according to their competences (4 SOE's are transferred by the Fund, the other 13 – by NASP). 5 SOE's are governed by legal entities subordinated to Ministries, and 6 SOE's – to private investors.

Conclusion:

Analysis of international practice and the situation in Georgia indicates that without a strategy, clear vision and development of core corporate governance principles, it is not feasible to increase profitability of SOE's. This would be a basic ground for ensuring effectiveness of SOE governance system. Otherwise, the SOE's would only be a burden for the state, without generating any benefits.

²⁵ The Law on State Property, 2010, article 2 („T”).

²⁶ The Law on State Property, 2010, articles 43-44.

Recommendation to National Agency of State Property:

- › Criteria for establishing State Owned Enterprises shall be determined. In case the exiting SOE's meet the criteria, they shall remain under state management;

2.2 State as a Partner – Inefficient Distribution of Management Functions

Description of Management Systems and International Practice

State, as a partner, may perform its authority in various forms. Namely, management functions towards various SOE's may be centralised and gathered under one coordinating body or be decentralised through different forms. International practice in the concerned area differentiates among 3 major models of corporate governance²⁷:

1. *Decentralised* – this model is the most traditional, according to which SOEs are divided by their areas of competence among the various Ministries²⁸.
2. *Double Governance System (a so-called Dual Model)* – implies the division of authority among the central coordinating body and ministries within the relevant areas of public administration²⁹.
3. *Centralised* – such type of governance implies that all the SOEs in the country fall under the governance of one coordinating body and the latter performs all the functions of the partner towards the SOE's³⁰.

It is to be mentioned that the apart from the above-mentioned 3 main types of governance, there are also transitive, so-called hybrid governance systems, which may incorporate signs and features of two different models.

All above-mentioned governance models have both advantages and disadvantages. However, OECD clearly indicates in its recommendations that the most justified and sound is still a *centralised* governance model, whereby one body carries out a partnership authority at all the SOEs. If it is impossible to fully centralise the governance system, the minimum requirement is to have a body, which will coordinate the SOE management by Ministries and will have a common (uniform) governance policy developed³¹.

Decentralised model has a lot of drawbacks³², Namely, functions are not clearly segregated between ministries and SOE management bodies, SOE management policy and practice is not uniform, information on the SOE performance is not aggregated (which makes it is impossible to create a common picture and timely identify recurring

²⁷ OECD; *Comparative Report on Corporate Governance on State Owned Enterprises*; 2006, p. 27; OECD; *State Owned Enterprise Governance Reform: An Inventory of Recent Change*; 2011, p. 13-19.

²⁸ OECD; *Comparative Report on Corporate Governance on State Owned Enterprises*; 2006, p. 27

²⁹ OECD; *Comparative Report on Corporate Governance on State Owned Enterprises*; 2006, p. 28.

³⁰ OECD; *State Owned Enterprise Governance Reform: An Inventory of Recent Change*; 2011, pp. 16-20, 41; OECD; *Comparative Report on Corporate Governance on State Owned Enterprises*, 2006, pp. 27

³¹ OECD; *Comparative Report on Corporate Governance on State Owned Enterprises*; 2006, p. 3, 23.

³² OECD; *Guidelines on Corporate Governance of State Owned Enterprises*, Paris, 2005, p. 29-30.

problems), etc.³³. Hence, countries that fail to directly centralise the management try to introduce an interim, so called dual model, which, in time, will lead to a fully centralised governance system in a much simple manner³⁴.

Overview and Analysis of Current Governance System in Georgia

Division of Authority

Agreements on Management Rights concluded by and between the Agency and Ministries indicate that all the SOE authorities are delegated to the Ministries. The only instrument of enterprise management from the side of the Agency is that ministries have no right to manage, liquidate, bankrupt, pledge, etc. SOEs without the consent of the Agency (e.g. ministries have no right to borrow for or invest in some SOE's without a consent of the Agency). At the same time, ministries do not report to the Agency on the performance and profitability of SOEs under their management (for more elaborated information please see chapter 2.3), respectively, state does not have an aggregated information on the operation of SOEs, which actually makes it impossible to timely identify the current problems in the supervision and the system.

Analysis of the current system in Georgia has identified that the existing model has signs of the decentralised and dual models. As a coordinating body, the Agency's existence is characterised exactly with dual governance model. Nevertheless, a coordinating body operating in a typical dualist governance format should be carrying out the partnership authority together with other ministries (i.e. authority should be shared by the Agency and ministries and should not be fully delegated). In real sense, relevant ministries carry out all the authority of the Agency. Besides, Agency actually carries out neither coordination nor supervision functions, as it initially requires the availability of relevant information on SOEs transferred for management rights. Agency practices the reporting system only towards SOEs within its management. Hence, it may be said that current system in Georgia is an interim (hibryd) model between decentralised and dual.

³³ OECD; *Comparative Report on Corporate Governance on State Owned Enterprises*; 2006, p. 29-30; The Government of the Republic of Slovenia; *Policy of Corporate Governance on State Owned Enterprises*; Ljubljana, 2009, p. 9.

³⁴ OECD; *Comparative Report on Corporate Governance on State Owned Enterprises*; 2006, p. 30.

Conclusion:

Due to decentralization, the governance practice is not uniform in Georgia (each Ministry has their own approach to this issue and the best model structure is not being developed). Information about the activities and profitability of the SOE's is incomplete and not aggregated. The Agency has difficulty in coordinating with the Ministries, which hinders timely decisions and implementation of modern corporate governance practice.

Recommendation to National Agency of State Property :

- › It is advisable that Georgia switches to the Dual model of governance of SOE's, the Agency should coordinate the SOE's with transferred rights of use, independently perform certain responsibilities of the partner and not delegate all the managerial rights to the Ministries.

2.3 Insufficient Transparency and Accountability

Introduction of a streamlined and flexible accountability system is an essential element for the effective implementation of monitoring and partnership authority over the state owned enterprises³⁵. Without proper operation of the referred system, it is impossible to define how SOEs perform their functions and to what extent they achieve their pre-defined goals.

In practice there are 2 main levels of accountability (reporting) on the operation of SOEs:

Individual level - accountability of SOEs towards the coordinating body and/or supervisory institution (Ministries, as a rule);

Central level – aggregation of reports by the coordinating body and submission of consolidated report to the Parliament, Supreme Audit Institution or other stakeholders.

Reporting at the Individual (Ministry) Level

Process of reporting at the individual level includes three main stages: *ex ante*³⁶, current and *ex post*.³⁷

Ex ante Reporting - it implies establishing aims and plans of the SOEs and based on that, defining corresponding indicators and monitoring them at current and *ex post* stages.

Current Reporting - should be deemed to include the SOE monitoring. The latter should be reporting in some regular manner (monthly, quarterly, etc.) and on an *ad hoc basis*³⁸.

Ex Post Reporting - should be deemed to include submission of annual reports by SOEs after the completion of a fiscal year on their performance. The reports shall include financial data, activity overview and status of achievement of pre-defined goals. It is particularly important for SOEs of strategic importance.

³⁵ OECD; *Comparative Report on Corporate Governance on State Owned Enterprises*; 2006, p. 58.

³⁶ Before- event stage

³⁷ After-event stage

³⁸ Centre for Corporate Governance in Africa; *Rating Corporate Governance of State Owned Enterprises*; Cape Town, 2012, p. 7; OECD, *Comparative Report on Corporate Governance on State Owned Enterprises*; 2006, p. 63-65;

a) Status of Implementation of the Reporting System at the Agency

System of reporting approximated to international standards and practice has been introduced in Georgia (at the individual level) and it ~~is~~ exists only at the agency, which has developed a template for capturing financial data and business performance of SOEs. It is regularly (monthly, quarterly and annually) filled in and communicated to the Analytic Department of the Agency, which, in turn, scrutinises and analyses gathered information.

Referred information is collected by the Agency only from 66 SOE's, as out of 310 SOEs under its governance 228 are idle, while 8 SOEs fail to provide information to the Agency for various reasons³⁹.

Ex ante reporting system is partially institutionalised at the Agency, because SOE's submit their business plans in advance to the Agency for clearance. As for the current and *ex post reporting* system, it more or less complies with international standards and practice, however to make sure that it fully complies with the referred practice it is reasonable that SOEs submit comprehensive report on the implemented activities and anticipated aims and goals together with their purely financial information and general description of business operation.

It needs to be mentioned, that reporting system was introduced in the Agency in the present form in mid-2013. It should be regarded as a step made forward. Respectively, it is logical that it has certain faults, though it is equally important to make sure that the Agency continues work on its further improvement and perfection, which will be impossible without engagement of SOEs and implementation of relevant measures (such as e.g. clear definition of SOE tasks, development of regulations on corporate governance, etc.).

b) Status of Implementation of the Reporting System at the Ministries

On the grounds of information submitted by Ministries and analysis of SOE charters the reporting systems at individual Ministries may be separately and briefly reviewed. Though, it should be mentioned beforehand that none of them requires reports about compliance with corporate governance principles and updated information about accomplishing pre-defined goals from their subsidiary SOE's⁴⁰. Moreover, none of the Ministries have developed particular methodology or report sample which would help them to collect the information in one format.

³⁹ The 8 SOE's do not submit information due to the following reasons (as stated by the Agency): weak management, unreliable information and going bankrupt. 1 SOE was established in 2012 and was undergoing personnel changes, as well as did not have business plan yet. 2 enterprises would not submit the information even though the Agency required it regularly

⁴⁰ As it was already mentioned, presenting certain informations is not quite possible from the Agency's side. Please see chapter 2.3.1 for more details

Ministry of Regional Development and Infrastructure - at the end of every year SOE's submit Business Plan Projects for the following year to Economic Department of the Ministry for approval. After relevant review and analysis they get approved with the Order of the Minister. SOE's submit Adjusted Business Plans for the respective projected periods during the year for their approval. At the same time, actual data (expenditures) on the execution of business plans are submitted on a quarterly basis. It also includes a briefing on the current status of the Profit and Loss Projections, but no performance report.

Ministry of Energy - SOE's present annual financial reports and other accounting data to the board of partners/shareholders (where the Ministry of Energy represents the state). SOE's also present an annual report about their performance and business plan for the next year. The latter is not done only in the case of JSC Telasi⁴¹.

Ministry of Agriculture - according to the submitted information, legal entities (1 limited liability company and 2 non-commercial NGOs⁴²) provide information on a quarterly basis on the execution of their budget allocations, detailed report on implemented measures and achieved results. LLC United Amelioration Systems Company also presents financial report, business plans and annual performance report.

Ministry of Sports and Youth Affairs – the SOE under the governance of the Ministry submits annual financial report about financial performance and other financial data. The business plan for each year is pre-approved by the Ministry as well. The Ministry does not collect information about the performance of the LLC.

The table below (2.3.1) presents consolidated information about status of implementation of reporting system in the Ministries.

⁴¹ Due to the fact that state only owns 24.5% of the shares of the JSC Telasi

⁴² One of the non-profit legal entities owns 11 SOE's

Table 2.3.1: Reporting System in the Ministries

	Ministry of Infrastructure	Ministry of Energy	Ministry of Agriculture	Ministry of Sports
Methodology and Framework	x	x	x	x
Business Plan/Strategy submission and approval	✓	x	x / ✓ ⁴³	✓
Setting goals (with measurable indicators) and evaluation of results	x	x	x	x
Annual activity report	x	✓	x / ✓	x
Financial report	✓	✓	x / ✓	✓
Analysis of compliance with Corporate Governance issues and reporting	x	x	x	x

c) *JSC Partnership Fund* - according to its Charter, Partnership Fund is accountable only towards President of Georgia⁴⁴. They annually publish consolidated financial information (with the audit report) on their web-site. The SOE's owned by the Fund which are under the governance of the Ministry of Energy report to the Ministry, as mentioned above. All the SOE's owned by the Fund present business plans and performance reports to the supervisory board of the Fund.

Central Level – Aggregated Reporting

Aggregated reports are intended to make complete and consolidated information available on all the SOE's and to clearly depict the current position in the area⁴⁵. The referred fact increases the effectiveness of the reporting system, responsibility of officials engaged in enterprise management, identification of problems and allows for a timely response to remedy them.

In case the enterprise management is not fully centralised, aggregated reporting requires all the governing bodies to submit a consolidated report on the enterprises within their respective management areas to the coordinating body, which should

⁴³ The sign implies that only the LTD submits the information to the Ministry, the non profit entities do not submit the particular information

⁴⁴ Government Decree N230 on the Adoption of Charter and Formation of Equity for JSC Partnership Fund; June 2, 2011, Article 9.

⁴⁵ OECD; *Guidelines on Corporate Governance of State Owned Enterprises*; Paris, 2005, p. 41.

aggregate all the reports in one consolidated report. The report shall be public and presented to the stakeholders such as the Parliament, media and general public⁴⁶.

Aggregated reporting system is not introduced either at the central or individual (Ministry) levels in Georgia. It means that the Agency and Ministries do not produce consolidated reports on SOE's under their management. It is necessary to make the reporting system on both individual and central levels more sophisticated to ensure that the reports are more comprehensive and of proper quality, to further improve the system and implement practice of aggregate reporting⁴⁷.

The Agency does not have complete information about all the operating SOE's

As mentioned above, there are 344 SOE's in the country. NASP also has a registry of the enterprises which are no longer under its governance (due to privatization, liquidation, bankruptcy, merging, etc.).

NASP has presented a list of the SOE's under its governance to the State Audit Office. The list has been cross-checked with the registries existing in other state entities (LEPL National Agency of Public Registry and LEPL Revenue Service). This resulted in revelation of 75 enterprises that are, in fact, state owned, but are not in the list of the Agency. There may be other such enterprises as well, due to the fact that the registries submitted to the SAO were not complete either.

The SAO asked NASP to analyse the list of above-mentioned 75 enterprises. After fulfilling the request, the Agency has concluded that some of the enterprises are state owned and shall be added to their registry. The others are still being analysed, because there were no valid/updated documentation available in the Public Registry.

Furthermore, the audit revealed a case of a SOE LLC "Tushetgza", which NASP has labelled as "not operating/idle" in their registry. The LLC has participated in 5 public tenders and won them⁴⁸ in 2014. This fact once again indicates that there are significant deficiencies in reporting system of NASP.

⁴⁶ OECD; *Guidelines on Corporate Governance of State Owned Enterprises*; Paris, 2005, p. 41-42; OECD; *Comparative Report on Corporate Governance on State Owned Enterprises*; 2006, p. 70

⁴⁷ It is to be emphasized that for this reason, other activities shall be carried out as well – Legal Act regulating corporate governance of SOE's shall be issued, goals and performance indicators for the SOE's shall be clearly determined, etc.

⁴⁸ SPA110015408; SPA120013088; SPA120019491; SPA140003828; SPA140012942

Conclusion:

Despite certain deficiencies, the most acceptable reporting system is the one implemented in NASP. However, it is advisable to further develop it to be in line with international best practice. Besides, not all the operating SOE's are involved in the mentioned system and there are SOE's which the Agency did not have information about. Concerning the Ministries, the reporting system is more or less functional in the Ministry of Infrastructure. The Ministries of Agriculture and Energy do not have actually functional reporting systems.

Apart from malfunctioning reporting systems on individual level, there are deficiencies on the aggregate level too – that is, the systems differ from each other, which results in NASP not having a clear picture about activity of all the SOE's. Hence, there is no aggregate reporting system implemented in the country, which prevents the Parliament and media to assess effectiveness of SOE operation and identify existing problems in the field in order to eliminate them. Hence, it is feasible to conclude that the current reporting system does not ensure transparency of SOE operation.

Recommendations to National Agency of State property:

- › The NASP shall, at first, check records for every existing SOE and update information about their assets and liabilities. The next step would be establishing internal control mechanisms for the operating SOE's to minimize the risk of fraud and incompliances with the law as well as increase accountability of the SOE management;
- › Reporting system should be unified and the Agency should design a report sample, according to which, every SOE will present their annual financial and activity report to their superior authorities (Ministries as well as the Agency). The next step would be consolidating collected information in aggregate report about the SOE's, which will be presented to the stakeholders and interested parties, to ensure transparency of the system.

2.4 Personnel Remuneration and Bonus System is not Implemented

According to the core principles of corporate governance, state, as a partner, is obliged to develop and implement such system (scheme) of management and staff remuneration and incentives at SOE's, which would serve to the long-term interest of the SOE and incentivise the qualified staff⁴⁹.

Georgia has no regulations or guidelines that would define core principles, volume and criteria for enterprise staff remuneration and incentives. Existing practice implies that institutions responsible for SOE management (Agency, Ministries) independently define the volume of SOE management remuneration, while the latter are responsible for the definition of remuneration for the rest of the enterprise staff.

State Audit Office studied the issue of salaries and wages paid in almost⁵⁰ every active SOE (in total such SOEs were 66) under NASP governance and identified that total staff pay bill amounted to 63.6 million GEL in 2013⁵¹, one fourth of which was paid to the administrative personnel (Table 2.4.1); remuneration of the personnel at the SOE's transferred with right of use to the Ministries (including 4 enterprises owned by JSC Partnership Fund) summed up to 130.3 million GEL, despite the fact that the biggest company – JSC Georgian Railway is not included here.

Table 2.4.1: Remuneration costs in SOE's in 2012-2013

Managing Entity	2012		2013	
	NASP ⁵²	Ministries ⁵³	NASP	Ministries
Number of SOE's	64	15	65	15
Remuneration of administration personnel (Million GEL)	14.9	33.3	15.1	38.9
Total remuneration (Including Administration, Million GEL)	61.1	111.4	63.6	130.3
TOTAL:	171.5		193.9	

Considering the fact that all the SOEs differ by their areas of operation, size, business portfolio, strategic importance and other factors, it is hard to *accurately* assess the

⁴⁹ OECD; *Guidelines on Corporate Governance of State Owned Enterprises*, Paris, 2005, p. 31; Junki Ki; School of Public Administration of Seoul National University; *State Owned Enterprises Reform and Corporate Governance Reform in Korea*, p. 5, 30.

⁵⁰ term "almost" is used due to the fact that 8 out of 74 operating enterprises does not submit any information to NASP for various reasons

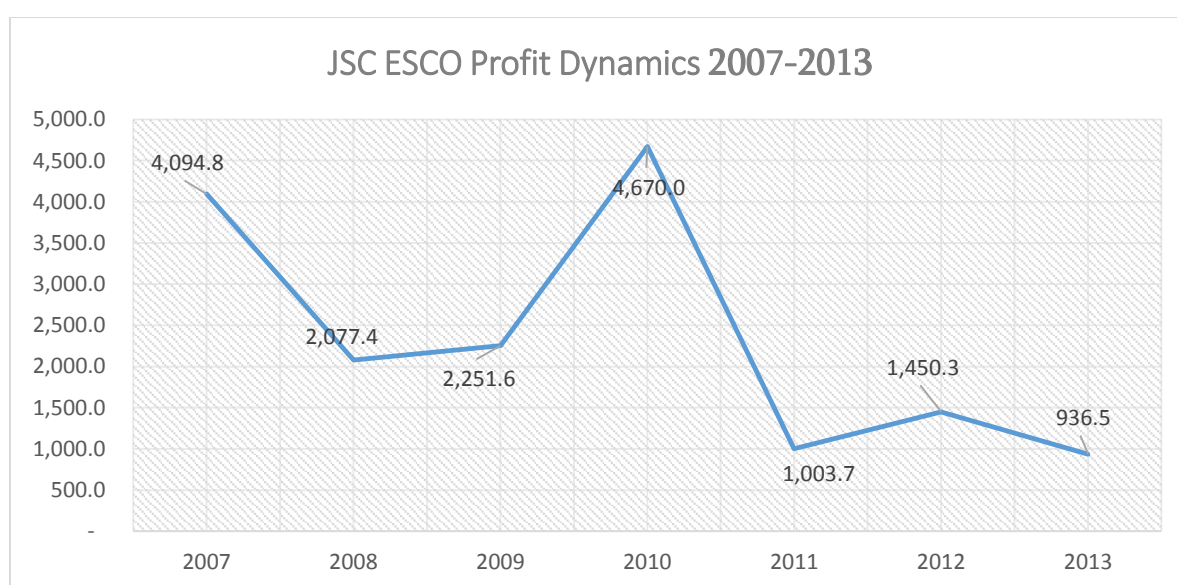
⁵¹ Net salary, financial data from LLC "Marabda-Kartsakhi Railway" is not included

⁵² financial data from LLC "Marabda-Kartsakhi Railway" is not included

⁵³ Including the 4 SOE's under the JSC Partnership Fund

adequacy and expediency of the remuneration mentioned above. Although, the salary paid to few members of administration of one of the SOE's (ESCO – JSC Electricity Market Operator) in 2012-2013 (3 members of administration received 361.5 thousand GEL in 2012 and 2 members received 327.4 thousand GEL in 2013) shall be considered unreasonably high, because its mandate is to generate the balance electricity and is less oriented at profit-making - e.g. in 2013 profits amounted only approximately 909 thousand GEL. The graph below shows profit dynamics of JSC ESCO. Due to the fact that the SOE has not brought significant financial benefit to the country, just fulfilling its function (selling and purchasing electricity, guaranteed capacity trading) can be regarded as unreasonable. It should be noted that given examples are just informative and does not address specific individuals.

Graph 2.4.2: JSC ESCO Profit Dynamics 2007-2013 (Thousand GEL)



Conclusion:

Remuneration of SOE personnel is one of the core principles of corporate governance. In Georgia, there is no specific regulation/guideline concerning the matter, while more than 170 million GEL is spent annually for that purpose. It is necessary to develop a regulation/guideline, which will define the core principles and criteria for remuneration and bonus system of SOE workers.

Recommendation to National Agency of State Property:

- › It is advisable to develop specific rule to regulate remuneration/bonus system. The Instruction shall take the labor market situation into consideration as well as relevance of management performance with the pre-determined goals.

3. Privatization of Shares and Assets of State Owned Enterprises

Privatisation of state-owned assets may serve to plenty of reasons. Nevertheless, nearly all the privatisation policies throughout the world have two main goals: 1) increased productivity and effectiveness through a de-politicization of SOE's and improved corporate governance; 2) generation of additional revenues to finance the priority areas and to attract investments, which is one of the key tools for the country's economic development⁵⁴.

Along with many other factors, 3 significant issues need to be considered in regard with privatization:

- › Determining optimal privatization price;
- › Creating competitive environment for auctions;
- › Assessing potential investors.

Determining optimal value for privatization object

After determining appropriateness of privatization of a SOE or its asset (meaning the SOE assets which were removed from SOE capital in order to be privatized), it is important to set the optimal price for the privatization object. Especially so in case of direct sales, to gain maximal revenue. However, setting the optimal initial price is important for auctions as well, because low competition may result in selling the property for non-optimal price.

Application of an external auditor/expert opinion may be deemed justified for the privatisation price setting, though it does not always ensure that decisions based on such opinion will always lead to a optimal value for the property. All auditors/experts have their own methodology and approaches, respectively their decision are based on subjective opinion together with a lot of objective factors. Hence, it is worthwhile to consider other features, such as net present value of the SOE and its assets, timeliness, political/economic environment in the locality, etc. Nevertheless, a detailed methodology would still be necessary. It is particularly important for shares, as the definition of their market value depends on many factors and gives more chances for subjective decision-making.

One of the commonly-known examples for this would be the sale of 2 medical-profile LLC's for 18.4 million GEL after a couple years from spending approximately 47 million GEL for their rehabilitation.

⁵⁴ National Bureau of Economic Research; *Determinants of Privatization Prices, Working Paper 5494*; Cambridge 1996, p. 3.

Creating competitive environment for privatization process

According to compliance audit report of NASP (2012-2013), majority of the auctions held during the audit period had only 1 buyer participating in it (2012 – 55% of the actions, 2013 – 85%), which indicates on the need for spreading the information about the forthcoming auctions. It is vital for auction to have several participants to ensure the competition, which will lead to the significant difference between the initial price and selling price of the privatization object, generated during the auctions with more than 1 participant⁵⁵.

Assessing potential investors

After setting the privatization price, it is important to assess the potential buyer/investor, especially during direct sales and when the property is sold for a symbolic price of 1 GEL and the buyer takes an obligation to make investments. It is advisable to assess the financial condition of the buyer in order to determine if there is potential for making the investments they have claimed. The importance of this pre-qualification procedure is acknowledged by a number of economically well-developed countries.

Table 3.1: *Status of Privatisation-Related Measures*

Procedures	Status	Pending Measures
Specific Nature of Processes Elaborated in the Instructions	✓	
Engagement of Relevant Structural Units	✓	
Determining Justification	Partially Met	Criteria need to be developed
Price Setting Rules	Partially Met	Methodology and relevant criteria need to be developed
System of Investor Evaluation	✗	

Conclusion:

Existing procedures have a number of deficiencies. As mentioned above, determination of optimal privatization price, competitive environment during the auctions and assessment of interested investors is not ensured, which creates risks for selling the privatization object for non-optimal price.

⁵⁵ Compliance Audit of LEPL National Agency of State Property, Audit period 2012-2013, chapter 2.1

Recommendations to National Agency of State Property:

- › It is important to determine the value of privatiozation object (assets, stocks) according to best existing practices. For this reason, methodology for determining privatization prices shall be developed, which will consider external auditor's/expert's opinion, but will not solely depend on it.
- › Before holding an auction, delivering information to the potential investors and creating competitive environment for the auctions shall be ensured by the Agency, which is the prerequisite for maximization of the sum gained through privatization.

4. Distribution of Profit of State Owned Enterprises

A commission was established in September 2004 with a joint Order of the Minister of Finance and Minister of Economy and Sustainable Development for the review and decision-making of proposals on the distribution and use of net profit generated by SOEs⁵⁶. It was aimed at the efficient decision-making and transparency of the process.

It is noteworthy, that the commission has gathered only once since 2011 (on 22 July 2013) to make decisions about profit generated by SOE's in 2011-2012. The following table (4.1) presents information about the decisions by the commission and the sums to be transferred to the state budget.

Table 4.1 Information on Resolutions Made at Commission Meetings on Profit Distribution in 2010-2014⁵⁷

YEAR	UNDISTRIBUTED PROFIT (MILLION GEL)	TO THE SOE (MILLION GEL)	TO THE STATE BUDGET (MILLION GEL)
2010	115.4	59.9	55.5
2011	37.4	13.4	24
2012	–	–	–
2013	0.43	0.27	0.16
2014	–	–	–

As shown in the Table, about 44% of profits were retained by SOEs in 2010, while the rest was contributed to the State Budget. In 2011-2012 less revenues were reinvested - 1/3 of total profits. As for 2013 and 2014, as mentioned above, Commission has not yet gathered to decide on the issue.

According to the best international practice, State should be actively performing its partnership authority⁵⁸ - relevant Commission/Council meetings should be held on a regular basis (at least annually),⁵⁹ so that timely decisions are made on the profit distribution.

Passive performance of the Commission has led to delayed revenues to the State Budget – funds that should have been received in 2012 were received only in 2013, as decision on the distribution of profit generated in 2011 (including the

⁵⁶ Joint Decree of the Minister of Finance and Minister of Economic Development of Georgia N589, N1-1/91; 2004

⁵⁷ The Commission has not gathered in 2012 and 2014

⁵⁸ OECD; *Guidelines on Corporate Governance of State Owned Enterprises*; Paris, 2005, p. 28.

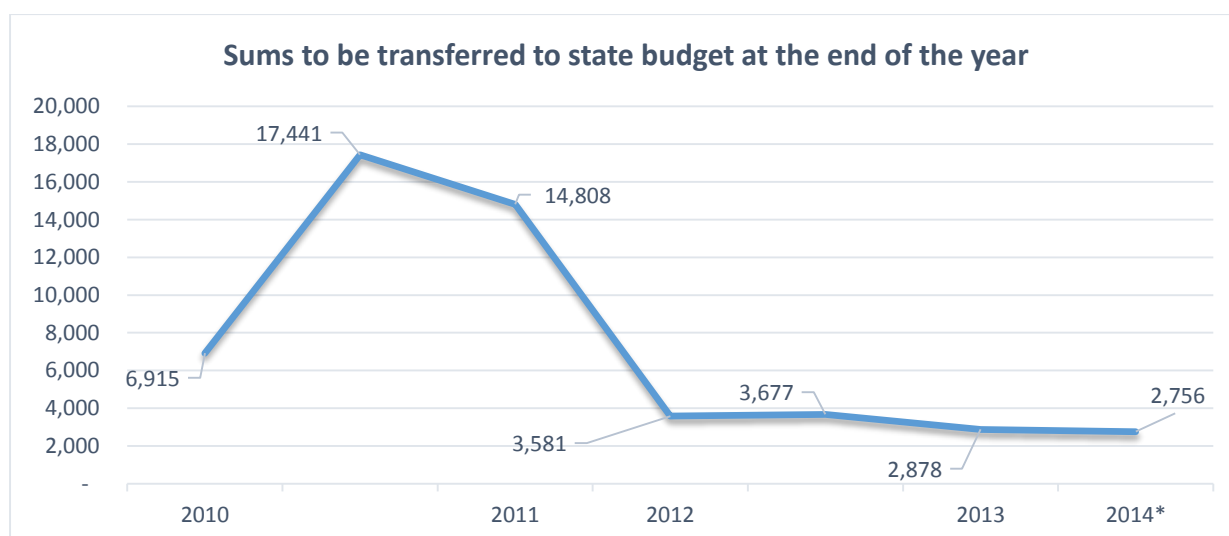
⁵⁹ Louis Kuijs, William Mako and Chunlin Zhang; *SOE Dividends: How Much and to Whom?*; World Bank Policy Note; October 17, 2005, p. 1

reinvestment) was taken at the meeting held in 2013; Besides, SOEs that required development and reinvestment failed to get part of their accumulated profit on time.

As for the profit generated in 2013, as mentioned above, it is still undistributed - State has not received its revenues and SOEs did not reinvest funds in their operation.

Table below (4.2) presents the trend of SOE contributions to the State Budget in the period of 31st December 2010 through 1st September 2014 on the grounds of the Resolutions made at Commission meetings. According to the Agency, by 31st December 2010 liabilities of the SOEs towards the State Budget amounted 6.9 million GEL. In 2011 this amount was augmented with 10.5 million GEL and actual contributions amounted 2.6 million GEL. As a result, by the end of 2011 SOE debt amounted to 14.8 million GEL. In 2012 Commission meetings were not summoned for the profit distribution, which SOE still contributed 11.2 million GEL to the State Budget, i.e. by the end of 2012 the referred debt was reduced to 3.6 million GEL. Similarly, on 31st December 2013 the debt was reduced to 2.9 million GEL, while in the first 8 months of 2014 it was further reduced by 122,384 GEL and as of 1st September 2014 State claim towards SOEs is 2,756 thousand GEL in the form of dividends.

Graph 4.2: Contributions due on the grounds of Resolutions Made at the Commission Meetings ⁶⁰



Conclusion

⁶⁰ The table shows total debt of the SOE's for state budget from 31 December 2010 to 1 September 2014

The state is not actively employ its partner rights towards profit distribution of the enterprises (which is one of the main principles mentioned in OECD guidelines) – the Commission does not gather annually, which hinders taking timely and adequate measures; besides, the Agency does not have implemented a functioning system for collecting dividends from the SOE's on time.

Recommendations to the Ministry of Finance and the Ministry of Economy and Sustainable Development of Georgia:

- › The commission responsible for the profit distribution of the SOE's shall have regular (annual) meetings to ensure timely mobilization of the sums to be received from the SOE's;
- › Effective measures shall be developed for the cases when the SOE management does not transfer the designated sum to the state budget on time.

Summarizing Conclusion and Recommendations

Examining existing situation in Georgia clarifies that without developing and implementing a strategy, clear vision and corporate governance principles, it seems impossible to optimize the governance system for SOE's and increase efficiency and profitability. This would be a starting point and fundament for ensuring effectiveness of the system. Due to the decentralization, governance system for SOE's is not uniform (each Ministry has its own approach to this issue), information about the enterprises is not complete and aggregate, the Agency and the Ministries have difficulty in coordinating, which hinders timely decision-making and modern corporate governance.

Despite certain shortcomings, the most acceptable reporting system is the one implemented in NASP. Though, the system needs to be further developed to achieve relevance to best international practices. The reporting system is more or less developed in some Ministries, but in others it does not actually work. One more deficiency is that there are some SOE's, which are not reporting to their supervising authorities at all. Moreover, the Agency does not have consolidated information about activities of all the SOE's in the country, which hinders transparency and the Parliament (as well as media and other stakeholders) does not have a possibility to understand the aggregate picture of the SOE activities, identify the problems and take adequate measures.

Concerning the privatization of shares and assets of the SOE's, a developed (though not yet approved) instruction for the privatization process can be considered a step forward, as it is already implemented in practice. Besides, all relevant structural units are involved in the process and the arisen issues are solved on the committee meetings. However, the procedures have certain deficiencies, specifically, determining the value of privatization object depends solely on the opinion of expert/external auditor, solvency of the potential investors is not pre-assessed and the competitive environment is not ensured for the auctions.

Due to the non-existence of a clear policy and methodology for profit distribution of the SOE's, it is quite difficult to assess how proper and expedient is the process itself. The state does not actively employ its authority as a partner in this regard either – the Commission responsible for profit distribution does not gather regularly, which hinders taking timely and adequate measures. Furthermore, the state has not developed effective measures to collect dividends without delays.

Recommendations:

To National Agency of State property:

- › Criteria for establishing State Owned Enterprises shall be determined. In case the exiting SOE's meet the criteria, they shall remain under state management;
- › It is advisable that Georgia switches to the Dual model of governance of SOE's, the Agency should coordinate the SOE's with transferred rights of use, independently perform certain responsibilities of the partner and not delegate all the managerial rights to the Ministries;
- › The NASP shall, at first, check records for every existing SOE and update information about their assets and liabilities. The next step would be establishing internal control mechanisms for the operating SOE's to minimize the risk of fraud and incompliance with the law as well as increase accountability of the SOE management.
- › Reporting system should be unified and the Agency should design a report sample, according to which, every SOE will present their annual financial and activity report to their superior authorities (Ministries as well as the Agency). The next step would be consolidating collected information in aggregate report about the SOE's, which will be presented to the stakeholders and interested parties, to ensure transparency of the system;
- › It is advisable to develop specific rule to regulate remuneration/bonus system. The Instruction shall take the labor market situation into consideration as well as relevance of management performance with the pre-determined goals;
- › It is important to determine the value of privatization object (assets, stocks) according to best existing practices. For this reason, methodology for determining privatization prices shall be developed, which will consider external auditor's/expert's opinion, but will not solely depend on it.
- › Before holding an auction, delivering information to the potential investors and creating competitive environment for the auctions shall be ensured by the Agency, which is the prerequisite for maximization of the sum gained through privatization.

To the Ministry of Finance and the Ministry of Economy and Sustainable Development of Georgia:

- › The commission responsible for the profit distribution of the SOE's shall have regular (annual) meetings to ensure timely mobilization of the sums to be received from the SOE's;
- › Effective measures shall be developed for the cases when the SOE management does not transfer the designated sum to the state budget on time.

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