

## AUDIT REPORT

November 16, 2012

No 5.1-2-13/2012

### **Governance of state owned enterprises operating in environmental sector and compliance of their performance with legal and regulatory framework**

#### **Legal Justification of the Audit**

1. According to the Section 2 of the State Audit Office Law and Audit Assignment No 5.1-2-13/2012 of 07.05.2012 of the Fourth Audit Department of the State Audit Office, a legality audit "Governance of state owned enterprises operating in environmental sector and compliance of their performance with legal and regulatory framework" was conducted.
2. The audit was conducted by Janis Salenieks, Senior State Auditor (team leader), Ineta Rancane, Senior State Auditor, Baiba Krumina, State Auditor, Kristine Loca, State Auditor, and Iveta Mansura – Garsija, State Auditor.

#### **Objective of the Audit**

3. The objective of the audit was to gain assurance whether the Ministry of Environmental Protection and Regional Development supervises state owned enterprises (Latvian Environment, Geology and Meteorology Centre and Environmental Investment Fund) in accordance with the internationally accepted best practices and ensures that said state owned enterprises operate in accordance with provisions of legal and regulatory framework.

#### **Accountability of the State Audit Office**

4. The auditors of the State Audit Office are responsible for issuing the audit report based on appropriate, sufficient and credible audit evidence obtained during the audit.

#### **Accountability of the Audited Entities**

5. The Ministry of Environmental Protection and Regional Development (hereinafter: MEPRD), state owned enterprises (hereinafter: SoE) Latvian Environment, Geology and Meteorology Centre (hereinafter: the Centre) and JSC Environmental Investment Fund (hereinafter: the Fund) are responsible for compliance with legal and regulatory framework and the credibility of information provided to auditors.

#### **Audit Scope**

6. The audit has been conducted in accordance with international auditing standards recognised in the Republic of Latvia. The audit is planned and performed so as to gain reasonable assurance in the governance of SoE operating in environmental sector and the compliance of their performance with provisions of legal and regulatory framework.
7. The audit covered the time period from 01.01.2010 to 31.05.2012. The information starting from 2006 was used when evaluating operations related to investing Olaine hazardous waste incineration plant into the share capital of the Center. The operations performed by audited entities during the time period between 31.05.2012 and the date of commissioning audit report were also taken into consideration by auditors.

8. Institutions included in the scope of the audit:
  - 8.1. Ministry of Environmental Protection and Regional Development<sup>1</sup>;
  - 8.2. the Centre;
  - 8.3. the Fund.
9. The audit scope included the following issues:
  - 9.1. supervision of SoE operating in environmental sector (the Centre and the Fund) by MEPRD, verifying:
    - 9.1.1. compliance of SoE governance with provisions of the *Guidelines on the Governance of Government-Owned-Enterprises in the Baltic States*<sup>2</sup> and the established legal / regulatory framework;
    - 9.1.2. operations of the MEPRD when investing fixed assets into the fixed capital of the Centre and granting permissions to put the invested assets on immediate auction;
    - 9.1.3. performance of the MEPRD when approving the amount of the annual state budget subsidy for financing public service tasks delegated to the Centre and the Fund;
    - 9.1.4. performance of the MEPRD when monitoring use of the subsidy by the Centre and the Fund.
  - 9.2. compliance of performance of the Centre and the Fund with the established legal / regulatory framework, verifying:
    - 9.2.1. maintenance of the fixed assets invested into the Centre;
    - 9.2.2. economic and financial justification for calculations performed by the Centre and the Fund to request the state budget subsidy;
    - 9.2.3. compliance of use of the subsidy granted to the Centre and the Fund with legal and regulatory framework;
    - 9.2.4. compliance of calculation and use of own revenues with the requirements of legal and regulatory framework;
    - 9.2.5. transparency of granting loans by the Fund and application interest rates to the loans.
10. Performance of the Fund when checking the reports and payment requests submitted by beneficiaries of the Climate Change Financial Instrument was not included in the audit scope.

## Summary

11. Supervision of the two SoE (Latvian Environment, Geology and Meteorology Centre and Environmental Investment Fund) by the MEPRD as a 100% shareholder is not sufficient, because the audit revealed breach of rules and regulations and uneconomical use of state budget funds resulting in non-compliances amounting to LVL 3,397,380:

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<sup>1</sup> As from 01.01.2011. the Ministry of the Environment and the Ministry of Regional Development and Local Government was reorganized to form the Ministry of Environmental Protection and Regional Development (Cabinet of Ministers (hereinafter: CM) Regulation No.676 of 22.11.2010 “On Ensuring Liquidation of the Ministry of Regional Development and Local Government”).

<sup>2</sup> *Guidelines on the Governance of Government-Owned-Enterprises in the Baltic States*. Baltic Institute of Corporate Governance, 2010.

- 11.1. the accounting system maintained by the Centre fails to provide basic data (ABC<sup>3</sup>) for calculating economically justified amount of the annual state budget subsidy, thus the annual state budget subsidy, among others, covers also commercial costs of the Centre;
- 11.2. prices for the services provided by the Centre are not economically justified;
- 11.3. fixed assets are being invested into the fixed capital of the Centre and permissions to put the invested assets on immediate auction are being granted without prior analysis and appraisal of added value from such actions;
- 11.4. the Fund grants loans with lower interest rates than approved by the shareholder of the Fund;
- 11.5. allocated financing for remuneration and fuel were not spent efficiently.
12. The governance of both SoE fails to comply with the best governance practices<sup>4</sup>, because:
  - 12.1. the strategy of the Centre is not approved by shareholder thus increasing the risk of political influence;
  - 12.2. the results to be achieved by the Centre are set only for the tasks funded by the state budget subsidy, while those relating to the commercial activity and funded by own revenues are not defined, thus limiting the possibility to assess the overall effectiveness of the SoE;
  - 12.3. the operational results of both SoE are not reviewed at shareholder meetings, thus limiting possibility of shareholder to take timely decisions and to pursue state interests.
13. A number of non-compliances with rules and regulations concerning SoE governance, where detected by auditors:
  - 13.1. the shareholder failed to approve the main principles of remuneration for the Centre, concerning granting benefits and compensations to employees, defining maximum level for wages, as well as other restrictions imposed by the law<sup>5</sup>; maximum level for wages was not defined for employees of the Fund as well;
  - 13.2. the monthly wage of the chairman of management board of the Fund exceeds the maximum amount set in the law<sup>6</sup>, thus LVL 927, paid to the chairman during the time period from 01.04.2011 to 31.05.2012, is to be considered as ineligible;
  - 13.3. authorization<sup>7</sup> and employment<sup>8</sup> contracts between the MEPRD and four SoE management board members envisage two to three times higher

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<sup>3</sup> Activity Based Costing.

<sup>4</sup> *Guidelines on the Governance of Government-Owned-Enterprises in the Baltic States*. Baltic Institute of Corporate Governance, 2010.

<sup>5</sup> Section 48 (3) of the Law "On State and Local Government Capital Shares and Capital Companies".

<sup>6</sup> Section 61 (3) of the Law "On State and Local Government Capital Shares and Capital Companies" (as amended on 01.04.2010); CM Regulation No.311 of 30.03.2010 "Regulations on the Number of Members of the Board, the Remuneration of a Member of the Council and the Board, a Representative and a Responsible Employee of the Holder of Local Government Capital Shares of State and Local Government Capital Companies" (in force from 01.04.2010).

<sup>7</sup> Authorization contract No.1 of 03.07.2012, Sub-Clause 3.4; authorization contract No.2 of 03.07.2012, Sub-Clause 3.4; authorization contract No.3 of 03.07.2012, Sub-Clause 3.4.

compensations, compared to the limits prescribed by internal rules and regulations of the MEPRD<sup>9</sup>. In addition, one of the contracts does not impose any restrictions on the management board member to take commitments in relation to third parties.

14. The shareholder of the Centre fails to ensure efficient supervision of delegated functions and economic use of state budget funds, because viability of investing fixed assets into the fixed capital of the Centre, and further sales of said assets by the Centre have not been properly appraised. Thus: :
  - 14.1. investing of four fixed assets (LVL 1,828,100)<sup>10</sup> into the fixed capital of the Centre and planned<sup>11</sup> investing of fixed assets (LVL 85,800) into the fixed capital of the Centre is considered to be unjustified and inefficient, and state budget will not get a revenue from sales of state property<sup>12</sup> in the amount of LVL 508,100;
  - 14.2. Olaine hazardous waste incineration plant with the value of Ls 500,850 was invested in the fixed capital of the Centre, however the plane was not operational, and currently causes losses to the Centre in the amount of Ls 50,085 per year as depreciation costs;
  - 14.3. the shareholder granted a permission for the Centre to auction eight meteorological stations with the value of Ls 243,900, although they were necessary to ensure commercial activity of the Centre and to perform the tasks delegated by the state.
15. The supervision by the shareholder over granting and use of state budget subsidy by SoE to perform delegated state functions is insufficient and does not comply with rules and regulations<sup>13</sup>:
  - 15.1. The amount of the annual state budget subsidy granted to the Centre is not justified, because:
    - 15.1.1. the Centre is not required to create and maintain a system ensuring accounting for actual costs incurred, when executing delegated public service tasks and when performing commercial activity, therefore the Centre is not able to propose economically justified calculations for the state budget subsidy required for execution of delegated public service tasks, as well as calculate the ratio of direct and indirect costs;
    - 15.1.2. when calculating the required subsidy for maintenance of real estate, the expected revenue from letting out real estate to third parties is not taken into account, thus unjustifiably increasing the amount of the state subsidy by LVL 169,025 in 2011-2012.

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<sup>8</sup> MEPRD employment contract No. 37 of 18.02.2002 (with amendments of 19.06.2002 and 19.12.2006), Clause 4

<sup>9</sup> Annex to the Internal Regulation No.9 of MEPRD of 03.04.2012 "Procedure of Management of State Capital Companies" ..

<sup>10</sup> One core storage with the market value of LVL 285,000, two hazardous waste disposal sites with the market value of LVL 223,100, the administrative building at Eksporta Street 5, Riga, with the market value of LVL 1,320,000.

<sup>11</sup> The property at Cesu Street 13, Rujiena, with the market value of LVL 12,500 and the property at Plata Street 11, Riga, with the market value of LVL 73,300.

<sup>12</sup> One core storage with the market value of LVL 285,000, two hazardous waste disposal sites with the market value of LVL 223,100.

<sup>13</sup> Section 43(3), 43(5) and 43(6) of the State Administration Structure Law.

- 15.2. In a number of occasions the Centre used the annual state budget subsidy illegally:
  - 15.2.1. in 2011, without getting approval by the shareholder, transferred financing between the budget categories, thus LVL 64,396 were not used in compliance with the delegation agreement signed between the Centre and the shareholder;
  - 15.2.2. illegally spent the budget subsidy in the amount of LVL 30,760 by covering costs not related to execution of delegated state functions, as well as by not observing the requirement of the delegation agreement<sup>14</sup> that the remuneration costs of the chairman of the management board shall be covered proportionally from the budget subsidy and commercial revenues.
- 15.3. The MEPRD as the shareholder has not gained assurance that LVL 23,991 spent by the Fund were related to operational objectives of the Fund.
16. The ratio between direct and indirect costs related to execution of public service tasks delegated to the Centre is not justified and indicates that commercial activity costs of the Centre are covered from the state budget subsidy, because:
  - 16.1. all administrative and infrastructure costs are considered by the Centre as indirect costs. The Centre assigns 61% of indirect costs to the state subsidy without any appraisal, although a part of the infrastructure is not used for performing delegated state functions, but rather for the commercial activity;
  - 16.2. differing direct/indirect cost ratios are used for executing delegated state functions and for commercial activity – for commercial activity indirect costs are set in the amount of 25% from direct costs, while for execution of state functions indirect costs reach 101% from direct costs.
17. The Centre has not developed methodology for calculating tariffs, and the applied prices are not traceable and justified. However, the following tendencies were observed by auditors:
  - 17.1. prices for a number of services that are also offered by other market players are below their actual cost and additional discounts were granted, thus reducing revenue of the Centre in the amount of LVL 164,345 in the time period from 01.01.2012 to 31.05.2012;
  - 17.2. furthermore, the services provided by the Centre as the only service provider in Latvia and rendered in accordance with the price list approved by the Cabinet of Ministers, are sometimes exaggerated. For example, much more time than actually needed rendering of the service was included in calculation of the price – thus prices were increased from LVL 25 (3.4 times) to LVL 1744 (7.1 times) for an item, and clients overpaid LVL 18,942.
18. In the period from 01.01.2010 to 30.05.2012 the Centre has not ensured receipt of planned revenues in the amount of at least LVL 212,153:
  - 18.1. depreciation of infrastructure of Zebrene landfill was not included in the price for services related to the disposal of hazardous waste in Zebrene

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<sup>14</sup> Agreement between the Ministry of the Environment and the Centre of 29.01.2010 on amendments to the Individual administration tasks delegation agreement; agreement between MEPRD and the Centre of 31.01.2011 on amendments to the Individual administration tasks delegation agreement, Indirect costs of the Centre in 2011.

- landfill, thus breaching regulations and not receiving the planned income in the amount of LVL 19,175;
- 18.2. real estate is not let out for the highest possible price, because calculations of rent prices did not include all the costs defined by rules and regulations<sup>15</sup>, thus reducing revenues by LVL 192,978.
  19. In the period from 01.01.2010 to 31.05.2012 the audited SoE did not adhere to provisions of rules and regulations<sup>16</sup> sound financial management principles:
    - 19.1. the Centre – at least in the amount of LVL 11,816:
      - 19.1.1. at least LVL 6962 were used to cover fuel and car parking costs incurred by commercial director and financial director of the Centre in order “*to ensure ad hoc travel of these employees from their places of residence back to the place of work*”, although no such occasions were detected by auditors during the whole audited period;
      - 19.1.2. LVL 4330 were used to cover fuel costs spent for travels not being related to the tasks of the Centre (vehicles were used in weekends or during vacation periods, fuel was filled in vehicles in volumes exceeding tank capacity or driving with an empty fuel tank was detected, which indicates about falsification of documents and fraud;
      - 19.1.3. LVL 797<sup>17</sup> were used to cover fuel costs incurred by the chairman of management board of the Centre, driving two vehicles simultaneously;
    - 19.2. The Fund – in the amount of LVL 404, because 6348 km longer distance than the actual one is entered into travel reports.
  20. The Fund grants loans with lower interest rates than approved by the shareholder of the Fund, thus revenue of the Fund in the audited period was reduced by LVL 41,971.

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<sup>15</sup> Paragraph 6 and Sub-Paragraph 8.2 of CM Regulation No.365 of 28.11.1995 “Procedure of Calculation of Rent for the Use of Non-Residential Premises in Buildings Owned by Ministries and Other State Institutions” (in force to 01.07.2011).

<sup>16</sup> Section 3(1) of the Law “On Prevention of Squandering of the Financial Resources and Property of the State and Local Governments”.

<sup>17</sup> Including expenses in the amount of LVL 273 on filling in fuel: on weekends, in cases of driving with an empty fuel tank, etc.