

INTOSAI



*Guidelines on
Best Practice
for the Audit of
Privatisations*

INTOSAI PROFESSIONAL STANDARDS COMMITTEE

PSC-SECRETARIAT

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CONTENTS

Introduction

Guidelines

Section 1: SAI Skills

- 1 SAI requirements
- 2 How to acquire the skills

Section 2: General

- 3 Involvement of the SAI in the privatisation
- 4 Access by bidders to the SAI's audit papers
- 5 Planning privatisation audit
- 6 Pre-sale restructuring of the business
- 7 Sale objectives
- 8 Timing of the sale
- 9 Pre-sale valuation of the business
- 10 Sale methods
- 11 Vendor integrity in conducting the sale
- 12 Residual management issues

Section 3: Trade Sales

- 13 External advice required by the vendor
- 14 Management of the business
- 15 Marketing the business
- 16 Information for potential bidders
- 17 Bid evaluation

18 Shortlisting bidders

19 Preferred bidder

20 Final negotiations

Section 4: Management Buy-Outs

21 Securing fair competition

22 Incentives

23 Securing the best possible price

Section 5: Mass Privatisations

24 Education of public investors

25 Intermediaries

26 Sale process

Section 6: Auctions

27 Competitions

28 Sale process

Section 7: Flotations

29 The role of the vendor

30 The vendor's management of the flotation

31 Underwriting

32 Management and employee incentives

33 Attracting potential investors

34 The retail market

35 Pricing the shares

36 Allocating the shares

37 Market stabilisation

Section 8: Sale Costs

38 Appointing external contractors

39 Setting and monitoring budgets for external contractors

40 Methodologies for quantifying overall costs

Glossary

Introduction

1. The privatisation of state-owned businesses has been one of the most striking economic developments over the last decade and more. Adopted in a variety of forms by most countries throughout the world, privatisation has been seen as typifying a radical reappraisal of the role of the state in society, leading to the withdrawal of government from direct participation in many areas of economic activity to a more detached role, often accompanied by economic regulation. The process has extended into areas previously seen as core state activities, such as the provision of a wide range of publicly funded services: governments now increasingly see themselves as purchasers or facilitators rather than providers, of such services.

2. Members of the International Organisation of Supreme Audit Institutions (INTOSAI) recognised early in the process that these profound developments in the role of the state have important implications for the work of SAIs who, in the midst of often tumultuous change, need to be able to understand these complex transactions and to carry out independent appraisals of them in the public interest.

3. Having regard to the considerable interest and work in many of its regions on the issues raised, INTOSAI decided in 1993 to establish a Working Group on the Audit of Privatisation, with the following terms of reference

- to identify and examine problems confronting SAIs in the audit of privatisation
- to exchange information on the range of experience within the Working Group's membership in resolving these problems, having regard to relevant work in INTOSAI regions, and
- to facilitate the provision of information on this subject to INTOSAI members.

4. With 23 members, the Group currently have the largest membership of any INTOSAI Committee or Working Group, reflecting the widespread interest in this subject. As at June 1998 the members were:

Albania	India
Argentina	Israel
Australia	Lithuania
Austria	New Zealand
Bahamas	Peru
Belarus	Poland
Ecuador	Russia
Egypt	Saudi Arabia
El Salvador	Turkey
Estonia	United Kingdom - Chair

Germany

Yemen

Hungary

5. In 1994, the Working Group invited 165 members of INTOSAI to participate in a survey of privatisation and its audit in their countries; 117 SAIs responded, providing the most authoritative and comprehensive survey of its kind that had so far taken place. The results of this survey, and papers from members of the Group on a number of major audit issues, were presented at the Symposium on the Audit of Privatisation hosted by the Central Accounting Organisation of Egypt in Cairo in October 1995, following INCOSAI XV.

6. The Symposium noted that one of the major tasks facing the Working Group over the two years following INCOSAI XV would be the preparation of guidelines on best practice for the audit of privatisation. The Working Group have now carried out that task, drawing on their own experiences and on the many valuable experiences and lessons contributed by other INTOSAI members and regional meetings.

7. The Working Group have identified eight areas of particular concern to INTOSAI members, as regards the transfer by central or local government of businesses and their assets from state to private ownership, which merit the development of 40 audit guidelines. These are set out below in eight sections corresponding to the eight areas of concern. They are:

Section 1: The skills required by the SAI to carry out privatisation audits.

Section 2: Ten guidelines which are general in character covering important questions which are likely to arise whatever the privatisation method employed, such as the point at which the SAI ought to become involved in the privatisation, understanding the vendor's privatisation objectives, and issues relating to the valuation of the business.

Sections 3 to 7: These five sections consist of 25 guidelines relating to specific issues which the SAI is likely to need to address, depending on the sale method used by the vendor, grouped by reference to five major and differing methods, namely:

Trade Sales

Management and Employee Buy-Outs

Mass Privatisations

Auctions

Flotations

Section 8: The final section consists of three guidelines relating to the audit of the costs incurred by the vendor.

8. None of the issues addressed in the guidelines is straightforward; all require the SAI to be well informed and balanced in reaching judgments on how well the vendor managed the sale, faced with uncertainty and, typically, with competing objectives. So each guideline has been drawn up to a format designed to bring out the reasoning and experience underlying it. To this end, there are four parts to each guideline

- the issue (i.e. the question for the SAI to address)

- why the issue matters (i.e. the risks to the vendor - and the SAI - if the question is not addressed)
- the guideline itself, and
- the reasons for the guideline (a background note, expanding as necessary on the previous points).

9. Although these issues are complex, the Working Group believe they can be summarised in three basic questions which SAIs should ask in deciding whether or not to examine and report on a particular privatisation

- was the privatisation carried out in accordance with the law?
- were the business and its assets properly valued by the vendor?
- was there more than one bid?

10. If the answer to any one of these questions is "no", it is possible that the SAI will have to report on the sale. If the answer to two of these is "no", it is very probable that the SAI will have to report on the sale. If the answer to all three is "no", the SAI will almost certainly need to report on it.

11. The Working Group invited comments on the draft guidelines from all INTOSAI members. Some 40 members have replied, all welcoming the guidelines, and a number offering suggestions on certain aspects. The Working Group are very grateful for these suggestions which they have taken into account in finalising the guidelines.

12. In commending the guidelines to INTOSAI, the Working Group are conscious of course that SAIs are operating in an environment which is changing rapidly, both within countries, ranging from former command economies to mixed economies, and across regions. It follows that some at any rate of the detail of what is proposed must be subject to further development and refinement in the light of experience. This underlines the nature of these guidelines. They are not laws or procedures set in stone which every SAI should apply in their entirety in studying every sale. They are a checklist, part of the process of encouraging and formulating a professional approach in a complex area of audit. We believe they offer the basis of valuable training for our staff.

13. While important, transfers by sale to the private sector, which are the particular focus of these guidelines, are only one aspect of privatisation which continues to take a variety of forms, including contracting, outsourcing, and competitive tendering between public and private suppliers. In addition, major public services are increasingly being funded by a mixture of private and public financing, often involving long contractual relationships. Many of the audit issues raised in the present guidelines are of relevance to these arrangements, which also however raise some new issues. In commenting on the draft guidelines, SAIs have expressed an interest in developing and sharing audit lessons in these developing areas of privatisation too, and also in the closely linked issue of the role of the state in economic regulation. The Working Group will be devoting further study to these important matters.

Section 1: SAI Skills

Guideline 1

SAI requirements

Issue

What skills does the SAI require to audit privatisations?

Why this matters

Throughout the world, state-owned enterprises are being sold into the private sector in order to develop the market economy and to improve business efficiency. In many countries these sales are taking place while the economy itself is undergoing radical and rapid changes. A variety of sale methods is used, often in combination, and the processes are frequently complex, raising difficult legal, financial and accountancy issues. Parliaments and the public look to the SAI for reassurance that the sales have been efficiently and properly handled, particularly as regards obtaining value for the business and its assets. They want to know what are the lessons for future sales. If the SAI does not have access to the necessary specialist skills, it is unlikely to be able to give reassurance where this is due, and to identify what, if anything, went wrong.

Guideline

The SAI should identify what are its audit responsibilities in relation to privatisations and decide how to carry these out. The specialist skills needed to carry out privatisation audits are likely to range wider than the traditional audit skills available. The SAI needs to identify these specialist skills.

Reasons for the guideline

In nearly all countries the responsibility for auditing the state agencies responsible for privatisations rests with the SAI. And in most of these countries the SAI has full or limited access to the accounts of the businesses prior to the sale. In many of these cases, the SAI is responsible for the financial audit of the accounts of the business when in state ownership. Where the SAI has this responsibility it needs to have regard to the fact that the audit of the pre-sale accounts carries a higher level of risk to the auditor's role than is likely to be the case where there is to be no change in ownership. This is because the parties to the sale will be relying on the financial information about the business which has been audited by the SAI. The audit will be more demanding if there has been a significant restructuring of the business before the sale, and if accounting practices have been changed to prepare the business for transfer to the private sector. For these reasons the SAI needs to secure both appropriate commercial accounting skills and the necessary level of knowledge of the industry and market in which the business operates.

Where the SAI also carries out performance audits of the sale process itself, the skills required by the SAI can be divided into two groups. First, there are the general audit performance skills required to undertake the effective audit of any complex or high risk assignment. These will include knowledge of the political environment and machinery of government. A particular feature in countries undergoing economic transformation is that laws relating to public and private ownership are likely to be changing and developing

while the privatisation is taking place, with a number of uncertainties, for example over the ownership of the business and residual state liabilities, remaining throughout the sale process. So the SAI needs to have access to good legal, as well as commercial, advice. Auditing privatisations calls for the exercise of judgment at the complex end of this range of knowledge, and the SAI will generally need to put its ablest performance auditors on to this work, experienced in carrying out difficult appraisals with incomplete/ambiguous data, and skilled in analysis and negotiation.

Second, the SAI needs to have access to specific skills relating to the business being privatised and the marketplace. These will include, in addition to contractual and legal skills, knowledge of investment banking, relating in particular to valuation, the sale process and the information required by financiers, together with financial, analytical and economic skills, covering issues such as discount factors and the ability to understand the basis of bids for the business being offered for sale.

Guideline 2

How to acquire the skills

Issue

How should the SAI acquire in a cost effective way the range of skills required to audit privatisations?

Why this matters

Privatisations vary in complexity, scale and volume. The SAI must be in a position to make an authoritative evaluation. But it would be very expensive for the SAI to recruit and retain in-house all the necessary skills to enable it to examine all aspects of all sales.

Guideline

The SAI should identify and secure the core in-house skills it needs to enable it to carry out authoritative studies of privatisations, having regard to the expected nature and timescale of the government's privatisation programme, and supplement these skills with expert external support as necessary.

Reasons for the guideline

For large or complex privatisations, it is unlikely that SAIs will have all the necessary skills and knowledge adequately to discharge their responsibilities. In these situations particular specialist skills will need to be bought in, otherwise the SAI may not be able to carry out a thorough audit, and its conclusions may be suspect. So the cost of not having adequate expertise available may be high in terms of the SAI's public credibility. Experience suggests that in order to complete a searching audit promptly it can be cheaper to buy in this expertise from external consultants on a case by case basis than trying to do all the work in-house. This is provided of course that the areas requiring specialist consultancy input are clearly identified by the SAI, and a careful selection is made of consultants who have the skill required, to ensure for example that they have no relationship either with the

privatised business or with the bidders. The consultants will require careful management, and they will need to have the respect of the audited body as well as the SAI.

It may also make sense for the SAI to recruit such experts on a longer term basis, especially for example where the state is embarking on a major programme of privatisations and the SAI needs to develop its range of core in-house audit skills in response. In such cases, staff joining the SAI with the new skills required can help to develop and train existing SAI staff with the right aptitude to become highly effective auditors in these challenging new areas. As part of this learning process, SAIs have also found it very helpful to exchange experiences and information with each other on completed audits, and to exchange staff on secondments. It can also be valuable for the SAI to second some of its staff to external specialist firms to obtain the necessary expertise, and to participate in seminars, symposia and conferences focusing on privatisation themes.

Once the SAI has developed the expertise of its staff in this way, it will be well placed to develop its audit role in response to other changes in the way the state is involved in the economy, for example the regulation of privatised businesses, contracting out state functions to the private sector, and other ways in which the public and private sectors are working in partnership. In this way the SAI can build up and retain teams specialising in such audits. But it is always likely to be cost effective to supplement SAI in-house skills with external advice from consultants in specialist fields calling for a high degree of up to date expertise.

Section 2: General

Guideline 3

Involvement of the SAI in the privatisation

Issue

When should the SAI become involved in the privatisation?

Why this matters

In many countries the SAI is the auditor of the business when in state ownership. The SAI may also be required to give certain approvals to the vendor before the sale can go ahead, or may have to advise the vendor on the financial state of the business, and to provide certificates or statements on the financial standing of the business which can be quoted in the sale documentation. Whether or not it is the auditor of the business before the sale, there are good reasons for the SAI examining the sale, and such an examination is likely to come within the SAI's mandate, because what is being sold is a public asset, and the public needs independent assurance that the process has been properly handled and that the taxpayer has received value. Also it will be clear both to the vendor and the buyer that there could well be an appraisal by the SAI of the outcome to the sale and that they would be accountable for their part in it. All of these features have a bearing on the point at which the SAI should become involved.

Guideline

The SAI should become involved in the privatisation process as soon as constitutionally possible, consistent with maintaining its independence.

Reasons for the guideline

The SAI needs to become involved as soon as possible in order to master the key aspects of the transaction, some of which may expose the SAI to risk. This is particularly important where the parties to the sale will be relying on financial information about the business audited by the SAI. It is of course important too for the SAI to establish close liaison arrangements with the vendor before the sale if the SAI has a role in the decision to sell.

The SAI is the auditor of government. Privatisations can however also be carried out by regional or local administrations. These privatisations may also be within the mandate of the SAI and, where they are not, the SAI may wish to seek an extension to its mandate if, for example, without such an extension these sales might not be subject to independent scrutiny. In any case the SAI needs to be clear who was responsible for what in carrying out the sale.

Where the SAI is not the financial auditor of the business but intends to carry out a performance audit of the sale process, it should establish close liaison arrangements with the vendor with the aim of commencing the audit as soon as possible after the sale has taken place, since experience suggests that those engaged in the sale, including key parties to the negotiations, will move on to other work once the sale has taken place.

Where the SAI is able to examine the sale before it takes place this will enable it to play a corrective role in the carrying out of the sale. It will be necessary to identify the key aspects to be covered in such a pre-sale audit. These could include establishing that there is a clear division of responsibilities between the vendor and the management of the business being sold, an evaluation of the risks and opportunities facing the business and the impact on its likely value, the information offered to bidders and the terms of the sale agreement. Whether or not the SAI is formally involved before the sale takes place, it will be important to ensure that any such prior involvement does not prejudice its responsibility for taking an independent view of the transactions. Its independence could be compromised for instance if, in approving any arrangements for the sale, the SAI had not taken care to explain that this was without prejudice to its subsequent appraisal of the outcome of the sale.

Guideline 4

Access by bidders to the SAI's audit papers

Issue

Where the SAI is the auditor of the business before sale, how should the SAI respond to a request from a potential bidder for access to the SAI's audit working papers?

Why this matters

Access to the SAI's audit working papers, where the SAI is the auditor of the state-owned enterprise being sold, opens the SAI to the risk of civil claims and reputational risk should

the buyer subsequently take action against the SAI based on perceived faults in the current or previous audits.

Guideline

Where the SAI is the auditor of the business before sale, the SAI should consider developing explicit guidelines relating to the right of bidders to obtain access to the SAI's audit working papers.

Reasons for the guideline

Potential bidders frequently seek access - either directly from the auditor or via the vendor - to audit working papers as part of the due diligence process. They do this

- to confirm the quality of the audit undertaken
- to obtain independent comment on the quality of the state enterprise's financial accounting systems in place, and
- to confirm the underlying assumptions and values in the most recently audited financial statements.

Many of the questions are often more appropriately directed to the management of the enterprise itself. Others can only be answered by the auditor.

In some countries SAIs may not be legally entitled to refuse such access to their papers. In other countries they may be so entitled. If they do refuse, bidders will obviously have to rely on other sources of information such as the sale documentation and their own examinations. In developing its policy, under the law and having regard to professional practice in its country, on access to working papers, the SAI needs also to bear in mind however the interests of the vendor in achieving a satisfactory sale outcome, and so may decide to co-operate with the request. Accordingly, questions which bidders are entitled to or are allowed to raise should be answered in a complete and forthright manner, but in a manner which minimises, and avoids, if at all possible, litigational or reputational risk to the SAI.

The SAI may find it sensible to develop guidance to be applied to all due diligence situations involving potential purchasers. The points that could be covered in such guidance include

- the SAI's audit staff should immediately inform the SAI when an approach is made to them by a potential purchaser conducting due diligence
- the express permission of the business should be obtained before any discussions can be engaged in with potential purchasers
- representatives of the SAI and of the business should always be present in any discussions with potential purchasers conducting due diligence
- a list of questions should be obtained from the potential purchaser, through the business, before any meeting with the potential purchaser, and
- at the meeting with the potential purchaser, any questions that relate to the responsibility of the management of the business should be directed to the business's representative, consistent with the auditor's understanding of the situation.

Guideline 5
Planning privatisation audit

Issue

What factors should the SAI take into account in planning the audit of a privatisation?

Why this matters

Audit planning is an essential audit discipline. Proper and thorough planning is particularly important for the audit of a privatisation. This includes ascertaining the objectives for the sale, including any unstated objectives, and who were the key parties to the sale, the risks and possibilities in the sale, and whether obligations to keep parliament informed were adequately met. The SAI should seek to identify lessons which may be of relevance to future sales. And where the SAI is involved before the sale takes place it should aim to warn the vendor of risks to the proper handling of the transaction so that the vendor can take corrective action. In countries which do not carry out privatisations through a central agency the vendor team frequently disperses to other work soon after a privatisation. So the SAI should generally plan to start the audit quickly after the sale to ensure adequate access to the audit evidence held by the vendors and their advisers, and also to the views of key third parties with a close interest in the sale.

Guideline

In planning the audit of a privatisation, the SAI should plan to cover all major aspects of the sale that have a bearing on propriety and value for money, to identify the key parties to the sale and to take evidence from them, and to be alert to identifying lessons from the sale, including the procedures followed and the outcome of the sale, together with the extent to which the sale objectives were achieved.

Reasons for the guideline

Without good planning the SAI risks undertaking an audit that is ill-focused and lacking in the breadth and depth of evidence needed to secure a credible report. The SAI needs to find out about the activities, financial situation and assets of the business and to identify what further information is required, and at what cost, in order to be able to carry out an audit of the privatisation process. The SAI will need access to the vendor as soon as possible since the vendor team may be dispersed to other work, especially where the sale is a unique event for the vendor concerned, rather than being handled as one in a series of sales by, for example, a central privatisation agency. Without such access, the SAI will not be able to probe such matters as the privatisation objectives, key criteria for success, and the views of the vendor on lessons for the future. Such information is essential to inform the audit approach, methodology, use of resources and reporting timescales.

It will also be important, whether or not the SAI has formal access rights to such bodies, to plan to seek the views of other parties involved in the sale. Privatisations typically involve a wide range of third parties in addition to the vendor. These may include the senior

managers of the business being privatised, bidders, institutional investors, advisers, staff representatives, industry and academic experts, and consumer groups. The SAI must quickly establish who these parties are and plan effective means of establishing their role in the sale and taking evidence from them about the sale. Techniques to establish such views typically include interviews, structured questionnaires and attitudinal surveys. Sometimes, for example in major share sales, the SAI may need to establish evidence on a global scale.

If there is a gap between the sale taking place and the SAI's report, the SAI will need to be alert to post-sale events which may cast light on the extent to which the vendor's sale objectives were achieved, for example whether the purchaser has met the terms of any agreement allowing for all or part of the payment for the business to be deferred for a specified period, what have been the movements in the share price after a flotation, and whether the purchaser has fulfilled any undertakings given as regards employment or investment levels in the business.

Guideline 6

Pre-sale restructuring of the business

Issue

What should the SAI examine as regards pre-sale restructuring of the business?

Why this matters

Restructuring state-owned businesses before privatisation ranges from putting the business into a legal form in which it can be sold to reorganising fundamentally the business and its finances to fit better the long term objectives of privatisation. Whether or not it carries out an assessment of the restructuring process in addition to auditing the ensuing sale, the SAI needs to understand how and why the business was restructured in order to make sense of the sale.

Guideline

The SAI should ensure it understands the vendor's objectives in carrying out any pre-sale restructuring, and what the vendor did in pursuit of those objectives.

Reasons for the guideline

Vendors have taken different approaches to the question whether and, if so, how and to what extent, a state-owned business should be restructured before being sold. These different approaches reflect differing economic circumstances from country to country, and differing privatisation objectives, which themselves can change within a country over time. For example, in those countries which have been seeking to move from a command to a market economy as quickly as possible, the emphasis has frequently been on privatising as a matter of urgency very large numbers of businesses, while at the same time trying to put in place the legal and trading systems needed to sustain a market economy. Changes in the framework of the law mean that the way in which SAIs audit privatisations will

change; for example, the SAI will need to pay particularly close attention to any uncertainties over the legal ownership of assets which the state is trying to sell or has sold.

Pre-sale restructuring has often been rudimentary and it has been left to the new owners to carry out any fundamental reorganisation after the sale if they wish, sometimes involving a significant reduction in the number of employees. In some advanced economies too downsizing has been left to the new owners, in the belief that such matters are best left to the market to decide. In such cases there may be social costs of privatisation (in particular unemployment) which may have to be paid later by the state. In order to avoid such social costs, some countries have made securing specified levels of employment and investment stated objectives of the privatisation. In other cases, however, governments have not had enough resources to pay for major pre-sale restructuring, which in any case could involve unacceptable delays to the sale. An examination of pre-sale restructuring policies followed by the vendor may throw light on the main reasons for the privatisation, and how the sale fits in to the government's general approach to privatisation.

The SAI needs to get a full understanding of the background to the sale, including the reasons why the state did, or did not, undertake a major restructuring as a prelude to a pre-determined sale, or whether at that stage the state was keeping open the option of privatisation. This careful research by the SAI will also help it to identify what were the key factors influencing the decision to privatise, which may or may not be set out in the stated objectives of the sale, for example any expected impact of the write-off of debt on the overall financial condition of the government.

There are likely to be a number of important questions of detail to address as regards the restructuring decision. For example, where the enterprise owed large debts to the government or other state-owned enterprises, to what extent these debts were written off entirely or converted into equity or new debt, and what impact this had on the price the vendor was able to get for the business. In some cases for instance the vendor may conclude that the business will be unsaleable unless all, or a large proportion, of its debts are written off. In addition, the structure chosen for the enterprise can affect its marketability. Other things being equal, for instance, a monopoly will command a higher price than a business sold into a competitive market. Where however vendors are seeking to develop competition, they may sometimes decide to split a large business into smaller units in order to encourage a wider range of potential bidders. This can enhance competitive tension during the bidding process and encourage a more competitive market after the sale.

Where the SAI is considering examining and reporting on the restructuring it will need to bear in mind that, apart from the impact on the sale, it may be some time before it will be possible to reach a view on how far the privatised business is contributing towards any overall objectives the government may have laid down for privatisation (for example, development of the market economy), and even then it may be difficult to evaluate the impact of the restructuring decisions.

Guideline 7
Sale objectives

Issue

What should the SAI seek to establish concerning the vendor's sale objectives?

Why this matters

Establishing the vendor's sale objectives is the critical starting point for a performance audit of a privatisation. The SAI needs to establish what were the immediate objectives for the sale, including any obligations placed on the business, and how these relate to longer term objectives including the development of the market economy and social and environmental considerations. Privatisation is not a static process, and the objectives for each sale will reflect the evolution of the economy, which can radically change over time. Both the immediate and longer term objectives are liable to be in competition with each other, at least to some extent. And not all objectives are always stated. Only by understanding these objectives in their complexity and interaction, and how they affected the conduct of the sale, will the SAI be able to identify what questions it should address in studying the sale.

Guideline

At the beginning of the audit the SAI should ensure it has a clear understanding of all the vendor's objectives in a privatisation, and how these relate to wider objectives for the economy.

Reasons for the guideline

Without a clear understanding of the vendor's objectives in all their complexity, including wider policy objectives, the SAI risks undertaking a performance audit that fails to identify and examine what the vendor was trying to achieve.

In many privatisations vendors are accountable by reference to specific sale objectives, often set by government. Sale objectives vary from country to country, depending on the particular economic challenges facing the country at the time of the sale and how the sale is seen as part of the response to these challenges. Objectives can include selling businesses quickly, demonstrating to perhaps sceptical markets that privatisation is possible thereby paving the way for future privatisations, securing investment, and encouraging wider share ownership. The SAI will need to consider what was the impact on the sale of the vendor's personnel policies, for example whether there was an objective of maintaining employment levels or of protecting employee rights in redundancy and, in the event of redundancies, how the vendor and the buyer agreed to handle the cost of redundancy payments.

By their nature, these objectives tend to be in competition with one another to some extent. One of the issues the SAI will need to address is whether the vendor struck a defensible balance, for example between selling the business to a demanding timetable on the one hand while maximising proceeds and minimising costs on the other.

It is of course for the vendor to decide how to cope with such competing objectives and the SAI should take care not to usurp the vendor's responsibility for determining priorities. For example, if the state as vendor decides to give priority to selling the business quickly over maximising proceeds, in order for instance to establish investor confidence in the privatisation process, it may be outside the SAI's remit to say that the vendor should have

delayed the sale in order to get a better price. But it is the SAI's job to examine what were the consequences of the way the state set about the privatisation, and to draw attention to any benefits lost to the public from that particular sale as a result. Experience shows, for example, that where the state loses value in privatisations, and the new owners make a fortune at public expense, the government's credibility can be seriously damaged because the terms and conditions of the sale will not be seen as fair by the citizen.

Some objectives can appear to be in conflict, but may not be so in practice. For example, offering incentives to individual investors in a flotation may conflict with maximising proceeds, but not if such incentives, by creating competitive tension between individual and institutional investors, help secure higher sale proceeds overall. This can however be difficult to demonstrate.

Ascertaining the full implications of a vendor's stated objectives will also help the SAI to identify any important unstated objectives, and also objectives which the vendor might usefully have set but did not. For instance, whether or not it was a stated objective, the SAI should examine to what extent the vendor secured a good price for the business. Such clarification will also assist the state in formulating objectives for future sales.

Guideline 8
Timing of the sale

Issue

What should the SAI consider as regards the timing of the sale?

Why this matters

It is not unusual to find that one of the vendor's sale objectives is to carry out the privatisation as quickly as possible. The SAI will wish to ascertain whether the vendor made key deadlines public, to ensure fairness between bidders. The SAI also needs to be alert that adherence to a demanding timetable is not at the expense of other sale objectives.

Guideline

The SAI should establish what objective the vendor had as regards the timing of the sale, and whether the pursuit of this objective had any impact, positive or negative, on the sale.

Reasons for the guideline

Vendors are often under considerable pressure to carry out the sale to a demanding timetable. This has been frequently the case, for example, where countries are seeking to move to a market economy as quickly as possible. But it can also feature in relatively advanced economies where governments may be counting on the sale to contribute to their public expenditure programmes or to reduce the national debt, or where, in the case of major flotations or sales of shares, there may be few windows of opportunity. In addition it is generally accepted as good practice to carry out particular stages of a sale as quickly

as possible in order to avoid losses to the business, as a result of uncertainty about its future viability, and to maintain competitive tension between bidders, and also to focus minds on securing a good deal, for example from initial bids in a trade sale, through to short-listing of bidders and to completion of the sale.

In examining these aspects, the SAI will wish to show understanding of such pressures. But meeting a demanding timetable is no excuse for getting things wrong. Among the points to examine are whether the sale was carried out so hastily that key stages in the process (for example, selection of external advisers, putting the business into appropriate legal form, decisions on the sale method, preparation of financial information, identifying and valuing the assets, valuing the business, marketing and negotiating the sale) were omitted, or carelessly and incompletely done, and if so whether there was any measurable deleterious effect on the outcome of the sale, for example loss of proceeds.

Guideline 9

Pre-sale valuation of the business

Issue

What are the key issues the SAI should address as regards the valuation by the vendor of the business to be privatised?

Why this matters

An independent pre-sale valuation of a business is a key element in a well conducted sale since it provides the vendor with a means of checking the reasonableness of offers and can be helpful in subsequent negotiations with the bidders.

Guideline

The SAI should ascertain whether the vendor obtained a pre-sale valuation of the business. If not, the SAI should review the reasons for not doing so and, in carrying out any study after the sale has taken place, should consider commissioning its own valuation. If a pre-sale valuation was done by the vendor, the SAI should establish whether it was

- **based on appropriate assumptions**
- **arrived at independently of the buyer and of the management of the business**
- **founded on accepted principles of business valuation, and**
- **a useful guide to the vendor in appraising bids and in negotiations leading to the final sale.**

Reasons for the guideline

It is generally accepted good practice for valuations to be made before privatisations, in particular to value the business as a going concern so as to have a benchmark of likely proceeds against which to appraise bids. In such cases the valuation - which can of course be a range of values, depending on the assumptions used - can also be used as a cross-check on the sale process itself when selective tendering processes are employed. If the

bids being received differ very much from the figures suggested by the valuation, questions may be raised about the effectiveness of the marketing process or the competitiveness of the sale. It is also good practice for the vendor to value the business to determine a reserve price for the business, that is the price below which it would not be sold.

In some cases vendors may argue that unique or novel features make it difficult to attempt a worthwhile valuation and that difficulty may be cited as a reason for not carrying one out. Bearing in mind, however, that the bidders are being asked to value the business and that they have, or should have, no better information than the vendor about it, it will be unusual for the vendor to be literally unable to carry out a valuation. Vendors also sometimes argue that a well conducted competition is the best guarantee of getting value out of a sale. Competition is of course important, but it is essential for the vendor to have benchmarks against which to evaluate bids; a failure to obtain a valuation is likely to be an indicator that the vendor is prepared to sell the business at an unsatisfactory price, and does not want to be held accountable for it. Of course the degree of sophistication and the associated costs of benchmark valuations will need to be related to the size and complexity of the business being sold.

The assumptions used in the valuation should be consistent with the purpose for which it is to be used. For example, if it is to be a cross-check on the outcome of a competitive bidding process to buy the business as a going concern the valuation should be carried out on a going concern basis.

The valuation should not be conducted by anyone who may have a conflict of interest regarding the outcome of the privatisation. That includes the managers of the business (even if they are not themselves bidding for it). But the valuation may properly use information supplied by the managers and verified if appropriate. In some cases, the vendor may need to get the valuation checked by an independent party, for instance where the valuation is carried out by the vendor's financial advisers and these financial advisers are entitled to receive a sale completion fee based on the extent to which sale proceeds exceed the valuation (see [guideline 39](#)). In such a case the advisers have an interest in the valuation being low.

Business valuation requires the use of skill and judgement. The basis on which that judgment is exercised must however include quantified information about the business concerned, and it should be based on principles that are generally accepted among professional valuers.

The SAI will also wish to examine whether the vendor considered restructuring the business before sale in order, for example, to improve the value obtained (see [guideline 6](#)).

Guideline 10
Sale methods

Issue

What factors should the SAI bear in mind when considering the vendor's choice of sale method?

Why this matters

The choice of sale method can be crucial to the success of the privatisation. In some cases, the choice may be fairly straightforward; for instance public auction may be the simplest and most cost effective way of disposing of very small businesses such as single shops. But for larger businesses there may be difficult choices to be made between, say, a carefully marketed trade sale and a flotation. The latter is likely to be more expensive in terms of total costs but if it succeeds in creating competitive tension between a wide range of investors, the net proceeds could be higher; and it may help promote wider objectives, such as the development of the domestic capital market. The SAI needs to consider what possible ways of privatisation were taken into consideration by the vendor and why the vendor decided on the chosen route.

Guideline

The SAI should examine what options the vendor considered before deciding on the sale method used, and what criteria the vendor applied in deciding on the chosen sale method, including the pursuit of any wider objectives of the privatisation programme.

Reasons for the guideline

The care, or otherwise, taken by the vendor in deciding on the sale method can throw considerable light on how well the vendor understood the nature of the business being sold, and its potential appeal to the market. In the case of larger businesses for example the vendor may find it useful to keep open the alternative options of trade sale or flotation as long as possible. For instance, the vendor may enter into negotiations with a potential trade buyer partly to test that market and partly to put pressure on the directors of the business (who may prefer flotation as offering a better prospect for securing their own jobs) to be more forthcoming about the business prospects which would need to be set out for investors in the event of a floatation.

Failure by the vendor to think carefully about the nature of the business before deciding on the sale method can result in a loss of value to the vendor. In one example, the vendor was required to dispose of the computer support services for a group of state-owned hospitals. This was an attractive business venture since the hospitals were anxious to secure continued support for their computer systems. But instead of marketing the business vigorously as a trade sale opportunity, the vendor treated it as a service procurement exercise and the SAI established, through a valuation, that as a result the vendor got a much less advantageous deal for the taxpayer. In the light of the SAI's report, the health department has undertaken to consider in future the case for trade sale in such disposals.

Guideline 11

Vendor integrity in conducting the sale

Issue

Was the sale carried out by the vendor with integrity and careful attention to the proper conduct of public business?

Why this matters

Privatisation involves the transfer by public servants of publicly owned assets to the private sector. The transaction needs to have strict regard to legal requirements for the proper accounting for state income and expenditure. And it needs to be conducted fairly, in accordance with the standards expected of those responsible for safeguarding the taxpayer's interests, including making provision for securing compliance by the new owners with any obligations they are required to undertake. There may be conflicts of interest, for example the vendors and their advisers may wish to advance a cautious estimate of the business' worth, so as to increase the chance of a successful sale, but this could be to the detriment of the taxpayer if value is lost.

The public servants concerned should not receive, either directly or indirectly, any unintended benefits from the sale. For their part, the public servants themselves may be facing criticism for the way they conducted the sale, and may be looking to the SAI to defend their reputations. The SAI may face difficulties in obtaining reliable evidence and may encounter objections on grounds of commercial confidentiality over publishing key details, such as the identity of bidders and the amounts they bid or paid.

Guideline

The SAI should examine whether adequate safeguards were in place to secure that the sale was properly and honestly carried out, and investigate allegations of improper practice, and establish whether there were any lapses in procedures.

Reasons for the guideline

There is a risk that those responsible for privatisations may look to gain personal advantage rather than maximising the value of the deal for the taxpayer. The risk can take various forms, and can flourish in the ambiguities and uncertainties surrounding such transactions. For example the vendors may sell the business to associates, or acquire it themselves on advantageous terms, in return for a share in the value lost to the taxpayer. Or the managers of the business to be sold may be tempted to conceal value in one form or another so that, on privatisation, they can benefit either directly by removing the value (eg surplus assets) or indirectly by yielding a good return for the business and so enhancing their position as its managers.

The SAI should evaluate the adequacy of vendor guidelines for the disqualification of bidders, and how in practice the public interest was protected.

The SAI will need to identify those who were responsible for authorising and carrying out the sale, and how those responsibilities were allocated.

The SAI will also need to check whether the state obtained all the money from the privatisation, or whether some or all of it disappeared into other pockets.

Carelessness on the part of the vendor can also lead to the sale being carried out without proper attention to the public interest. This has arisen for example where the vendor has failed to provide equal access to information about the business to all bidders, leaving some more advantageously placed than others, thereby blunting the competition for the business.

Conflicts of interest can arise where for example managers and/or advisers with intimate knowledge of the business are given privileged status as bidders.

In many cases where the sale has not been properly conducted, this will have become public knowledge. Such information may assist the SAI in its examination. But such reports may be incomplete or incorrect and the public servants, or other parties concerned, such as the bidders, may look to the SAI to exonerate them. Unless reliable evidence is available, this can place the SAI in a difficult position. And even where such evidence is found, other parties to the sale may object to its being published on grounds of commercial confidentiality. Experience suggests that it is in the interests of all those who wish to see sales properly conducted that all parties to the transaction should know that the sale may be the subject of an independent and searching examination by the SAI, and that its detailed findings are likely to be published in the public interest.

Guideline 12

Residual management issues

Issue

What steps should the SAI take to assess the manner in which residual responsibilities are managed by the state following the sale of a state-owned business?

Why this matters

In most cases there will be some residual responsibilities remaining with the state following the sale of a state-owned business. The effective management of these responsibilities will undoubtedly have an impact on the finances of the nation in both the short and long term because they can lead to a requirement for settlement from public funds or require the effective management of a public resource. The SAI should therefore consider auditing the way in which residual issues are managed following the sale of a state-owned business.

Guideline

The SAI should assess the adequacy of the state's structural arrangements to manage any residual issues, and ascertain whether the public or national accounts adequately reflect (including quantification where possible) any residual assets and liabilities, actual or contingent.

Reasons for the guideline

Following privatisation residual issues can arise for a number of reasons. Some can arise because the state decided not to include everything in the sale, or was otherwise unable to detach itself from all the activities or obligations of the enterprise being sold - for example, management of shareholder obligations, an incomplete or uncertain legal framework, outstanding litigation issues, or residual employee or property obligations for those items not included in the sale. Other issues can arise as a direct consequence of the sale arrangements themselves - for instance, the active and responsible management of indemnities or warranties given in the sale and purchase agreement, or the on-going management of residual assets.

Examples of undertakings are the provision of indemnities to the vendor's agents (eg investment banks and institutions) in the flotation of a business, indemnifying directors of the business for prospectus statements, and the borrowings and liabilities of the privatised business, including off-balance sheet exposures. An example of a residual asset could be the management of a lease agreement with the purchaser providing access to or use of publicly owned land not being included in the sale, for instance the land under the permanent way of a privatised railway network.

Other risks attaching to this aspect of a privatisation can include the absence of any permanent residual management function, loss of records, and the risk of loss of institutional knowledge as former employees disperse to other job opportunities.

The SAI should examine what undertakings the vendor gave to the purchaser of the business, whether these were quantified, and how the vendor sought to protect the interests of the taxpayer by, for example, establishing time limits, financial limits or other termination arrangements.

The SAI should get a clear understanding of what residual issues arise following a privatisation, and ascertain whether there is effective and on-going management by the state of these assets and liabilities over their life cycle. These issues may extend beyond the obligations remaining with the state. For example in the case of mass privatisations it may happen that enormous numbers of businesses are privatised over a short period and in the process important issues relating to the responsibilities of the new owners are not addressed. The SAI may need to monitor on an on-going basis the liabilities remaining with the state, especially if these are unclear or undecided at the time of the sale.

Section 3: Trade Sales

Guideline 13

External advice required by the vendor

Issue

What steps should the SAI take to ensure that the vendor obtained access to good external advice throughout the sale process, at a reasonable price?

Why this matters

Vendors frequently appoint sales advisors to assist them in managing the sale process, including the parties involved, and to provide specialist advice on the sale. Securing sound external advice can be the key to the success of the sale.

Guideline

The SAI should examine the process followed by the vendor in identifying what specialist and impartial external advice they needed to carry out the sale, and what steps they took to secure such advice cost effectively.

Reasons for the guideline

Rarely will the vendor possess the full range of requisite skills to oversee all aspects of a trade sale. The skills required to ensure a satisfactory outcome will vary according to the nature of the business being sold. Vendors commonly invite expressions of interest/tenders from selected potential sales advisors to assist them. Not only should potential sales advisors be competent, and have the requisite industry knowledge, but they must also be free from any conflicting interests in the business being sold. This latter consideration can eliminate potential sales advisors in smaller economies where the potential for conflict can arise more frequently.

The SAI will need to check that the process of the appointment of advisors to the sale recognised the importance of ensuring neutrality of advice to the vendor as well as demonstrating competence. The SAI should examine whether the fees paid to sales advisors were reasonable, placed the right incentives on advisors to optimise their performance for the vendor, and were transparent. Where fees are paid as a percentage of final sales price, the SAI should ensure that a higher sales price has not been achieved at the expense of, for instance, timely settlement, or excessive warranties and indemnities.

The way sales advisors are remunerated varies significantly from sale to sale. Some are paid on a fixed fee basis, others a percentage of the sales price, and others on an hourly rate. Each method has advantages and disadvantages. The sums involved, however, are rarely insignificant either in amount or politically and publicly. Thus the community needs to be assured that the fees paid to sales advisors are reasonable in the circumstances. On costs, see also [guideline 39](#) (setting and monitoring budgets for external contractors).

Guideline 14

Management of the business

Issue

What are the audit risks the SAI should consider in relation to the management and employees of the state-owned business being privatised?

Why this matters

To preserve the integrity of the sale process and to ensure the best sales outcome, it is important to ensure that the management and employees of the state business being sold do nothing which undermines the sale process.

Guideline

The SAI should ascertain whether the management and employees of the state business which was to be sold acted competently and in a manner which effectively supported the integrity of the sale process, and served the best interests of the vendor.

Reasons for the guideline

The management of a state-owned business being sold are subjected to numerous pressures throughout the entire sale period. They are frequently called upon and are expected to provide access to books and records about the business, provide answers to questions from the vendor, sale advisors and potential bidders in an even handed fashion, yet at the same time to carry out their own routine duties and responsibilities, including managing any uncertainties that employees have about the impact of the sale on their future. Management personnel need to be available during the process, yet they themselves will be considering the impact of the sale on their own position and career prospects. Retention of at least the key managers at this time will be highly desirable, and arrangements (incentives) may need to be entered into to secure their continued employment until the sale process is complete.

These personnel will also be considering their own futures and may be tempted to favour one bidder over another in order to secure their own future employment, either with the state or with the new owner. They may switch allegiance from vendor to purchaser once agreement is reached.

The SAI needs to be aware of these potential impacts on the outcome of the sale and to satisfy itself that the risks to the sale process and result were recognised and adequately managed by the vendor, for example in laying down clear guidance for the management and employees as to the nature and extent of any communication permitted with bidders.

Section 4 of these guidelines addresses the additional issues that arise where the management and/or employees of the business are also bidding to buy it.

Guideline 15 *Marketing the business*

Issue

What steps should the SAI take to assess the marketing of the business?

Why this matters

A successful sale which achieves good value for money is most likely where there has been competition between bidders. For that to happen, vendors need to consider which method of sale is most likely to be best suited to the nature of the business and how potential bidders can be made fully aware of the opportunity. There are likely to be important legal considerations affecting the nature of the marketing, for instance regulatory requirements and rules governing the advertising of such opportunities. There is a risk

that, through inexperience or short-sightedness, vendors may be reluctant to test the market thoroughly.

Guideline

The SAI should examine the extent to which the vendor succeeded in drawing to the attention of potential purchasers the business opportunities represented by the business offered for sale.

Reasons for the guideline

Competition cannot be relied on to emerge unless positive steps are taken by the vendor to encourage appropriate bidders to come forward. In some instances, businesses have been sold by single tender, where the vendor approached employees inviting them to put in bids which were likely to be uncontested. The SAI should examine, for example, whether the business was advertised for sale in the financial press and trade journals, and whether the vendor also considered surveying the market sector in an appropriate way to identify possible purchasers, and with what result. If the sale only succeeded after one or more failed attempts the SAI should examine what were the reasons for this, what costs were incurred in the process, and what lessons could be learned which would help prevent such failures occurring in the future.

The SAI will also need to examine whether the vendor paid careful attention to regulatory requirements, whether domestic or international, which might have a bearing on the marketing and whether the vendor met any international obligations as regards invitations to tender for the provision of public services, or the purchase of public assets. The SAI will need to be alert to cases where the vendor may have uncritically relied on presumed constraints as an excuse not to market the business vigorously, so jeopardising the achievement of full value from the sale.

Guideline 16

Information for potential bidders

Issue

What information should be provided to potential bidders?

Why this matters

For a variety of legitimate reasons, including commercial confidentiality but also to stimulate imaginative, competitive bids, the vendor may not wish to provide at the initial bidding stage comprehensive information to all potential bidders about the business to be sold. On the other hand the vendor needs to encourage initial bids and to minimise the risk that shortlisted bidders will significantly reduce their bids at a later stage when further information may be made available to them. Whatever level of information is provided, it should be made available on an equal basis to potential bidders, or the vendor will risk undermining bidders' confidence in the integrity of the sale process.

Guideline

The SAI should review where the vendor considered the balance of advantage to lie in providing information to potential bidders, and whether the vendor ensured that these details were provided equally to all potential bidders.

Reasons for the guideline

If the vendor fails to provide adequate information on an equal basis to all bidders there is a risk that bidders may withdraw, significantly reduce their bids, or reduce their offers at a later stage in the sale process if, for example, information subsequently made available to them gives them grounds to reduce their assessment of the value of the business. If the purchaser only becomes aware of such information after the sale this may give rise to litigation.

Guideline 17
Bid evaluation

Issue

What steps should the SAI take to assess how the vendor evaluated bids received?

Why this matters

Unless the vendor has established criteria for evaluating the bids received there is a risk that the best possible sale outcome will not be achieved. But it can be difficult to identify satisfactory criteria, especially where the sale objectives are in competition with each other and where some of them are qualitative in nature, for example to achieve an impression of success. Yet if the bids are not evaluated in a consistent manner the vendor may have difficulty demonstrating the extent to which the resulting deal met the sale objectives, and there is a risk that the vendor may be accused of impropriety.

Guideline

The SAI should review the vendor's criteria for evaluating bids by reference to the objectives of the sale, and examine how successfully the vendor applied these criteria in evaluating the bids received.

Reasons for the guideline

Without robust criteria against which to evaluate bids received, the vendor will not be in a position to assess to what extent each bid meets the objectives for the sale: in the absence of a tender evaluation plan, which incorporates the priority to be ascribed to each criterion, it can be difficult to demonstrate the reasons for, and fairness of, the decision to select a particular bidder. But this can be difficult because in the typical case the objectives for the sale are likely to be in competition with each other and not all of them are likely to be measurable. In such circumstances vendors sometimes attribute different weighting to different criteria, but in practice the combination of such criteria is often informal and subjective, making it difficult to establish whether a consistent approach has been taken in evaluating each bid. Even if the vendor succeeds in applying a set of weighted criteria consistently, there is a danger that the appraisal will be too mechanistic, giving too much

weight to aspects that can be measured (eg. price) and less to more qualitative aspects that may nevertheless be very important (eg. the business potential of the bidders), and offering scope for game playing and abuse. This risk of adopting an over-mechanistic appraisal may arise when the vendor wishes to reduce the opportunities for corruption by those making the appraisal. The same potential drawbacks apply to an extent if the vendor, instead of assigning weights to each criterion, chooses one major objective - a quantifiable one - and treats all other objectives as constraints that must be satisfied.

Whatever method of evaluating bids is decided on by the vendor, if this is not communicated to bidders they may not submit bids most likely to meet the vendor's requirements. Criteria should be appropriate for the particular stage of the sale and should not be so rigid as to discourage innovative proposals. The SAI will wish to consider how successfully the vendor addressed these difficult issues. In some cases it will be possible to examine this in the context of individual sales. In other cases, where numerous trade sales are being conducted in parallel, it may be more practicable for the SAI to examine the vendor's systems for applying the criteria.

The audit of bid evaluation is likely to be one of the most technically demanding aspects of privatisation audit. The SAI will need to equip itself with the appropriate skills for this work (see guidelines 1 and 2).

Guideline 18
Shortlisting bidders

Issue

How should the SAI assess the way in which the vendor decided which bids should be shortlisted?

Why this matters

To bring the negotiations to a satisfactory conclusion the vendor may need to reduce the number of bidders to what is manageable while maintaining competitive tension between serious bids.

Guideline

The SAI should examine whether the vendor's criteria and processes for shortlisting bidders were well thought through and explicable in the context of the sale objectives, and how the vendor struck a balance between negotiating with too few bidders and negotiating with too many.

Reasons for the guideline

Assuming the sale process has produced a number of initial bids which satisfy the sale criteria, the vendor needs to decide whether to reduce the number of bidders invited to go to the next stage. Experience shows that vendors often do so in the hope that this will enable them to complete the sale more quickly. And there is an argument for doing so - the more bidders left in the next stage, the less likely each one is to rate its chances of

success. So reducing the number of bidders can increase competitive tension. But if the vendor does not maintain that tension and press on with the concluding stage of the sale, the bidders invited to go to the next stage will be encouraged to whittle away their initial offers, to the detriment of sale proceeds, as has happened in a number of cases. The vendor also needs to be careful to keep serious bidders in the running as long as possible. It can happen, for example, that the eventually successful bidder obtains a low ranking at the initial bidding stage. For these reasons some vendors have concluded that, depending on the size and complexity of the sale, they should aim to keep at least three bids in play as long as possible. The SAI will need to consider those factors, and to what extent the vendor's short listing decisions facilitated or impeded a successful outcome to the sale.

In reporting on this crucial stage of the sale process, the SAI is likely to be under Parliamentary and public pressure to reveal the identity of the bidders, how much they bid and what conditions they attached to their bids. But bidders frequently seek and obtain from vendors an undertaking that their identity and these details will remain confidential, particularly if they are unsuccessful. In such cases the SAI will need to consider whether there are any public interest arguments for keeping such details confidential. If the SAI concludes that such arguments are compelling (in order for example not to discourage bidding in future sales) the SAI may wish to consider providing these details in a confidential report to Parliament.

Guideline 19
Preferred bidder

Issue

What points should the SAI examine where the vendor negotiated in the final stages of the sale with a single preferred bidder?

Why this matters

Frequently both initial bids and second stage bids are conditional, for example because the vendor has difficulty in overcoming market doubts about the sale. In these circumstances, vendors may find that the only way to get the conditions removed from a bid is to give one bidder preferred status by entering into exclusive negotiations with that bidder in order to complete the sale.

Guideline

The SAI should examine whether the vendor had criteria for selecting a preferred bidder which were consistent with the sale objectives, and whether these criteria were applied.

Reasons for the guideline

The vendor should be able to demonstrate that a preferred bidder was the bidder expected best to meet the sale objectives, who would be acceptable to all parties with an interest in the sale, and who would not withdraw or press for significant reductions in the bid during the closing stages. The SAI will wish to check that, in selecting the preferred bidder, the

vendor gave consideration to any difficulties that might be expected to emerge during negotiations, and had ascertained that the preferred bidder had finance in place to complete the transaction.

Guideline 20
Final negotiations

Issue

How should the SAI examine the final negotiations between the vendor and a preferred bidder?

Why this matters

Even if granting preferred status to a bidder results in that bidder's formal reservations or conditions being withdrawn, the vendor is exposed to risk that during the closing stages the preferred bidder may exploit the strong negotiating position implied by preferred bidder status.

Guideline

The SAI should examine what steps the vendor took to guard against the risk that a preferred bidder might seek, in the crucial final stage, significant reductions in the value of the bid, and that the final terms of the transaction were no worse than those which any other bidder could have offered.

Reasons for the guideline

A preferred bidder is normally in a position of exclusive negotiations with the vendor and unless this stage is carefully managed by the vendor the preferred bidder may successfully press for late reductions to the price or other concessions such as indemnities. The SAI will wish to examine what steps the vendor took to reduce these risks. Safeguards could include: a reserve price, based on a thorough valuation of the business (see [guideline 9](#)); the early disclosure of information which might cause a bidder to decrease its assessment of the value of the business being sold; taking steps to ensure that negotiating tension was maintained with the preferred bidder in order to conclude the deal as quickly as possible consistent with a satisfactory outcome; and not closing the door on other bidders, so that they could be invited to re-enter the negotiations if the preferred bidder sought significant concessions.

Section 4: Management Buy-Outs

Guideline 21
Securing fair competition

Issue

What safeguards should the SAI look for when the management and/or employees, as well as external bidders, are allowed to bid for the business?

Why this matters

The vendor may wish to encourage the management and/or employees to bid for the business, for example to show potential external bidders that it is worth acquiring and to keep the management and employees well motivated in the period leading to the sale. But the management know more about the business than anybody else and unless the vendor introduces special safeguards there is a danger that external bidders will be deterred, to the detriment of the sale.

Guideline

The SAI should examine how the vendor sought to secure fair play, including the provision of information, between the management buy-out team and external bidders.

Reasons for the guideline

The existing management of the business are in a potentially preferential negotiating position. Their close involvement in and familiarity with the operations, strengths and weaknesses of the business, its clients and its future prospects will give them an inside track in the bidding process. The management may also seek to deter external bidders by being negative about the business prospects. In order to counter these risks, the vendor should consider excluding from the decision making process management/employees who are directly or indirectly involved in the management buy-out team. The vendor will also be well advised to issue a code of conduct for management buy-out teams which require them to register their interest, and specify what information they can give to their financial backers. An independent review could be carried out of the information to be provided to all bidders to check it is accurate.

The SAI will need to examine whether the vendor ensured that, as far as possible, all bidders were given access to the same information about the business on an equal basis and that due consideration was given to relevant regulations relating to abuse of inside information. This is especially important when a management team is one of the bidders. The arrangements can include establishing a data room for supervised use by all bidders, ensuring that the vendor or the vendor's agent is present at all meetings between the management of the business and bidders to secure that information is made available on an equal basis to the bidders, recording all information requested by and provided to bidders, and ensuring that, where information is requested by and provided to a bidder, it is also sent to all other bidders as well. In such ways, the vendor should aim to secure, as far as possible that the outside bidders are given as much information as inside bidders about the history and future prospects of the business. In some cases vendors have decided not to allow the management or employees to be involved in a bid for the business until a preferred external bidder has been identified, at which point the potential purchaser and the management/employees are allowed to enter into negotiations.

Guideline 22

Incentives

Issue

What factors should the SAI take into account in assessing the value for money of any incentives the vendor may offer to encourage bids from the management and/or employees of the business?

Why this matters

Over-generous incentives to encourage management buy-out bids, especially if they are ill-defined and undisclosed, may deter external bidders and risk loss of value.

Guideline

The SAI should examine whether any incentives offered to management buy-out teams were well thought through, having regard to the sale objectives, assessed as to their likely impact on sale proceeds, and whether the key details were explained to all bidders.

Reasons for the guideline

Vendors may wish to encourage management buy-out bids so as to create competitive tension with external bidders and/or to safeguard the interests or maintain the morale of the management and employees. Incentives may take the form of assistance with the costs of mounting a bid, or the vendor may decide to give preference to a management bid if it is within a certain percentage of the leading bid, and satisfactory in other respects. The nature and value of such incentives, and the circumstances in which they could be applied, should be carefully thought through by the vendor and this information given to all bidders in advance and, where possible, to the general public, otherwise potential external bidders will be deterred. The SAI should check whether the vendor considered withdrawing any financial support to the management buy-out team for mounting a bid once the management team had found financial or commercial backers.

There are some circumstances in which incentives might be unlikely to represent value for money - for example, where the management team lack the skills to run the business successfully. But in other circumstances a management bid, if encouraged, can produce a better sale result than would otherwise have been possible - for example, in a disposal of ten operating subsidiaries of a publicly owned company, four were sold to management teams with an overall benefit to the sale proceeds and bids from trade buyers were improved as a result of the competition from the management teams.

The SAI should examine whether the terms of the sale meant that any gains were concentrated in the hands of a selected few in the management, to the detriment of the ordinary employees as well as the taxpayer.

Guideline 23

Securing the best possible price

Issue

What should the SAI examine in checking whether a vendor achieved value for money from the sale of a business to its management?

Why this matters

There have been well publicised examples where management buy-out teams have acquired the business and then resold it at a significant profit to themselves and their backers within a relatively short timescale. This can bring the privatisation process into disrepute, because it is prima facie evidence that the original sale of the business failed to maximise the proceeds for the taxpayer.

Guideline

The SAI should examine what steps the vendor took, having regard to the sale criteria, to offset the risk that the business might be acquired cheaply by the management buy-out team, for example because they obstructed rival bidders.

Reasons for the guideline

As a result of their knowledge of the business, there is a risk that the management may acquire the business at the lowest price and on the best terms, enabling them to realise its full value shortly after the sale. The principal protection against this risk is a fully competitive sale process - backed by a valuation of the business by the vendor (see [guideline 9](#)) - based on equality of key information to all bidders. Other safeguards include appointing to the managing board of the business one or more independent directors with the role of providing the vendor with a clear view of the viability and prospects of the business, against which the views of the management buy-out team, and other bidders, might be assessed, and to ensure that other measures, such as the equal provision of information to bidders, and steps to counter possible conflicts of interest, are applied. The vendor may think it prudent to exclude members of management buy-out teams from particular decision making processes, such as the preparatory stages to the privatisation including restructuring the assets and resources, any partial disposal before the main sale, restructuring debts, or any other investment decisions which could affect the value of the business. The SAI will also wish to check whether the vendor has taken into account any audit reports made on the reorganisation, especially any deficiencies in the arrangements identified by the SAI.

Where for example the sale is the first in a series of novel sales, and the market may be initially doubtful about the chances of a successful privatisation the vendor may wish to negotiate a share of any profits that might be realised within a specified period after the sale, especially if the business is sold on. In such an example, the vendor would of course have to have regard to the possibility of any downward impact that such an arrangement might have on the price at which the business is sold to the management. In one instance, a high value business with a small number of management and employees was acquired by a management buy-out team with venture capital backing for the equivalent of

US \$750 million and sold on seven months later for US \$1,200 million, with the management buy-out team receiving over a quarter of the profit, the rest going to the venture capital backers. The state received no share in these profits.

Section 5: Mass Privatisations

Guideline 24

Education of public investors

Issue

What steps should the SAI take to ensure that the public has sufficient information about and understanding of the mass privatisation process so that broad based participation by the eligible public as investors can be secured?

Why this matters

The overall objective of mass privatisation programmes is to disseminate as quickly as possible to the public, as potential individual investors, the shares of state businesses being sold. In most countries where mass privatisation measures have been introduced, members of the public have previously had little or no experience as private owners. In order to encourage the public to become investors, substantial education by the vendors and other advisers about the process, the type and quality of equity being offered, and the meaning of share ownership and shareholder rights, is required.

Guideline

The SAI should examine the process of public education including public awareness campaigns and the mechanisms used to provide key information about the businesses being sold through the mass privatisation programme. The SAI should satisfy itself that both the process and the quality of information were sufficient to allow informed decision-making by potential investors.

Reasons for the guideline

Ownership diversification is typically a stated objective of mass privatisation. It is intended to address the perceived inequalities of ownership resulting from other forms of privatisation, especially given that workers and the public in general saw themselves as part of the collective ownership structure of former command economies. To that end, mass privatisation programmes seek to include the broadest participation of the public as investors. The public may, however, generally lack any significant experience of private ownership and may know little about the meaning and rights of share ownership. Yet the success of mass privatisation programmes is often judged on the percentage of participation by citizens as investors. Public education campaigns and easily accessible, objective, data on investment choices are critical to transforming the public into investors. Even in advanced market economies however the majority of shares may be owned by institutional or corporate investors. For example, in the United States, where information is readily available, only 22 per cent of the population owns stocks and shares.

The SAI should examine the types, duration, dissemination methods, and appropriateness of the messages of public awareness/public education campaigns which are used to promote investment by the public. In addition, it should examine whether a basic level of information was provided on each enterprise to be included in the programme, including reliable information about financial performance, employment, management structure, and a description of key products and markets for each enterprise. It should be alert to the risk that the likely earnings and profits and financial position of the business were overstated and that the responsibilities of management to shareholders were not clearly defined.

Guideline 25 *Intermediaries*

Issue

What steps should the SAI take to examine whether the regulation of intermediaries is proving effective?

Why this matters

Because of individual investors' lack of experience as private owners, intermediaries often come to represent the bulk of share ownership through the creation of investment funds and trusts. They play a critical role in developing a new marketplace into one where trading of shares is supported and some liquidity exists. At the same time, however, there is a risk that intermediaries may dilute or ignore important corporate governance responsibilities and may use their market knowledge to take advantage of uninformed investors.

Guideline

The SAI should examine the legal and regulatory framework within which mass privatisation intermediaries are required to operate and satisfy itself that the regulatory framework is operating as intended.

Reasons for the guideline

A consequence of mass privatisation is the creation of market intermediaries including investment funds, trusts, and a network of brokers and dealers. These groups include both those with real knowledge of market mechanisms and those who simply present themselves as knowledgeable. Just as investors may have little knowledge of their rights as direct shareholders, they may also lack knowledge of their rights when dealing with intermediaries. This has been evidenced through widespread pyramid schemes in a number of countries. The outcome of these schemes has resulted in severe economic losses as well as political and social unrest, some of which has turned to public violence. In order to protect the public therefore the state will normally establish a regulatory framework to govern both the creation and operation of these intermediaries.

To guard against the risk that intermediaries will exploit their shareholders, governments are likely to impose on each type of intermediary certain obligations to customers and/or shareholders as regards investment/divestment policies, disclosure of financial

performance (both of direct investments and investment in a fund or trust itself) and participation in corporate governance. The SAI should examine how well the regulatory body carried out its responsibilities for oversight and enforcement in these areas.

Guideline 26

Sale process

Issue

How should the SAI assess the transparency, efficiency and fairness of the sale process?

Why this matters

The successful implementation of a mass privatisation programme depends on sufficient supply of and demand for shares which are worth buying. If the sale process is not transparent, efficient and fair, the management of the state businesses being sold, or the government vendors who control groups of such businesses, may exempt the most attractive and viable ones from the sale, or create significant bottlenecks and delays to the process. Also if individual investors do not perceive the process as measuring up to these requirements they will be reluctant to invest and it may be derailed.

Guideline

The SAI should examine key stages of the sale process, including information dissemination, bidding procedures including submissions, collection, and clearing, post-sale registration of ownership, compliance with corporate governance requirements and procedures for the admission of the shares of the businesses to the stock market.

Reasons for the guideline

If a government is to build public trust in its privatisation programme and successfully gain the participation of both the businesses to be sold and the public to invest, the sale process itself must be seen by all parties as transparent, efficient and fair. If that process is not viewed favourably against these criteria, subsequent participation by foreign investors and multi-national agencies may be deterred.

Particular problems which have been encountered by vendors include uncertainty over the ownership of the assets, in particular land and buildings, an inadequate or developing legal infrastructure, and question marks over the credit-worthiness of the businesses and the quality of management.

The sale process also includes post-sale ownership registration. The SAI may need to examine the integrity of share registries and the operations of the regulatory framework. Critical too is the ability of shareholders to buy and sell shares in a business without management's interference or approval (open trading). The sale process should also cater for the provision of sufficient information to the new investors about their rights as shareholders, and to the management of the newly privatised companies about their

obligations as regards corporate governance. The SAI may also need to examine how quickly government vendors complete the process.

Section 6: Auctions

Guideline 27

Competitions

Issue

How can the SAI assure itself that bidding competitions are carried out fairly?

Why this matters

Clear guidelines should be in place to ensure that an appropriate group of bidders is made aware of all relevant information concerning the auction process, that bidders participate in good faith, and that the competition is transparent and fair.

Guideline

The SAI should review the methods for preparing the businesses for privatisation, and for gathering and publishing information on them. This will include announcing the auction, qualifying and registering bidders, calculating the opening bid price and any reserve price, ensuring that the auction processes are clearly defined and are legally correct, checking the fairness of the competition (including being alert to the risk of collusion between bidders), selecting the successful bidder and expeditiously completing the sale process.

Reasons for the guideline

Conducting a competitive auction begins with auction organisers using a clear method of valuation. The value of the business or asset is usually based on balance sheets, often using a multiplier if high inflation warrants it. Starting prices which are too inflated may discourage potential bidders from participating, and increase the possibility of collusion between bidders.

Public knowledge and support of the auction process is important. The SAI will wish to check whether the auction rules were made public well in advance of the auction date. There should also be a clear process to ensure that appropriate information on the business or asset being sold is made available to allow a proper level of due diligence to be undertaken by potential bidders in advance of the auction. Potential bidders will often receive essential information through direct contact with the privatisation authority, but wide promotion and education campaigns are likely to expand the participant base. Auction organisers should also state clearly who can participate in the auctions. For example, definitions of natural persons and legal entities should be made known, as should rules on foreign participation.

The competition between bidders should be transparent. Often bidders approach the auction with different objectives, for example a foreign investor and local employees may have differing interests in purchasing an asset. There is a potential for dispute among

bidding parties. Auction sponsors must remain objective in fact and appearance. One way to do this is to appoint an auction commission. The commission could intervene if any irregularities are detected in the process. If there is an auction commission, the SAI needs to be satisfied that the commission witnessed the signing of negotiation papers and the deposit of the agreed transaction amount. If coupons are involved, the destruction of the coupons should be supervised.

The SAI will need to check that the commission, or those otherwise responsible for conducting the auction, took steps to ensure that bidders complied with any rules introduced to guard against the auction being rigged, for example rules requiring the identity of the bidder to be stated.

The SAI will need to check whether identical information was made available to all parties, whether bidding methodology and rules were clearly defined, whether the bidding process was administered by an organisation without conflicts of interest in the outcome, and whether the auction itself was open to the general public. If these requirements are not fulfilled, bidders and the public will lose confidence that the auction is being conducted fairly, and the competitive dynamic essential to a successful auction is likely to be lost.

Guideline 28
Sale process

Issue

What steps should the SAI take to ensure that a sale by auction leads to a completed transaction in exchange for the agreed purchase price?

Why this matters

The sale process begins with the initial registration and ends with ensuring that ownership rights are respected. The registration process is important because it allows the vendor to limit the group of bidders to include only those who would eventually be able to assume legal ownership of the property. At this stage bidders can also be asked to sign an agreement which commits them to the regulations of the auction and which establishes penalties for not complying with these regulations. Guidelines for ownership transfer need to be clear to both buyer and sponsoring body and be supported by laws. There are several issues which need to be addressed in transferring the state property to the buyer post-auction, including the creation of a fund (or a specific bank account) to collect the proceeds of the auction and determining how and to what state organisations the proceeds will be allocated.

Guideline

The SAI should examine the registration and sale procedures of an auction from beginning to end, including whether there were adequate incentives for successful bidders to carry out their obligations, whether the transfer of ownership was in accordance with laws and regulatory provisions, and whether there were procedures for settling disputes between vendors and purchasers.

Reasons for the guideline

The desired outcome of an auction is clear: the bidder assumes ownership of the former state-owned business or asset upon full payment for it to the vendor. A completed bidding process in an auction does not however equal a sale and experience suggests that, without adequate incentives beginning at initial registration, the bidder may push sale prices higher than the market value without intending to follow through with payment. The SAI will wish to examine what arrangements were in place to guard against this risk. For example in some countries each bidder is required to deposit a certain amount as a guarantee. On the other hand, requiring such deposits may limit competition if a number of businesses are being auctioned at the same time. The rules of the auction may provide that if a bidder defaults, it should lose the registration fee and the next highest bidder should have the right to obtain the business or asset at that price. These and other related rules and procedures should be announced before the auction is held. If the mechanism of the sale and the concluding documents do not comply with legal requirements, the sale itself might be considered invalid. This would also cast doubts on the ability of the auction sponsors to facilitate property transfers and would undermine investor confidence.

The SAI will need to examine how the auction fund was established and monitored. An assessment of the allocation of the proceeds should be made to determine the interests of various stakeholders. The SAI may also need to examine to what extent the auction method (whether through open public bidding or sealed written bids) maximised proceeds.

Support for buyers post-auction is relevant since the transfer is not complete until the new owner has the legal rights to the business or asset. Setting up procedures to address potential conflicts, such as those arising between new owners and previous managers, will help conclude the transfer and will increase public confidence in the auction process. Furthermore, the re-sale rights of the new owners should be clearly defined in order to increase investor confidence.

Section 7: Flotations

Guideline 29

The role of the vendor

Issue

What should the SAI bear in mind in evaluating the role of the vendor in a flotation?

Why this matters

Even in a highly developed market economy, with advanced financial markets and access to overseas investors, a flotation can be a very demanding undertaking. Government flotations frequently dwarf private share sales and, where the flotation is creating a new market sector, it can be beset with uncertainties, especially if the business did not inspire public confidence when in state ownership. In such circumstances, the vendor faces contradictory risks. On the one hand the vendor may underprice the shares, so provoking levels of demand which cannot be satisfied while discrediting the process in the eyes of the public who will see a minority of people getting rich at public expense. The contrary risk is getting such a good price that investors feel cheated, so that their tendency to

participate in future flotations will be reduced. It is the responsibility of the vendor to set a sale strategy which will address both risks and secure a result which will be perceived as successful by the public, paving the way for future flotations.

Guideline

The SAI should examine whether the vendor carefully developed a strategy for the flotation which took account of medium and long term privatisation objectives.

Reasons for the guideline

Undertaking a flotation, particularly early in a country's privatisation programme, can be very challenging. There may be uncertainty about how the market will respond to the offering and there will be genuine difficulties about pricing the shares especially where the flotation is creating a new market sector. Experience suggests that in early privatisations it may be very difficult for the vendor to get a good price for the shares, since investors may be looking for a substantial premium. But experience also shows that, once the state has demonstrated that public businesses can be floated, it gains confidence and expertise and can get increasingly better deals for the taxpayer while still giving investors a good business opportunity. The SAI should examine how successfully vendors build on these experiences in developing strategies for successive flotations.

Guideline 30

The vendor's management of the flotation

Issue

How should the SAI evaluate the vendor's management of the flotation?

Why this matters

Having a carefully thought out strategy is the first essential step in securing a successful flotation. The second is putting that strategy into effect through effective handling of the sale. On this will depend, in particular, whether the state maximises the net revenue from the sale, subject to the achievement of other objectives, for example widening share ownership, floating the shares by a deadline, and achieving an impression of success. There is a variety of methods to conduct a flotation and there is not a single rule which generally applies. Thus, in some cases the selling of the shares in several stages is likely to be beneficial, eg. when there is uncertainty about how the capital market may value the business. Experience in the sale of the first tranche of shares should enable the vendor to price the second issue more accurately.

Guideline

The SAI should examine how effectively the vendor carried out the flotation having regard to the objectives, and the basis for any discrepancy between the price at which the shares were sold, including any target premium, and the price at which the shares were traded in the aftermarket.

Reasons for the guideline

Competent management of the sale by the vendor can substantially increase the net revenue from a flotation. The number of factors the vendor ought to consider is large and the effects of such factors may vary between flotations. The SAI will need to identify all the key aspects of the vendor's management of the sale, and cover these in its examination. For example, was the value attached to the shares accepted by all relevant parties, for instance through bookbuilding (guidelines [31](#) and [35](#)), or was there a diversity of opinions?

A multi-stage approach to the sale can reduce the risk of getting the initial issue price wrong, since experience shows that, given the propensity of the state to underprice the shares, selling the shares in stages can, over time, bring in much higher proceeds. In one case, all the shares were sold at once. They were seriously underpriced and the government department concerned lost a lot of value. The department realised they would be criticised for this by the SAI and Parliament. As a result, in two subsequent large flotations, they decided to sell only 60 per cent of the shares initially.

Where shares are sold in stages the SAI will need to examine whether the vendor considered all the available information about the prospects of the company following the first issue of shares, and took this into account in the timing, pricing and quantity of subsequent issues. In the two flotations noted above, when only 60 per cent of the shares were sold initially, the vendor subsequently disposed of the remaining 40 per cent of the shares in a series of well judged sales which overall yielded the taxpayer the equivalent of an additional US \$3.5 billion in proceeds.

Guideline 31 *Underwriting*

Issue

How should the SAI evaluate the use of underwriting in flotations?

Why this matters

Underwriting traditionally played a key role in the sale of shares, whether public or private offerings. The vendor's lead financial advisers would put together a team of underwriters, usually investment banks, who would agree, in return for a fee (underwriting commission), to underwrite the offer, that is, they promised to buy any shares not taken up by the market. Underwriters have often in effect determined the offer price itself since they will not agree to underwrite the offer unless they are happy with the price. Traditionally, underwriters are risk averse so the vendor may pay a double price: the fee itself, which may be regarded as an insurance premium, plus proceeds foregone because the underwriter does not want to accept real risk.

In many cases however the state as vendor can absorb such a risk and reduce the cost of the flotation. And it has become increasingly normal to dispense with underwriting. Experience suggests that giving up the service of the underwriter has not adversely affected the marketing of the shares, and flotations have accordingly yielded higher net proceeds on that account.

Guideline

Governments are usually best placed to assume risks. If however the issue was underwritten the SAI should examine the reasons and what was the effect on the net sale proceeds.

Reasons for the guideline

As vendors have gained more experience in carrying out flotations they have found alternative methods to underwriting to help them price the shares at a level which makes it likely that all the shares on offer can be sold, while maximising net proceeds. These alternative methods include persuading institutional investors and banks to indicate, in advance of pricing the offer, how many shares they would buy at various prices (bookbuilding). The SAI should examine whether the vendor sought all possible methods to avoid or, at any rate reduce, the cost of underwriting, consistent with getting a good outcome to the sale.

Guideline 32

Management and employee incentives

Issue

How should the SAI evaluate the allocation of incentives such as shares or share options to management and employees as a part of the flotation?

Why this matters

In any privatisation it is useful to obtain the co-operation of the management of the business, its employees and their trade union representatives. The success of the business in private hands is likely to depend to a large extent on their goodwill and efforts. And many of the employees may fear for their jobs. Allocation of part of the shares, either free or at a reduced price, could provide an incentive to co-operation. The vendor needs to strike a balance between providing such an incentive to employees and maximising the sale proceeds to the state, bearing in mind too that a decision in any specific flotation could become a precedent. It is particularly important to make sure that the existing management of the business do not exert undue influence on decisions regarding the share options to be allocated to themselves.

Guideline

The SAI should examine what incentives, such as shares allocated on favourable terms, were provided for the management and employees, how their interests were balanced against the interests of other investors in the privatised company, and those of the state, and whether the terms on which such privileged allocations were offered, especially those benefiting the managers of the business, were publicly announced in advance.

Reasons for the guideline

To achieve the best results from the offer of shares or share options the vendor ought to balance the particular requirements of the issue with the need to maintain such basic principles as fairness (among the various groups of employees), economy and consistency (between flotations).

The granting of shares or share options could be a sensitive issue and could arouse public interest and controversy. It is therefore good practice for the vendor to announce publicly, in advance of the offer, which groups of management and employees will be entitled to which incentives, including share allocations (amount, value, price or other incentive). Also, while the granting of such options may reduce resistance to privatisation by employees, an ill-planned allocation programme, for example one which was seen to be far too favourable to the existing top management, could have the opposite effect. The management of the business may, for instance, seek to have such incentives introduced because of their likely beneficial effects on employee motivation after the sale, in which case it is for consideration whether the cost should fall on the vendor at all. Disclosure is an important element in securing public confidence in the process. Thus the SAI needs to monitor the execution of such programmes and to check whether consistency was maintained, whether the objectives of granting the incentives were achieved, and whether the interests of management and employees were balanced against those of investors and taxpayers.

Guideline 33

Attracting potential investors

Issue

What points should the SAI consider in examining how the vendor attracted potential investors to buy shares?

Why this matters

The success of the flotation depends on the vendor identifying and stimulating interest among the most appropriate groups of investors, having regard to the particular objectives of the flotation. Potential investors will include individuals and institutional investors, both at home and abroad. It will be important to identify the segments of the domestic or foreign market which are likely to be most interested in the flotation. If the vendor can create competitive tension among the various groups of potential investors he is more likely to be able to sell the shares at a good price. And in the long run success depends upon finding the kind of investors who are likely to continue to hold the shares, and upon securing a wide distribution and an orderly trade in the aftermarket. Also the more dispersed is the ownership of the shares the greater is likely to be the public support for the privatisation programme.

Guideline

The SAI should examine how successfully the vendor identified the market for the shares and stimulated competition between the various groups of investors.

Reasons for the guideline

The vendor may need to consider whether the local capital market can absorb the entire issue. If not, he will need to sell at least part of the offering on the international market. If one of the objectives of the flotation is to widen directly or indirectly individual share ownership, the vendor will wish to consider how much should be allocated in this way, using for example free bonus shares, or providing special terms (such as staged payments) designed to attract individual investors.

If special inducements are offered to individual investors it may be useful to build in further incentives (such as reduced charges for the service provided by the business) to persuade such buyers to hold on to the shares. But persuading individuals to buy shares could of course backfire if the value of the shares declines.

Whether or not the vendor wishes to widen individual share ownership, successful flotations show that to get the best possible price it is desirable to create competitive tension between institutional and individual investors. Institutional investors can be told for instance that, if they do not indicate sufficiently aggressive demand during bookbuilding, more shares will be allocated to individuals.

Targeting large corporate investors can best be achieved through the trade sale method, but it is also possible to attract such investors to participate in flotations. The targeting of the right investors, and a wide dispersion of the shares, may affect the success of a specific flotation and those which may follow it. The use of special incentives to attract particular groups of investors calls for close examination by the SAI.

Guideline 34

The retail market

Issue

How should the SAI assess the effectiveness of retail marketing in a flotation?

Why this matters

In a flotation aimed at individual investors (known as the retail market) effective marketing is the key to securing a good price and is also necessary if the vendor has objectives relating to widening or deepening share ownership.

Guideline

The SAI should examine whether the vendor had a strategy for marketing the shares to individual investors, whether the strategy was consistent with the sale objectives, and how effectively the strategy was implemented.

Reasons for the guideline

There can be a variety of reasons why vendors want to promote interest among retail investors in a flotation. These include increasing individual stakeholding in businesses, winning public acceptance of privatisation as a process, tapping a source of funds in

addition to those available from the financial institutions and providing a source of competitive tension in pricing the shares.

It is good practice in marketing for a strategy to be formulated and recorded, and the SAI should be able to see how far the strategy was carried out in practice. The analysis of the vendor's marketing strategy should take into account the motives for seeking retail investors.

There may well be competition between some of the vendor's sale objectives and the objectives of the marketing. For example, an objective to promote share ownership might point to setting a low share price so that the new retail shareholders have an immediately satisfactory result from their investment. This could compete with the objective to maximise the price. But involving retail investors does not necessarily mean that the price objective is compromised. Retail demand can be promoted as an effective means of putting institutional investors under competitive pressure and lead to higher share prices than would be the case in the absence of retail demand. Marketing may involve giving retail investors incentives to buy which are not available to large scale investors. The SAI should check whether the cost of those incentives is controlled and whether it is reasonable in relation to the marketing objectives. For example, it might not be reasonable to give large incentives when the only aim of promoting retail interest is to seek sophisticated private investors willing to bid for large numbers of shares.

There are normally strict regulatory restrictions about what can be said to potential investors in a flotation. The SAI will need to examine whether the vendor checked that the marketing campaign complied with such requirements.

Guideline 35
Pricing the shares

Issue

What are the key issues the SAI should address in reviewing how shares were priced in a flotation?

Why this matters

There is a risk that market uncertainty, combined with the need to secure a successful sale, often to a demanding timetable, will result in the shares being underpriced leading to substantial oversubscription and therefore disappointed investors, as well as loss of proceeds to the vendor.

Guideline

The SAI should examine what steps the vendor took to ascertain likely demand at different prices, and to what extent, in the circumstances of the particular sale, account was taken of best practice in deciding on the size of the issue and the sale price.

Reasons for the guideline

An increase in the price of the shares after the sale significantly in excess of any upward movement in share prices generally, may reflect an absence of competitive bidding in the sale or an element of underpricing by the vendor, or both. In a flotation, the vendor is likely to be pursuing a number of competing objectives which will influence the pricing decision. For instance, the vendor might wish to maximise proceeds but might also aim to complete the sale by a published deadline or seek to widen and deepen share ownership among individuals. The existence of competing objectives, however, is not an excuse for the vendor not seeking to secure good value for the business.

With experience, vendors have become increasingly successful in devising more and more sophisticated methods of building competitive tension between individual, institutional and foreign investors, and ascertaining the likely strength of demand at different prices, leading to the setting of prices at which proceeds are likely to be maximised. Such methods include bookbuilding, in which the shares are priced at the end of the offer period on the basis of competitive bidding by investors who are required to indicate how many shares they would be willing to purchase at different prices. At the close of the process, a price can be determined which will take account of both investor demand and general movements in the stock market up to the close of the flotation. This contrasts with the situation in which shares are sold to intermediaries for onward sale at an underwritten price to investors, and where there is no firm indication of demand at various prices from investors. In such circumstances there is a significant risk that proceeds will not have been maximised ([guideline 31](#)).

Even if the vendor uses the best available advice and techniques in seeking to price the shares in a way likely to maximise proceeds, compatible with the other objectives, it may not be possible to do so with total confidence - where for example there is no existing market. This has been a factor in serious underpricing in a number of major flotations. In circumstances of uncertainty it may be more prudent for the vendor to sell the shares in stages ([guideline 30](#)).

Guideline 36
Allocating the shares

Issue

What should the SAI examine in reviewing the vendor's allocation of shares to investors?

Why this matters

In order to secure the best possible price for the shares, the vendor will wish to generate competitive tension between the various groups of potential investors. One way the vendor can do this is to announce allocation policies in advance of the sale which imply that the supplies of shares will be restricted. It can also help create some competitive tension to announce a policy of allocating shares to likely long-term investors, because that can reduce the perceived risk that shares will be sold for a quick profit immediately after the sale.

If the allocation process is not carefully handled, and the subsequent allocation of shares is not seen to be fair by investors generally, there is a risk that the vendor's credibility will be damaged with adverse impact on future sales.

Guideline

The SAI should examine whether the vendor retained control over the allocation of shares, what were the allocation criteria, whether the vendor enforced those criteria, and whether allocations were made on an impartial and systematic basis, in accordance with the criteria.

Reasons for the guideline

The vendor needs to distinguish between the three main groups of potential investors in a flotation: institutional, individual and foreign. Allocation policy will depend on the vendor's sale objectives. For instance, the sale to individuals of significant proportions of the shares available in some major privatisations may be a key aspect of government policy to widen share ownership. Seeking to attract individual investors may be an essential feature of very large flotations, in order to encourage realistic bids from institutional investors (competitive tension). Vendors will be seeking to ensure that the offer is oversubscribed in order to secure the best possible price.

In such circumstances, some investors are not going to get all, or perhaps any, of the shares they bid for and vendors will need to state their allocation policy clearly in advance of the sale to ensure that investors understand the basis on which shares will be allocated.

Guideline 37

Market stabilisation

Issue

What should the SAI consider if it decides to examine any arrangements to stabilise the market price of newly-issued shares following a flotation or a secondary sale of shares?

Why this matters

Unless the vendor can satisfy the market that prices are unlikely to fall following a flotation or major secondary sale of shares, it will be difficult to maximise the price at which the shares are sold.

Guideline

The SAI should establish the outcome of any market stabilisation activities and what consideration the vendor gave to the various market stabilisation options available, consistent with rules governing the regulation of the market, how any stabilisation trading was financed and how the risks and trading profits/losses were shared.

Reasons for the guideline

Market stabilisation arrangements have been adopted in major share sales, including global public offerings, in association with devices such as bookbuilding (see [guideline 33](#)). This is because, in return for offering a higher price for shares than they might otherwise have done, investors in companies - many of which may be critical to the economy - will want some reassurance that this price will not fall in the immediate after-market.

Although the risk of widespread selling leading to a fall in the share price after a privatisation may be reduced by allocating shares to long-term investors, further assurance for investors of a stable after-market will be provided if stabilisation mechanisms are put in place which allow the vendor or an agent to purchase a proportion of the newly-issued shares on the stock market at the vendor's offer price for a specific period after the sale. Such arrangements must, of course, comply with local stock market and other legal requirements, in order to ensure that the vendor avoids the risk of accusation that the market has been rigged. In a number of major sales of shares such arrangements have worked reasonably smoothly, and have helped to secure a good price for the shares. In one case however the vendors were left holding some of the shares they had intended to sell, therefore reducing their immediate proceeds from the sale, but they were later able to sell the shares at a comfortable premium.

Stabilisation mechanisms can include a range of options. For example, the institution handling the sale on the vendor's behalf (known as the global co-ordinator), sometimes in co-ordination with the syndicate of financial intermediaries which it leads, may undertake to support the issue price in the after-market in return for a percentage of the offer. Another example would be where the global co-ordinator has the right but not the obligation to purchase additional shares from the vendor at the offer price, for up to, say, 30 days after the share allocation date.

Section 8: Sale Costs

Guideline 38

Appointing external contractors

Issue

What cost/benefit factors should the SAI bear in mind in assessing how the vendor appointed external advisors/contractors to the sale?

Why this matters

In carrying out the sale vendors are likely to need specialist external advice. This is likely to be expensive, both in absolute terms, and as a percentage of proceeds. The list of advisors can be long and is likely to include lead financial advisers, legal advisers, bankers, accountants, global co-ordinators in large share offerings, printers and marketing specialists. Vendors therefore need to specify clearly what external advice is needed, and to include that specification in the contract with the external adviser. In order to get the best value for money, and to be able to demonstrate that the contractor was selected in a proper fashion, the vendor will be well advised to select each contractor through a competitive process.

Guideline

The SAI should assess how thoroughly the vendor examined what external advice from specialist contractors was necessary and whether the vendor selected these advisers in a competitive process, taking into account both price and quality.

In cases where competition did not take place, or was limited, the SAI should assess whether the vendor established exceptional value for money grounds to justify the appointments made non-competitively.

Reasons for the guideline

It is generally good practice to choose external contractors following competition. Effective competition will put pressure on outside experts to tender at minimum cost. It is also likely to concentrate the minds of potential external advisers on identifying the best way of meeting the sale objectives, enabling vendors to deepen their understanding of their needs and sharpening their appointment decisions. And a competitive process can help to guard vendors against accusations of favouritism in making such appointments. In one example, consultancy contracts, amounting to the equivalent of US \$6 million, were awarded without competition to a firm of which one of the vendor's directors had previously been a senior partner. If however advisory appointments without competition are unavoidable, vendors should be able to demonstrate how they sought to mitigate the disadvantages, particularly in price negotiations.

Vendors will generally benefit from investigating their needs in some depth with a wide range of potential advisers before appointment. The greatest benefits frequently arise in sales where high quality financial, legal and marketing skills have a marked positive impact on proceeds, or where there are difficult technical issues to be resolved in bringing the business to the market.

In assessing the quality of advice on offer, vendors will wish to examine the track record of potential contractors, including their knowledge of the sale processes concerned and whether they have successfully developed appropriate sales techniques with positive benefits for vendors. This can be particularly important as regards selecting lead financial advisers; for example, have they successfully marketed businesses to potential investors at a good price, and have they minimised incentive and other costs such as selling commission, printing and advertising?

Guideline 39

Setting and monitoring budgets for external contractors

Issue

How should the SAI assess whether a vendor has successfully budgeted for and monitored the costs of external contractors?

Why this matters

Privatisations, particularly large flotations and complex trade sales, are likely to require co-ordinated planning and disciplined project management by vendors and their external advisers. Unforeseen problems may arise requiring changes to plans, leading to upward

pressure on costs. Having selected external contractors and settled on a sales strategy vendors will need to manage the costs of implementing that strategy on the basis of sound budgetary control procedures.

Guideline

The SAI should assess how far the vendor set appropriate contract budgets based on careful planning, reviewed outcomes against budgets, in accordance with progress towards achieving the sale objectives, successfully negotiated with external advisers any changes to budgets arising from unforeseen events, and ensured that any special features, such as success fees paid to lead financial advisers, represented value for money.

Reasons for the guideline

Advisory costs can be substantial, requiring effective management and control by vendors to ensure they get value for money.

Budgets should therefore be set on bases which clearly link back to agreements with the contractors, and work plans. In one instance the vendor incurred substantially higher than budgeted charges because the information supplied to the reporting accountants was seriously deficient, and the accountants had to carry out much more work than planned. Payments to contractors should be in accordance with the contractual undertakings and at rates approved at appointment. Payments should take account of any special arrangements, such as those relating to contract variations arising from unforeseen events. Outcomes should be periodically reviewed against budgets by a designated budget holder.

Vendors may not always place sufficiently high priority on controlling contract costs. This frequently happens where the contractor is to be paid at an hourly, or daily rate, without any cap on overall fees. It increases the risk of unanticipated overspends, which can frequently be traced back to a failure to set and review budgets carefully. The SAI should check whether, in the outturn, payments to the contractor exceeded initial expectations. This may call into question the adequacy of the budget setting and the soundness of the vendor's arrangements for monitoring the contractor's charges. Where the contractor asked for higher than expected costs, the SAI will wish to check whether the vendor sought to minimise any additional payments, for example by negotiating lower fee rates or capping fees for the extension to the contract.

Sometimes contracts with, for example, lead financial advisers make provision for the payment of success fees on completion of the sale. Particular care should be taken where the success fee is based on the amount by which the privatisation proceeds exceed a benchmark valuation, especially if that benchmark valuation was provided by the lead financial advisers themselves. In such cases the SAI will wish to check whether the vendor had the benchmark valuation separately validated by a respected expert.

Guideline 40

Methodologies for quantifying overall costs

Issue

How should the SAI quantify and report on the costs incurred by the vendor in conducting a privatisation?

Why this matters

The costs incurred by the vendor in undertaking a privatisation can amount to a considerable proportion of the gross sale proceeds and should be monitored by the vendor, who is responsible for them. If the methods employed by an SAI for assessing the costs of undertaking a privatisation are not reliable and comparable, the financial implications of various courses of action may not be capable of being estimated with reasonable accuracy. The provision by the SAI of relevant and transparent information on the vendor's costs of conducting a privatisation is important for

- current accountability purposes, since so many stakeholders will be interested in the SAI's assessment of the vendor's conduct of the sale of what are frequently high profile and economically important assets
- future public policy making purposes, for example whether future privatisations can be expected to deliver the projected financial outcomes given the sale costs
- future management of sale processes, for example reviewing the size of international selling commissions on initial public offerings
- providing assurance that the costs of sale were reasonable when compared to the level of proceeds, and
- facilitating an evaluation of the outcome of the sale in terms of quantifiable and non-quantifiable benefits.

Guideline

The SAI should seek to identify, analyse and report those costs which are directly attributable to the actual sale process.

Reasons for the guideline

The SAI is normally expected to report on the public resources used to facilitate the sale and to suggest improvements in administrative processes for maximising total net returns in future sales. An essential element is the application by the SAI of an appropriate costing methodology. Identifying the costs directly attributable to the sale is however rarely straightforward. Qualitative judgements by the SAI are frequently required, given problems with distinguishing actual sale costs from other forms of outlays associated with, for example, restructuring the business. But if the costs of undertaking a privatisation cannot be accurately identified this may limit the ability of the SAI to determine whether the major sale objectives have been achieved. In carrying out its analysis the SAI may wish to consider : obtaining a knowledge of the relationship between the various forms of costs involved in undertaking the sale, including any associated restructuring costs; establishing criteria for determining whether costs are directly attributable to a sale, for example the payment of success fees to the vendor's advisers; evaluating all relevant costs associated

with the sale process to determine if costs that may not be directly traceable to a single activity can be apportioned to the sale process; calculating and comparing sale costs with sale proceeds; and considering whether such a level of costs provides value for money, compared with the cost of other options, for example, doing nothing or closing the business.

Glossary

Aftermarket	The period following the start of dealing in shares newly issued on a stock market
Allocation	A method by which shares are divided between investors in a flotation or secondary sale of shares
Assets	Anything, physical or otherwise, including intellectual property, owned by a business
Auction	Public sale at which businesses are sold to the person making the highest bid
Benchmark Valuation	A pre-sale valuation of a business prepared by or on behalf of the vendor
Bookbuilding	Indications from investors of the numbers of shares at different prices they would be willing to purchase
Business	An enterprise, private company, partnership, or individual carrying out commercial or industrial undertakings
Capital Market	A market, for example in a stock exchange, through which funds are obtained for investment. A potential bidder will often need to obtain financial backing in a capital market before making a major bid in a privatisation
Clawback	Provisions, usually limited in duration, in the terms of the sale enabling the vendor to receive, in defined circumstances, a proportion of any subsequent profit made by the purchaser after sale - for example following the disposal or deemed disposal of surplus land or other assets, or if the purchaser disposes of the business
Command Economy	An economy in which the most important financial and industrial interests are controlled by the state
Commercialisation	A process in which a state-owned business is put on a more market

orientated footing while remaining wholly or partially in the public sector

Competitive Tension	A process by which the existence of two or more competitive bids can lead to the vendor benefiting from higher proceeds because of the competition between these bids
Contracting Out	A process, usually following competition, by which instead of continuing to provide a service itself a government body pays a private provider to deliver the service
Corporate Governance	The system by which businesses are run, including the responsibility of those directing the business to ensure that it is properly and honestly managed
Discount Factor	A means of calculating the present value of future costs and revenues
Downsizing	A reduction in the staffing requirements of businesses which can follow after privatisation for a variety of reasons, for example in response to competitive pressures or in order to increase the profitability of the business to its new owners by cutting costs
Due Diligence	A process by which the bidders verify if the facts and assumptions made at the time of their bids are accurate at the time the sale is completed
Equity	That part of a company's capital belonging to its shareholders
Flotation	Sale to individuals, financial institutions or private sector businesses of shares which can then be traded on a market
Global co-ordinators	Financial institutions which co-ordinate the marketing of an international share offer
Indemnities	Conditions of sale by which a vendor agrees to pay costs incurred by the purchaser if certain events stipulated in those conditions occur
Intermediaries	Agents, both corporate and individual, representing the interests and acting on behalf of individual investors in privatised businesses
Liabilities	Costs which may be incurred after the sale and are either transferred

to the purchaser or retained by the state

Management and Employee Buy-out	Sale of the business to its management and/or employees, giving them control of future management
Market Economy	An economy where key elements in the financial and industrial sectors are owned by private corporations rather than by the state
Marketing	A process by which the vendor attracts bidder/investor interest in the sale
Market Stabilisation	A process by which, for a specified period following a flotation or secondary sale of shares, the government supports the issue price
Mass Privatisation	Arrangements differ between countries, so there is no single definition. Broadly speaking however the term refers to a programme of widespread privatisation, which may include the broad participation of the public as investors, and is often part of a rapid move away from a command economy towards a more market orientated economy
Mixed Economy	An economy in which ownership of some key elements in the financial and industrial sectors resides in the state and other key elements are in private hands
Performance Audit	An independent examination of how economically, efficiently and effectively the audited body has carried out its tasks
Preferred Bidder	The bidder who is selected by the vendor as being the party to whom it intends to sell the business, subject to the completion of negotiations and legal arrangements
Premium	The amount by which newly issued shares are traded on the stock market above the share issue price
Privatisation	Transfer by central or local government of a business and its assets from state to private ownership
Regulation	A system by which the state exercises some control or influence over, for example, the operation of monopoly power, either directly or through a public body operating at arms length from the government
Residual Management	The management of any remaining responsibilities or liabilities by the state following the sale of the business

Restructuring	A process in which the vendor prepares the business for sale
Retail Market	The market for individual investors in a flotation
Success Fees	Fees charged by advisers for advice in which the level of fees depends on the transaction being completed
Taxpayers	The citizens of a country, whose taxes have been invested in state owned businesses
Trade Sale	Direct sale of a business in state ownership to another business. This includes joint ventures and part sales
Tranche Sale	A part sale of a business in a flotation
Underwriters	Financial institutions which agree, in advance, in return for a fee, to buy unsold shares in a flotation
Vendor	The legal entity representing the state which owns the business whose privatisation is subject to audit.
Voucher	Document which can be exchanged for shares in a privatised business or for shares in a fund which holds shares in a privatised business
Warranties	Provisions in a sale agreement through which the vendor guarantees certain matters to the purchaser about the business being sold
