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SCOPING STUDY FOR FINANCIAL EVALUATION OF ENERGY ENTERPRISES

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Final Report

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Prepared by

Hagler Bailly
1530 Wilson Boulevard
Suite 400
Arlington, VA 22209-2406
(703) 351-0300

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BACKGROUND AND PURPOSE OF THE STUDY

During the Winter of 1998, in response to a severe shortage of fuel for power generation, the Government of Georgia (GoG) requested assistance from the United States In response to this request the U S agreed to provide $5 0 million, to cover the costs associated with the procurement of approximately 70 million cubic meters of natural gas A Memorandum of Understanding (MOU) was signed in February 1998 between the GoG and the United States Agency for International Development In exchange for the funds provided, the GoG agreed to several conditions including the initiation of five independent financial audits of the largest Georgian energy enterprises

In connection with this requirement, USAID requested Hagler Bailly Services, Inc (HBC) to perform a scoping study of the enterprises to be evaluated The purpose of the study was to determine what type of review or audit would be most appropriate in fulfilling the requirement of the MOU HBC entered into a subcontract with CARANA Corporation to undertake the scoping study

The organizations selected to be evaluated in the study were

Telasi

Sakenergo Generatsia

Sakenergo

Saktransgas

Saknavtobi

Georgian Gas International Company

The following items were required to be included in the report

- Summaries of discussions with management of each company
- Summaries of discussions with World Bank, EBRD and Merrill Lynch
- Initial observations of operations and management of each company
- Synopsis of the various levels of attestation or other type of engagement and the potential applicability of each type to the enterprises based on their present circumstances
- Estimation of the scope and associated costs of performing each of the various levels of attestation engagements
- Recommendations of the level of attestation engagement appropriate for these enterprises

APPROACH AND TASKS

To gather the information necessary for this study and to determine the appropriate follow-on engagement, the following tasks were deemed necessary

1) Review reports resulting from prior donor projects and due diligence to gain an understanding of the energy environment in Georgia and the financial and operating environments at each company to be evaluated

2) Conduct interviews with key people at donor agencies and enterprises with a stake in the outcome of this study

3) Meet with key management officials in each of the companies to be evaluated to discuss the current financial and managerial environment including the internal controls structure

4) Meet with the accounting departments of each company to gain an understanding of the accounting system including organization of the department, journals and ledgers, source documents, form of financial statements, reporting requirements (internal and external) and the extent of computerization

5) Determine the feasibility, costs and benefits of performing financial audits

6) Determine the feasibility, costs and benefits of performing other types of engagements

Review of Prior Reports

In order to gain an understanding of the current energy sector in Georgia we reviewed many documents produced by USAID and other donor agencies The most significant were

- Electrical Distribution Sector Privatization Due Diligence Assistance (Price Waterhouse for HBC and USAID)
- Sakenergo Debt Management (Kantor and KPMG for EBRD/World Bank)
- Review of Financial Controls of Sakenergo (TACIS)
- Analysis of Environment for Financial Management in Power Sector (TACIS)
- Characterization of Georgia's Power Sector (HBC for USAID)
- Report on Main Results of the Electricity Sector in January - April 1998 (USAID)

Interviews with Key People

Meetings were arranged with the following people to discuss the enterprises the energy sector the needs of donor agency and needs for privatization

- McNeill Watkins, HBC
- Levi Hanson, Price Waterhouse
- Jonathan Walters, World Bank
- Margaret Wilson, World Bank
- Xenophon Martinis Kantor Management Consultants
- Jurgen Schramm, EBRD
- Vasico Papuashvili Director, Relasi Distribution Company

Meetings with Management and Accounting Staffs of Enterprises

Due to the limited time available for this study, two days were spent with each of the companies being evaluated The scope of each visit included the following

- Initial meeting with General Director and Finance Director to discuss history of company, organization chart, lines of authority for essential functions, current problems, plans for solutions to problems, plans for privatization
- Meetings with department heads responsible for the following functions procurement, sales, planning, maintenance, barter
- Meetings with Accounting Department personnel responsible for billing, receivables, payables, bank transactions, property, plant and equipment, tax filings

Determine the Feasibility of Financial Audits

To determine the auditability of each company in accordance with International Accounting Standards (IAS), the following workplan was utilized

- Analyze transaction cycles for internal control weaknesses that would prevent an auditor from rendering an audit opinion
- Determine potential problems in restating balances to IAS
- Determine required evidence for performing substantive tests of account balances in major asset and liability categories These include cash, receivables, fixed assets (property, plant and equipment), investments in joint ventures and payables
- Determine the availability of required evidence for performing substantive tests
- Evaluate the audit risk and the cost of reducing the audit risk to an acceptable level Audit risk is the probability of either expressing an audit opinion on financial statements that is incorrect, or the probability of not being able to render an opinion due to lack of required evidence or critical uncertainties

Report on enterprise

A report summarizing the findings for each enterprise is included in the Appendices The reports include

- Description and history of the company
- Prior donor work and due diligence
- Summary of meetings with company
- Analysis of transaction cycles
- Auditability of key account balances
- Recommendation regarding auditability of entire company

POSSIBLE FOLLOW-ON ENGAGEMENTS

The following types of engagements were considered for the enterprises being evaluated

Full Financial Audit This encompasses performing an audit on the financial statements of each company in accordance with International Standards of Audit (ISA) as published by the International Federation of Accountants (IFAC) The purpose of an audit of this type is for the auditor to express an opinion as to whether the financial statements taken as a whole present fairly the financial position (balance sheet) of the company at a specific date and the results of its operations (income or operating statement) and cash flows (statement of cash flows) for a period of time in accordance with International Accounting Standards

The scope of a financial audit requires the auditor to evaluate the company's internal control structure (ICS) The ICS is the system that should provide reasonable assurance that errors and irregularities are prevented or detected in a reasonable amount of time so that they do not make the financial statements misleading In cases where controls are utterly lacking so that there is not reasonable assurance that the financial statements are free of material error, the auditor will not be able to express an opinion on the fairness of those statements In this case, "control risk' is considered unacceptably high

To determine control risk the auditor must identify and test the critical controls This is generally accomplished through sampling transactions in each transaction cycle (e g , procurement, sales, payroll, cash) As the possibility of control risk increases, the auditor must increase testing which can substantially increase the cost of the audit

If control risk is at an acceptable level, the auditor will then perform substantive tests to verify account balances This requires the auditor to gather sufficient, competent evidential matter regarding the existence of assets, the occurrence of recorded transactions, the inclusion of all required transactions, the valuation in accordance with IAS, and, proper disclosure Substantive tests are also performed by sampling transactions The higher the control risk, the greater the sample size must be to provide reasonable assurance that the account (e g , Accounts Receivable) is free from material error

If the auditor is able to gather sufficient, competent evidence, and the evidence provides reasonable assurance that the financial statements are in accordance with IAS, the auditor will given an "unqualified opinion" in his audit report If the evidence leads to the opinion that the financial statements are materially misleading he will issue an "adverse opinion" that states the financial statements are not fairly presented and will provide an explanation as to what is misleading

If the auditor is satisfied with the overall presentation but finds portions of the financial statements are not in accordance with IAS he may give a qualified opinion which says that the statements are fairly presented "except for' items that are specifically identified in the report

Finally, in some cases the auditor will not be able to gather enough evidence to reach any opinion In this case the auditor will issue a report that "disclaims" an opinion and gives the reasons why an opinion cannot be expressed

Audit of Financial Statement Elements This encompasses performing an audit on one or more components of the financial statements in accordance with ISA The purpose is to express an opinion as to whether the component is in accordance with International Accounting Standards For example, an audit could be performed on Accounts Receivable without auditing the remainder of the balance sheet The audit report would be similar to a full audit, except that the opinion would only refer to the component

The same types of evaluation of internal control and substantive testing would be required, except that it would be limited to the component However, the ISA states "in determining the scope of the engagement, the auditor should consider the financial statement items that are interrelated and which would materially affect the information on which the audit opinion is to be expressed " For example, the audit of Accounts Receivable would need to cover related accounts such as Sales Revenue, Sales Discounts, Allowance for Uncollectible Accounts Cost of Sales and Uncollectible Accounts Expense

Financial Statement Review The objective of a review of financial statements is to enable an auditor to state whether, on the basis of procedures which do not provide all the evidence that would be required in an audit anything has come to the auditor's attention that causes the auditor to believe that the financial statements are not prepared in accordance with IAS This type of engagement provides a moderate level of assurance that the financial statements are free of material misstatement

Although the specific procedures to be included in a review are not prescribed, the ISA does state that the auditor should apply judgment in determining the specific nature, timing and extent of review procedures based on previous knowledge of the company, its industry, its accounting system and its management Further, the ISA states that procedures for a review will normally include

- Obtaining understanding of the business and industry
- Inquiries regarding accounting principles and practices
- Inquiries regarding procedures for recording, classifying and summarizing transactions for recording in the financial statements
- Analytical procedures designed to identify relationships and items that appear unusual

- Inquiries regarding occurrences at meetings of shareholders board of directors regulatory commission, etc

- Obtaining reports from other auditors (e g , Chamber of Control, tax inspectors)

Unlike an audit, a review engagement does not require the auditor to consider or evaluate internal controls, although such procedures are not prohibited In an instance where the auditor suspects that internal control is very weak, he may need to insist on such an evaluation if he is to give even moderate assurance on the financial statements

Another example of the difference in scope between an audit and review is that in an audit an auditor would normally require external verification of cash in bank and accounts receivable by direct communication with the external party In a review such procedures are not required

Applying Agreed Upon Procedures The objective of an "agreed upon procedures" engagement is for the auditor to carry out procedures of an audit nature to which the auditor and the entity and any appropriate third-parties (e g , donor agencies) have agreed and to report on factual findings

It is important to note that the ISA states that no assurance is expressed in the report The users of the report draw their own conclusions In an engagement of this type all the parties involved should agree on the following

- Nature of the engagement including the fact that the procedures performed will not constitute an audit or a review and that no assurance will be expressed

- Stated purpose for the engagement

- Identification of the financial information to which the procedures will be applied

- Nature, timing and extent of the specific procedures to be applied

- Anticipated form of the report of factual findings

- Limitations on the distribution of the report

Engagements to Report on Internal Control There are two types of reports on internal control

a) Required communications based on a financial statement audit This is a report to management (or a specific named party) of material weaknesses in the design or operation of internal control which have come to the auditor's attention during a financial statement audit In this report, the auditor must state that

- the accounting and internal control systems were considered only to the extent necessary to determine the auditing procedures to report on the financial statements and not to determine the adequacy of internal control for management purposes or to provide assurances on the accounting and internal control systems, and

- it discusses only weaknesses that have come to the auditor's attention as a result of the audit and that other weaknesses in internal control might exist

b) Reporting on the results from applying agreed upon procedures The purpose of this engagement is to discover material weaknesses in the internal control structure A "material weakness" is described as follows

> A material weakness exists when the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that errors or fraud in amounts that would be material in relation to the financial statements may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions

Procedures would include

- Obtaining an understanding of the internal controls over specified transaction cycles and account balances including
    a) how transactions are initiated
    b) what accounting records and supporting documentation exist
    c) the accounting process
    d) management's attitude, awareness and actions
    e) specific control procedures

- Making a preliminary assessment of control risk for each transaction cycle and account balance to be included in the report Control risk will be assessed at a high level when the *design* of the entity's internal controls are not likely to prevent or detect a material misstatement

- Testing controls where the design of the control system appears to provide the basis for reliance on the system to prevent or detect material misstatement

The report would include a description of each material weakness detected and recommendations for improvements

Operational (Management) Audit Operational Audits are not covered by ISA However the Institute of Internal Auditors, an international self-regulating organization which is a member of IFAC, has issued professional standards starting in 1978

The general purpose of operational audits include

- Assessing performance - compare the way a company operates with objectives established by management or a third-party, such as organization policies, standards or goals
- Identify opportunities for improvement in economy, efficiency and/or effectiveness
- Develop recommendations for improvements or further action

There are four components to an operational audit

- Financial focusing on proper and adequate accounting and reporting
- Compliance focusing on adherence to rules expressed in laws contracts, regulations etc
- Economy and Efficiency focusing on achieving the optimum balance between costs and results
- Effectiveness focusing on results and accomplishments achieved and benefits provided compared to established expectations

Specific reasons for having an operational audit include

a) Financial

- Adherence to financial policy
- Performance of accounting procedures
- Appropriate segregation of duties in accounting
- Adequate audit trail
- Procedures can be observed

b) Adequacy of Internal Control

- Safeguarding of assets

- Reliability of financial records
- System of authorization and approval
- Separation of duties
- Physical control overassets
- Operational efficiency
- Adherence to managerial policies
- Adequacy of managerial information
- Employee competence and training
- Quality controls

c) Procedural Compliance with

- Laws and regulations
- Administrative policy
- Authorization and approval
- Long-term and short-term plans
- Management objectives
- Recruiting and training objectives

d) Organizational Efficiency

- Clear understanding of responsibilities and authority
- Logical nonconflicting reporting relationships
- Current job/functional descriptions
- Separation of duties
- Staffing levels

e) Operational Results

- Organizational planning goals, objectives, and detail plans
- Detail plan development and implementation, considering alternatives constraints cost-benefit and resource allocation
- Evaluation of operational results appropriateness of measurement criteria, feedback of success or failure adjustment of goals, objectives, strategies

Like other audits, the operations audit has the following phases planning, preparation of audit program, fieldwork, development of audit findings and recommendations, reporting

In the fieldwork phase, the auditor analyzes operations to determine the effectiveness of management and related controls The purpose is to determine whether a situation needs improvement, whether it is significant and what should be done about it

Based on the results of the fieldwork phase, specific findings are developed according to the following criteria

- Condition what was found
- Criteria what it should be
- Effect the impact on operations
- Cause why it happened
- Recommendation how to correct the situation

Unlike financial statement audit reports, the operational audit report does not provide assurance and there is no standard report In many ways, the report in an examination that provides "agreed upon procedures" would be appropriate (see previous section), although generally the operational audit report would be more comprehensive

MAJOR FINDINGS

Meetings with Interested Parties

During our fieldwork, we had meetings with representatives of the World Bank EBRD and Kantor Management Consultants We were also going to meet with Merrill Lynch which is assisting Telasi with its privatization However, their representative was not available to meet with us Since Kantor has performed due diligence for Merrill Lynch, they were used as a substitute

Since the World Bank and EBRD are considering investments in the power sector and since Merrill Lynch was going to be involved in the privatization, they all have an interest in receiving more information about the companies being evaluated The purpose of the meetings was to determine what type of information would be most useful to them

In all three meetings, the representatives did not think that full financial audits of the five companies would be worthwhile The basic reason is that it is already well known that all of the companies have liquidity problems, operational assets in disrepair, poor internal control and poor management

Both Mr Schramm of EBRD and Mr Walters of World Bank expressed a preference for a management audit that would lay the groundwork for how to remedy the situation that now exists The following summarizes the views of all of the organizations regarding how to move forward

1 A systems and management audit would provide the basis for restructuring the sector and would be more useful

2 Meaningful restructuring would require

   a A study of the requirements for an efficient and effective energy sector

   b Design of systems including management information system (MIS), profile of effective managers, functional organization charts and job descriptions

   c Train or replace current management

   d Pilot study to test the adequacy of the newly designed system in generation, transmission and distribution

   e Modification of systems design based on results of pilot study

   f Re-test after modification

g Implement throughout the sector

3 The final goal is a full functioning MIS, management reporting system accounting system with proper internal controls that allows preparation of financial statements in accordance with IAS

B Summary of meetings with Companies

Over a four week period we met with representatives of all six companies that were evaluated We found management very cooperative at each company They appeared to be quite open about their problems, but in most cases did not volunteer many solutions

Since our time at each company was limited to two days, we concentrated on two objectives

- Evaluate the internal control systems by meeting with managers who were the primary decision makers in each major transaction cycle
- Evaluate the accounting procedures and the auditability of the financial statement elements where there is the most audit risk

As previously discussed, audits of financial statements under ISA require analyzing and testing the internal control systems and performing audit procedures to determine that financial statement elements are free from material misstatement Therefore, based on the time available, these two objectives would give us the best understanding of the auditability of each company and would allow us to estimate the length and cost of a full IAS audit

The accounts that were evaluated were cash, receivables, fixed assets, investments in joint ventures and payables

C Summary of Findings

The results of our evaluation of each company are presented in the appendices The findings and the most important results are summarized below

1 Except for GIC, there were major internal control weaknesses noted at each company that would either

a) make the company not auditable (i e , an auditor would be unable to express an opinion on the financial statements due to poor controls not allowing the auditor to examine sufficient, competent evidential matter), or

b) would require a large increase in substantive tests due to the control weaknesses This would make the audit considerably more expensive

2 Typical weaknesses included

- Poor control over purchasing due to lack of procedures for approval and for barter transactions
- Lack of control over fixed assets and repairs (custody function)
- Lack of separation of functions in the accounting department
- Lack of subsidiary ledgers to track receivables and payables
- Lack of realistic budgeting for control of cash
- Lack of automation of accounting system and other operations results in missed opportunities to improve internal control

3 Control over cash was relatively good except for Telasi where there are critical weaknesses due to the existence of a large cash fund Money collected from customers is not deposited in the bank but is kept in the cash fund at the company The fund is used to make cash purchases Therefore there is inadequate control over both cash receipts and disbursements In addition, customers pay cash to collectors who also do not have adequate controls

4 Non-payment for electricity by residential customers causes a chain reaction that leaves SakGen, SakDis and Telasi with a very material amount of uncollectible receivables

5 In half of the enterprises, a large portion of fixed assets in some companies are either damaged or completely inoperable The liquidity problem does not allow for needed repairs This puts a strain on usable assets which cause more assets to be damaged From an accounting standpoint, these damaged assets should be reclassified and written down to scrap value in some cases

6 The cost of auditing fixed assets will be very high due to

- the need to inventory fixed assets
- the need for a valuation specialist to review the condition of fixed assets
- the need to reclassify inoperable assets and to write them down to scrap value
- the need to verify that previous revaluations are in accordance with IAS

7 It is not clear who owns the gas pipeline assets

8 The number of joint ventures that make up the bulk of Saknavtobi's operations creates an audit problem in that the accounting method used is much different than IAS and the cost of restating the investments could be very expensive if they can be done at all

9 With the exception of GIC, all of the companies have liquidity and operating problems that make it questionable whether they are ' going concerns In such a case, IAS requires the company to disclose the problem and the reasons therefor in the financial statements If this is not done, ISA requires the auditor to give a qualified or adverse opinion for poor disclosure If the company does adequately disclose the problems, the auditor would add an "emphasis" paragraph to discuss the issue in the audit report

RECOMMENDATIONS

The primary purpose of our scoping study is to determine the appropriate level of attestation engagement appropriate to the enterprises and beneficial to USAID USAID's overall objective in the energy sector includes assisting the sector in establishing privatized, competitive enterprises that can meet the energy needs of Georgia

Full Financial Audit Based on our study, we believe that it is highly probable that, with the possible exception of Saknavtobi and GIC, each audit would result in, at best, a qualified opinion, due to poor internal control and/or lack of sufficient, competent evidence In some cases a disclaimer of opinion (i e the auditor cannot reach an opinion) would be appropriate due to the materiality of the items involved where evidence is not adequate The final possibility is that the auditor would reach the conclusion that one or more of the companies is not a going concern (i e , the company is bankrupt and will be liquidated) In that instance an adverse opinion would be appropriate (Note an adverse opinion is highly unlikely since it is doubtful that the GoG would allow a liquidaton)

Although an unqualified opinion would provide the greatest assurance that the financial statements fairly reflect IAS, the other possible opinions also provide useful information These can be categorized as follows

- Any opinion that is not unqualified requires a separate statement explaining each substantive reason why a qualified opinion could not be given Therefore the financial statement user would know specifically where to intensify the examination or what problems require attention

- Since all substantive reasons for <u>not</u> qualifying the opinion must be stated, all items not leading to a modified opinion are therefore in accordance with IAS So effectively, the auditor is giving an unqualified opinion on all financial statement items other than those leading to the modified opinion

- Auditors are required to communicate to management internal control weaknesses discovered during the audit, and oftentimes include recommendations for improvement to the internal control structure in their report

Audit Cost It is very difficult to estimate the cost of a full audit in this situation for the following reasons

- The companies have never undergone an audit under ISA A first audit is always much more expensive than subsequent audits since there are many audit procedures that are required only in a first audit In addition recurring procedures require additional effort in a first audit due to the auditor s complete lack of experience in working with the entity These include

a) Obtaining knowledge of the entity's business and industry In subsequent audits this step only requires updating the auditor's previous knowledge

b) Obtaining knowledge about the entity's internal control structure and the risk management policies of management

c) Identifying related party transactions

d) Making preliminary materiality judgments

e) Gathering evidence regarding beginning balances In a first audit, an auditor is unable to provide an opinion on the Income Statement or the Statement of Cash Flows unless an audit is performed on the balances of assets and liabilities at both the beginning of the year and the end of the year The reason for this is that beginning balances affect the calculation of revenues and expenses for the audit year

For example, the correct calculation of depreciation depends on the beginning balance of depreciable assets The correct calculation of revenues depends on the beginning balance of accounts receivable

The result of this is that the auditor must actually audit the balance sheet at two points in time, both the beginning and the end of the year In subsequent years the beginning balances do not need to be audited since these balances were audited during the previous year's audit

- The cost of the audit is highly dependent on the auditor's evaluation of internal control In a first audit, since the auditor does not have experience with the entity, it is impossible to estimate the assessment of control risk which will have a significant impact on cost

The following factors would result in the audit being expensive relative to an audit in a country with an established accounting profession

- To achieve the necessary credibility of the financial statements being audited, investors would require the audit to be completed by a firm with which they are familiar and have confidence in This would most likely result in the audit being done by an international firm None of these firms are currently located in Georgia, therefore to retain these firms would result in additional costs for travel and per diem In addition, the hourly rates for auditors from the international firms range from approximately $100 to $250 per hour

- Our initial findings regarding the poor condition of the internal control structure of the companies would most likely result in the auditor not being able to place much if any, reliance on internal control This would increase the amount of substantive testing substantially

- As discussed earlier, first audits require substantially more and extensive auditing procedures than subsequent audits

Conservatively, it is estimated that a full audit could cost a minimum of $750,000 for each entity (other than GIC which has had relatively few transactions and Sakenergo Dispatch and Sales which has recently commenced operations)

Audit of Financial Statement Elements The same conclusions discussed above for full financial audits would apply for an audit of any component of the financial statements The benefit of a "partial" audit would be in its economy *Where limited funds are available, the audit could be limited to financial statement elements where the benefit of the information to be received is assumed to be the greatest*

Audit Cost The cost will be dependent on which financial statement elements are audited Clearly, the costliest element would be property, plant and equipment and related elements The next costliest element would be Accounts Receivable for Telasi For the other companies the effort to audit this element would be considerably less For Saknavtobi the costliest element would be the audit of joint venture operations The other elements should cost much less to audit However, the discussion above for full audits, regarding the additional costs for first time procedures, for utilizing international firms and for poor internal control would also apply

A strategy that could be employed would be to determine the amount of money available for audit and to ask the international audit firms to provide a bid by financial statement element Then it would be possible to select for audit a combination of financial statement elements that would be within the budgeted amount

Financial Statement Review A Review engagement provides less assurance than an audit that financial statements are free of material misstatement A Review would only be recommended where the additional cost to perform an audit is considered to be greater than the additional benefit to be received by the beneficiary of the information

In this case the expectation of poor internal control would increase the cost of a Review to the point where its economic advantage would disappear Therefore, a Financial Statement Review is not recommended

Applying Agreed Upon Procedures to an Internal Control Engagement

In a financial statement audit the auditor evaluates only those internal controls where there is a reasonable probability that the controls can be relied upon to reduce the extent of the substantive audit procedures necessary to reach an audit opinion

It would be useful, however, for potential investors and donors to have a more complete study of the internal control structure than that provided by a financial statement audit An engagement identifying material control weaknesses and providing recommendations for improvement would allow the company to improve its operating efficiency while substantially reducing the probability that material errors and fraud would occur without detection The resulting improvement in internal controls would reduce the cost of future financial statement audits and increase the probability of receiving an unqualified audit opinion that the financial statements are in accordance with IAS

Audit Cost This type of engagement should be considerably less expensive than a financial statement audit for the following reasons

- This is not an "attest" engagement, therefore, it would not require retaining a company licensed to perform financial statement audits A management consulting firm with the requisite skills could be retained Billing rates are likely to be lower

- The scope of this type of engagement is considerably less than a financial statement audit

We estimate the cost of this engagement to be $237,612 per company A sample budget is included at the end of this report Assuming that an Internal Control engagement is not necessary for GIC, due to the small amount of activity, the estimated cost for five audits would be $1,188,060

Operational (Management) Audit

In our discussions with the World Bank, EBRD and Kantor Consultants, all agreed that an operational (management) audit which could be used to derive a plan for fixing the problems of the industry, would be the most helpful

As discussed earlier, management audits consist of

- Assessing performance - compare the way a company operates with objectives established by management or a third-party, such as organization policies, standards or goals

- Identify opportunities for improvement in economy, efficiency and/or effectiveness

- Develop recommendations for improvements or further action

In our opinion the objectives of the audit should be to provide recommendations on the design and implementation of a management information system that would include

- Staged automation over several years
- Training of accounting staff in using the new chart of accounts *
- Inventorying of receivables and payables
- Inventorying of fixed assets with evaluation of condition
- Capital budgeting study to determine whether assets should be repaired or replaced
- Cost reduction plan
- Debt restructuring plan
- Implementing managerial cost accounting including cash budgeting
- Plan for replacing residential meters with tamper proof meters located outside the premises with the ability to turn off individual unit electricity for non-payment
- Improved collection procedures where customers pay through bank transfers
- Improved purchasing procedures
- Improved procedures for tracking barter transactions including obtaining information necessary for proper accounting
- Provide management training to line managers or consider replacing current management

We estimate that the cost of the Management Audit itself, without including the cost of implementation, would be $320,580 for each company A sample budget is included at the end of this report Assuming that a Management Audit is not necessary for GIC, due to the small amount of activity, the estimated cost for five audits would be $1,602,900

A word of caution The cost of the audit does not include the cost of implementing the recommendations, which would be substantial Past history shows that it is often the case that recommendations do not get implemented when donors provide a plan of action, but do not provide staff training and do not assist in the implementation of the plan As an example, from 1995 to 1997 Kantor and KPMG performed a management audit on Sakenergo (before the split of the generation and transmission functions) that included conversion of accounting records to IAS, internal control recommendations and other significant recommendations However, most of the recommendations have not been implemented and the new accounting system is not being used

In its report titled TA to the Ministry of Fuel and Energy in Georgia (February 1998), TACIS attributes this failure partially to the breakup of Sakenergo and partially from resistance to change They postulate that a major reason is lack of commitment from top management and that this can only be corrected by decrees from the highest level of government Their estimate of that the full cost of implementation of lasting improvements at SakGen and SakTrans would be $5 million over a five year period

* Note that a current USAID project is developing a chart of accounts for the electricity sector based on IAS That project is also developing a plan for the implementation of IAS throughout the sector, but will not itself be involved in the implementation

Conclusion

The final decision on what type, if any, engagement to support, USAID must assess its primary goal and the resources available Clearly a full audit would be too expensive However, an audit of specific strategic financial statement elements may be helpful in attracting investors The question of cost cannot be determined until those strategic elements are identified Since international audit firms would most likely have to do this work, the cost may still exceed the resources available

An engagement to evaluate internal controls would be very useful to both managers and investors It would also be helpful to investor representatives who need to perform due diligence on the companies Assistance in implementing the recommendations would be necessary to achieve the desired result of this engagement The amount of assistance needed would be much less than that required under a Management Audit The recommendations could be implemented within one year

Likewise, the success of a Management Audit would depend on implementation of the recommendations This is a long-term strategy that potentially has the greatest benefit, but would take several years before the final results would be achieved

INTERNAL CONTROL ENGAGEMENT BUDGET

Level of Effort Category	Qty	Salary Rate (includes multiplier)	Work Days	Total Cost
Senior Auditor	2	$1,300	30	$78,000
Auditor	2	1,000	30	60,000
Local Labor	6	50	50	15,000
Total LOE				$153 000

Travel & ODC Category	Unit Cost	Units	Unit	Cost
Intl Airfare	$3,500	4	Trips	$14,000
Per Diem	334	168	Days	56,112
Communications	5,000	1	Project	5,000
Reproduction	2,000	1	Project	2,000
Other	7,500	1	Project	7,500
Total Travel & ODC's				$84,612
Total all categories				$237,612

MANAGEMENT AUDIT BUDGET

Level of Effort Category	Qty	Salary Rate (includes multiplier)	Work Days	Total Cost
Senior Auditor	2	$1,300	50	$130,000
Auditor	2	1,000	50	100,000
Local Labor	6	50	50	15,000
Total LOE				$245,000

Travel & ODC Category	Unit Cost	Units	Unit	Cost
Intl Airfare	$3,500	6	Trips	$21,000
Per Diem	334	280	Days	93,520
Communications	5,000	1	Project	5,000
Reproduction	2,000	1	Project	2,000
Other	7,500	1	Project	7,500
Total Travel & ODC's				$129,020
Total all categories				$374,020

APPENDIX A

REPORT ON TELASI

Georgia Scoping Study

Financial Evaluation of Energy Enterprises

REPORT ON TELASI

Description and Background of the Company

Telasi is the electricity distribution company for the city of Tblisi and is by far the largest of the 66 distribution companies in Georgia Prior to 1996, Telasi was part of the overall state owned power structure Subsequent to a Presidential Degree, all distribution companies were ' unbundled" from the combined state owned power sector and turned over to the municipalities Recently Telasi was corporatized to ready it for privatization A joint stock company was formed with 98% of the stock owned by the Municipality and the remaining 2% by the company personnel The plan for privatization calls for a company that would be 93% investor owned with 5% to the Municipality and 2% to the employees There is a strong movement by personnel to obtain a 5% stake which would permit them to have a seat on the Board of Directors Currently the Municipality controls the Supervising Council which appoints the Director who in turn appoints his staff

Telasi receives the great majority of its electricity from Sakenergo the state owned transmission company It distributes to residential industrial, commercial and government organizations Electricity provided to Telasi is metered by both the supplier and Telasi Distributions are also metered, however there are many damaged meters that either do not function at all or provide faulty data There is also poor security over the meters resulting in a significant amount of theft of electricity through the manipulation of meters Management estimates that repairing, replacing and securing meters would cost approximately $50 000,000 Estimates from other authoritative sources range from $20 000 000 to $30 000 000

In addition there is a problem collecting from customers In 1997 only 43% of amounts billed were collected and only 25% of this amount was in cash The remainder was primarily ' offsets" against amounts owed by Telasi Accounts Receivable are currently about 100 million GEL but at the current time, approximately 80% is considered uncollectible

Telasi has over 2,000 employees in six major departments Due to cash flow problems, payments to employees are five months in arrears

The primary creditor is Sakenergo which transmits the electricity As of this writing the liability is over 100 million GEL

The purchase price for electricity has been set by the Regulating Commission at 3 1 Tetri per kWh and the selling price established at 4 5 Tetri per kWh Price is set at a level where even with 100% collections the company would report a loss (i e the selling price does not cover full costs) Basically, Telasi purchases almost all of its power from Sakenergo with about 1% negotiated at a better rate from a small privatized company

There is frequently a 100% load on transformers and as a result approximately 80% of the transmission lines should be replaced Management further disclosed that Telasi required approximately 500 000 GEL for maintenance per month to sustain operations Almost all of the gross cashflow in excess of 500 000 GEL is paid to Sakenergo

Prior Donor Work and Due Diligence

The Government of Georgia (GoG) requested the help of the World Bank in privatizing the power sector and Telasi was the first enterprise selected to be privatized The advisors selected to assist with the privatization was the consortium of Merrill Lynch Kantor and KPMG KPMG performed the due diligence and issued its report to Merrill Lynch This report included unaudited financial statements for 1995 1996 and 1997 We have requested this report but have been unable to obtain it Had we received this report it may have affected our conclusions regarding Telasi

In addition, under a contract with USAID Price Waterhouse was selected to assist in the initial due diligence necessary for preparation of an information memorandum for the sale Their report dated May 30, 1998 was utilized in preparing the background section of this report and in planning our fieldwork See informational Exhibit 2

EBRD financed a study of the distribution sector which was conducted by Kantor which produced recommendations as to the development of commercial management systems including specific recommendations to adopt IAS based on a review of the accounting systems

Summary of Meetings with Company and Analysis of Transaction Cycles

A Introduction

Our fieldwork was conducted on June 4 and 5, 1998 when we visited the Telasi administrative offices During our visit we interviewed and obtained information from the following people

Bejan Khutsishvili General Director

George Gvichiani, Deputy Director for Finance and Economv

Tehgiz Imnadze Chief Engineer

George Adamashvili Deputv Director for General Subjects

Edgar Kobakhidze, Deputy Director for Procurement

Nugzar Chaduneli, Deputy Director for Security

Lazhvard Tsiklauri, Deputy Director for Sales

Meldia Chokheli, Chief Accountant

Madlena Dadianidze, Deputy Accountant

Nikoloz Dadiani, Head of Economic Analysis and Planning

Temuri Kakhidze, Chief Economist

B Acquisition and Production Cycle

1) Power deliveries from Sakenergo are verified through check-meters with employees from both companies present Technical losses during transmission are estimated at 15% and are included in the tariff While the rate of loss is high there appears to be good control over purchases with cost recovery

2) Purchases of material and equipment is the responsibility of the Director of Procurement The Technical Director and the Director of Construction periodically prepare a Plan of Materials, although this plan is not subsequently used for guidance in making the purchasing decisions and there is no analysis of differences between the plan and actual purchases

3) Cash purchases are approved by the Financial Director Approval for barter transactions are not defined and vary greatly from one transaction to the next There is no accurate or verifiable way to determine the value of goods received in barter transactions Purchases on credit are used only in emergency situations related to breakdowns

4) Cash purchases are paid from a cash fund There are not proper controls over this fund

5) No determined procedure for purchases is observed nor are optimal quantity orders calculated Purchases are made to satisfy immediate demands which result from breakdowns on the lines Planned repairs are minimal and purchase decisions are made during the daily management meetings

6) The most common form of settlement for materials and equipment is barter and offsets Surprisingly, the Director of Procurement indicated that material costs were 10-15% less by barter but this was not verifiable A weekly purchase report presents the amount of material, price and vendor to be approved

7) Purchase documents normally include an agreement signed by the purchaser and supplier, an invoice, a receiving report and payment documents In barter transactions documents confirming receipt of services and products are present And in the case of offset involving several enterprises agreements, bills and payment orders from companies participating in the transaction are present It was noted that barter transactions are sometimes negotiated without the knowledge of the sales department

8) Transactions supporting inventory purchases are posted and reconciled by the accounting department monthly Inventory is updated annually by the Commission appointed by the General Director

C Fixed assets subsequent to acquisition

1) Fixed assets include office buildings and equipment substations transformers towers conduits and cables Depreciation is calculated by applying a fixed rate to the net book value of major asset categories

2) Asset revaluation Assets have been revalued three times based upon historical value Assets were increased by an indexation method In 1992 the value of fixed assets increased by an average multiple of 35, in 1993 by an average multiple of 300, and in 1995 by an average multiple of 12 7 The multiple was determined by Presidential Decree in each case, and another revaluation is scheduled during the Summer of 1998 Revaluations are allowed under IAS under certain conditions and utilizing certain methods Without knowing the basis for the calculation of the index it is not possible to determine if the valuation is in accordance with IAS

3) Capital assets are built by the construction department and include substations and transmission lines There have been few additions in the last several years Maintenance is performed by contractors who prepare a cost estimate which is ultimately approved by the General Director Over 95% of all work is settled by barter Under IAS self-constructed assets should be initially measured at direct costs plus production overhead No amount should be included for general and administrative costs or interest expense

4) The upkeep and safeguarding of company assets is often referred to as management's

stewardship and custody function Management has the responsibility to ensure that assets are properly used properly maintained and properly guarded against theft This is accomplished by internal controls that provide appropriate ' tagging of the assets so they can be located proper documentation so movement of the asset can be tracked and so that only authorized individuals have access to the assets Internal control also requires keeping maintenance records and having a system that flags assets for required maintenance

D Revenues, Accounts Receivable and Cash Collections

1) Monthly billing is provided to essentially all industrial/commercial and residential customers, although the company is able to collect only approximately 43% billed Of this amount only 25% is cash (20% received by collectors and 5% paid at the bank) and 75% is discounts offsets and transfers Company does not deposit cash collections in the bank but keeps a "petty cash' type fund from which it makes cash purchases Essentially meters are used with all customers although the equipment is old and/or in poor repair The amount of unbilled revenues due to broken meters and theft cannot be determined Plans for the purchase and installation of new meters have been made once the funding becomes available and is estimated to cost 50M GEL by management with investments in stages and 2 to 5M needed up front

2) Industrial and commercial customers read their own meters and take payments to banks A two part receipt is credited and Telasi receives notification from the bank The sales group delivers bills to residential customers and the customers can make payment directly or through the bank

3) Delinquent customers are hard to control because Telasi is not allowed to charge a penalty for late or non-payment And if a customer reconnects his disconnected line the company can only bill for the power used Collections continue to deteriorate as the rate noted was 57 9% in 1997 and is currently under 40% in March and April 1998

4) Barter transactions are not the norm, but an offset with a manufacturer of meter boxes is an example In such cases, the assets are recorded at market value with a corresponding credit to the industrial company's account for electricity billed

E Payroll

1) Employee hires are based upon requests of Department Heads, and salary level is determined by the Financial Planning Department based upon job classification There is no significant differentiation between groups and salary ranges from 80 GEL per month for a general employee to 250 GEL per month for a dispatcher The monthly salary of the General Director is 200 GEL and the Financial Director receives 180 GEL

2) Salary payments to employees are five months behind schedule and payment is made from the cashier as monies become available With the exception of collectors there are no incentive systems or bonuses Collectors are paid according to the percentage collected and are also penalized 9 lari for a lost bill

3) Payroll is an automated function and the system provides for the calculation and payment of salaries, as well as accruals of payments due and journal entries

F Disbursements and Accounts Payable

1) Essentially there is no financing on purchases Receiving report and purchase document are matched before disbursement is made through the bank or the special ' petty cash fund that is maintained at the headquarters

2) Cash collections are generally not deposited in the bank, enabling the utility to withhold payment from Sakenergo in violation of their percentage of collection arrangement This fund also represents a serious violation of internal control procedures over cash receipts and disbursements

3) Accounts receivable and accounts payable records were maintained in the same subsidiary ledger, thereby creating an unnecessary possibility for posting errors In addition the combined ledger makes it difficult to provide control over receivables and payables since the total of the subsidiary ledger accounts will not tie in directly to the controlling accounts in the general ledger

G Budgeting and Financial Planning

1) Financial forecasts and budgets are not prepared for the purposes of management of the enterprise All existing forecasts are used for tariff applications which are submitted to the Regulatory Commission For this purpose the following indicators are prepared

- Amount of electricity supplied to the purchasers for the fiscal year
- Amount of electricity purchased from the suppliers for the fiscal year
- Technical losses of electricity
- Expenses for capital constructions
- Other indirect expenses

Most of the planned indicators are far from actual and the plans are viewed accordingly

2) Estimations of electricity to be delivered are based on actual experience, with no regard

for changes in demand It should be noted that the calculations submitted to the Regulatory Commission do not appear to influence the determined tariff

3) Selling price is determined by order of the Government Telasi has the opportunity to influence the purchase price and calculates according to the following formula

$$\frac{\text{Selling price per kWh x Planned Amount to be Delivered - Indirect Expenses}}{\text{Planned Amount to be Delivered + Planned Technical Losses}}$$

4) Indirect expenses include the amounts required for capital investments Planned Amount to be Delivered includes the demand of all buyers, including those having partial or 100% payment discounts According to the present formula purchase price shall equal 2 8 Tetri per kWh although the Commission determined the price to be 3 1 Tetri per kWh

H Accounting Function

1) Telasi maintains a centralized accounting function at the administrative headquarters in Tbilisi and staff interviewed appeared to be conscientious and knowledgeable The Deputy Director has plans to automate the accounting and sales/billing functions when money becomes available but currently only the payroll system is computerized

2) Journals and a general ledger were manually prepared and appeared to provide the basis for a mechanical summary of financial records However it was noted that the Income Statement was prepared on a cash basis while the Balance Sheet included accruals Thus, the Financial Statements are not being prepared in accordance with IAS but should be convertible without major effort

3) Accruals are made monthly and depreciation is recorded quarterly All entries in the ledger are made from journals or other supporting documents The Deputy Accountant approves all journal entries and prepares the financial statements Accounting Personnel did not appear to be well-trained and errors were noted in the financial reports

4) The financial statements are prepared in accordance with legislation and as directed by the Ministry of Finance The statements include a prescribed Balance Sheet and Income Statement, with other reports and supporting schedules as required under the circumstances Cash flow statements are not prepared by Telasi

5) For 1997 the Company reported a loss and had no income tax Losses may be carried forward to future years and used to reduce taxable income in those years

6) Telasi successfully protested a VAT charge and is owed a 9 5M GEL refund

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I Information System

1) The automation of recordkeeping at Telasi is in an embryonic state A computer with a word processing program is available but management is not taking advantage of the benefits that would result from a management information system

2) Currently only three areas have been partially automated payroll cash and accounts receivable Payroll is processed with supporting records and journal entries The bank program provides for the analyses of transactions and account reconciliation The accounts receivable program contains the credit history and indebtedness of customers

3) There are no plans to enhance the system further at this time to due to liquidity problems Personnel involved are not computer literate and appear indifferent to the project

Findings and Auditability

A Cash

1) Overview

Customers may make payment for amounts due by a) bringing their payment to the bank b) bank transfer from their account to Telasi's account, or c) by paying Telasi employees (collectors) who come to their residence or place of business The great majority make payments to collectors

Collectors are required to provide a signed, pre-numbered receipt to the customer that details the amount paid The cash plus the original copy of the signed receipt are to be returned to Telasi

The cash is transferred from the collector to the Finance Director's office with the receipt The receipt is then sent to the Accounting Department for posting to the general ledger and to the customer s subsidiary account receivable record

The cash collected is generally not deposited in the bank but is kept in a cash fund controlled by the General Director and Finance Director This fund is used to make cash purchases for items other than those for electricity

Payments for electricity purchased are made by bank transfer or offset

2) Audit Objectives

a) Cash exists and is owned by the client

Cash in bank – Cash in bank accounts can easily be confirmed by bank personnel and adequate documentation exists to prepare and audit bank reconciliations Company documentation exists for each bank transaction Adequate controls exist over the authorization and execution of bank transactions However only a small percentage of customers pay their amounts owed by bank transfer

Cash Fund - The procedures used for cash collections reflect major control weaknesses that could result in both misappropriations of assets and improperly recorded transactions The control weaknesses include

- Anecdotal evidence indicates that collectors often "bargain with customers by offering to reduce customer balances by more than the amounts actually paid
- It appears that the control provided by using pre-numbered documents is ineffective due to the lack of independent employees checking that all numbered documents are accounted for and are properly credited to customer accounts
- The collector surrenders both the documentation and the cash collected to the Finance Director thereby allowing for the possibility of altering the documentation prior to its being sent to the Accounting Department
- Amounts collected from customers should be deposited into the bank account intact Cash funds should be kept on an imprest basis by setting the amount of the fund at a specific amount and reimbursing the fund only after proper documentation is provided to the Accounting Department for amounts paid out of the fund By having customer collections added to cash funds, the possibilities for misappropriation increase significantly

b) Cash balances reflect a proper cutoff of receipts and disbursements

As discussed in Audit Objective 1, a proper cutoff at the balance sheet date is determinable for cash in the bank, but would not be determinable under the current system for cash funds

c) Cash balances as presented in the balance sheet properly reflect all cash and cash items on hand, in transit, or on deposit with third parties

For the reasons discussed in Audit Objective 1 the lack of control over cash funds would not allow an auditor to determine that cash balances are fairly stated Specifically, the possibility of misappropriation of cash would cause control risk to be at an unacceptably high level

d) Cash balances are properly classified in the financial statements and any restrictions on the availability of funds are properly disclosed

As discussed previously, Telasi currently owes its major supplier in excess of 100 million GEL Due to the size of the debt, the supplier has begun legal action to allow it to attach the bank account of Telasi The legality and success of this action is unclear at this time The resolution of this issue will determine whether there is a restriction on cash that would result in a separate financial statement classification At this point in time more evidence would be needed to determine the appropriate classification and required disclosures to be included in the financial statements

Conclusion At this point in time it appears that control risk would be too great to place any reliance on internal control over cash collections and cash funds These weaknesses would most likely prevent an unqualified opinion based on substantive tests alone

B Accounts Receivable

1) Overview

Customers are billed monthly for electric services Collectors who also have the responsibility for collecting the amounts due read the residential meters This is a serious control problem over cash and receivables

Commercial and industrial customers read their own meters and submit payment directly to the bank, with meters spot-checking by Telasi to verify the propriety of payments

Currently, the collection rate is marginally over 45% of receivables billed, and non-payment cannot be enforced because individual meters are not installed at multiple-residence buildings Any disconnected meters can be quickly reconnected

2) Audit Objectives

a) Accounts Receivable are authentic obligations owed to the company at the balance sheet date

The authenticity of accounts receivable is generally determined by mailing confirmation letters to customers who are asked to acknowledge the amount of their debt at the balance sheet date This procedure would most likely be ineffective in Georgia due to

- Unreliable postal service
- Rampant non-payment by residential customers with lack of enforcement would indicate that a large majority of customers would not reply

Therefore, confirmation of receivables could only be done with an extensive door-to-door effort Alternative procedures such as examination of meter readings re-calculation of amounts owed, and tracing collections to cash records are suspect because of the lack of controls surrounding meter readings and payment receipts

b) Accounts Receivable includes all amounts owed to the company at the balance sheet date

The inclusion of all valid receivables requires accurate meter readings of substantially all customers at the balance sheet date This would be extremely difficult, if not impossible due to

- The large numbers of damaged meters
- Meter tampering
- The inaccessibility of meters located inside the premises of residents and commercial enterprises
- Lack of controls over meter readers
- Difficulty of achieving a proper cutoff as of the balance sheet date
- Unknown reliability of manual subsidiary records kept by the accounting department

At best a "reasonableness test" could be performed to determine that electricity distributed to customers, after an allowance for technical and commercial losses was billed to customers Such a test could provide evidence that billings were accurate *in total* but would not provide evidence that individual accounts were accurately billed

c) The allowance for doubtful accounts is adequate but not excessive

The adequacy of the Allowance for Doubtful Accounts is generally determined by

- Reviewing cash receipts subsequent to the balance sheet date
- Preparing and reviewing an "aging" of accounts receivable to determine how long individual amounts have been outstanding and applying estimated percentages of

uncollectibility to individual receivables It is assumed that the longer a receivable is outstanding the lower its probability of collection The percentage applied is based on the experience of the enterprise as well as current economic circumstances

Based on recent experience and the current economic situation in Georgia a conservative approach would be necessary This would probably result in establishing the Allowance for Doubtful Accounts at an amount equal to at least 55% of current receivables (those billed within the last 30 days) and larger percentages to past due receivables

d) Accounts Receivable are appropriately classified in the balance sheet and required disclosures are made

Accounts receivable that are due and collectible within one year should be classified as current assets The Allowance for Doubtful Accounts should be separately shown The method for determining the amount of the Allowance and bad debts expense should be disclosed None of these items should cause significant audit problems

Conclusion Audit risk is extremely high for receivables due to

- The difficulty and cost of verifying the authenticity of receivables
- The near impossibility of verifying that all amounts owed are recorded due to damaged meters tampered meters, inaccessible meters and lack of controls over meter readers who also collect cash
- The difficulty in determining an adequate Allowance for Doubtful Accounts due to the current economy, potential government interference and the difficulty of motivating customers to pay due to the current legal environment

These difficulties would most likely lead to one of the following

- A qualified opinion or a disclaimer of opinion due to limitations of scope due to poor internal control and the inability to perform substantive tests that would reduce audit risk to an acceptable level
- The possibility of the "going concern assumption" no longer being appropriate Due to the high probability that a large percentage of receivables are uncollectible, there is a high degree of risk that the company is not a going concern This requires additional audit procedures to determine the amount of risk This may lead to a required inclusion in the audit report that emphasizes the possibility that the company would not be able to continue as a going concern

C Fixed Assets

1) Overview

Fixed assets include office buildings and equipment, substations transformers towers conduits and cables

According to Georgian accounting law, purchased fixed assets are stated at historical cost Historical cost under IAS and Georgian law is calculated differently The primary difference is that under IAS, historical cost includes the amount paid for the asset plus additional costs required to obtain the asset and to get the asset ready for use These costs include taxes installation, freight and insurance Under Georgian accounting, these costs would be treated as period costs or overhead

Self-constructed assets are valued at the total of direct costs (materials and labor) plus an allocation of overhead It is standard practice in Georgia to include all indirect costs in the calculation of overhead, which is then allocated to the cost of self-constructed assets Under IAS, for the purpose of calculating construction costs only indirect construction costs are allocated to the cost of the asset

Since 1989, fixed assets have been revalued three times The revaluations were required based on a Presidential decree Companies were allowed to choose any of three methods in calculating the revalued amount These methods were

- Indexation Method – historical cost was multiplied by an index specified by the government
- The index varied based on the type of asset and its date of purchase In 1992, under thismethod, assets were increased by an average multiple of 35 In 1995 the average multiple was 300 In 1997, the average multiple was 12 7
- Direct Valuation Method – assets were valued at their replacement cost
- Combined Method – assets were valued by a combination of the above methods

Under IAS, companies may revalue assets under certain conditions and using certain allowed methods An indexation method is allowed where the index is based on a reliable measure of the change in prices over time Replacement cost is also an allowable method subject to consideration of technological change

Tax law prescribes depreciation rates A fixed percentage, specified by law, is applied to the undepreciated cost of the asset This is similar to the declining balance method which is allowed under IAS However, under IAS the rate allowed must be calculated based on the estimated life of the asset The rate prescribed by law may not approximate the rate allowed under IAS

Under IAS, fixed assets are generally classified under the title of property, plant and equipment To be included in this classification assets must be in use in the operations of the business Telasi has a large percentage of fixed assets that are currently damaged to the point that they are not operational These assets must not be shown under the classification of property, plant and equipment but should be segregated and listed under a separate category such as Other Assets If the assets will not be repaired they should be written down to their salvage value

2) Audit Objectives

a) Property, plant and equipment (PPE) reflected in the accounts represent a complete listing of capitalizable costs of assets purchased constructed or leased by the company and such assets are physically on hand

This objective requires the following procedures to be performed

- Preparation of a schedule of all PPE in existence at the balance sheet date based on physical observation of those assets

This schedule could easily be prepared by company personnel and the accuracy of the schedule could be verified by applying appropriate sampling techniques

- Comparison of the schedule to assets included in the accounting records

The comparison could be performed by accounting department personnel who do not have direct responsibility for fixed asset accounting

- Preparation of a schedule of existing assets not included in the accounting records and preparation of a schedule of assets included in the accounting records that were not physically observed

The schedules could be prepared by accounting department personnel who do not have direct responsibility for fixed asset accounting

b) PPE is valued at cost in accordance with IAS Accordingly, noncapitalizable costs are properly expensed and capitalizable costs are excluded from maintenance or other expense accounts

This objective requires the following procedures to be performed

- Vouching of the historical costs to supporting documentation and to determine that non-capitalizable costs have not been included

Company procedures do require source documents to be maintained for all purchases This could be verified on a test basis

For cash purchases differences between the calculation of historical cost under IAS and Georgian law should not be material

For barter transactions (defined as exchanging an asset for a "dissimilar' asset) purchased fixed assets should be valued at their fair value A gain or loss would be recognized for the difference between the book value of the asset given up and the value of the asset received

Barter transactions present a significant audit problem in cases where the value of the asset received is not readily determinable The auditor would also need to verify gains and losses on barter transactions which may be difficult and costly due to the sheer volume of barter transactions

- Examination of repairs and maintenance accounts to determine that account balances do not include costs that should have been capitalized

  This procedure should be able to be performed in a reasonable amount of time It is probable that extraordinary repairs that would be capitalizable under IAS have been charged to overhead

- Recalculation of the components of the cost of self-constructed assets

  This procedure requires the restatement of historical cost to exclude non-construction overhead items that have been allocated to asset cost This may be a difficult and time consuming procedure depending on the age of the asset and the available records that support the original calculation A first step would be an estimate of the materiality of expected adjustments If adjustments are expected to be material and adequate evidence is not available this could potentially preclude an unqualified opinion However, subsequent revaluation procedures could make this calculation irrelevant

- Review of methods used in revaluation of PPE to determine if in accordance with IAS

  As discussed above, the methods of revaluation prescribed by law would be in accordance with IAS depending on the measurement techniques adopted and applied

- Test of revaluation calculations for reasonableness

Where the indexation method has been used it would be necessary to determine if the index used approximates price changes in the cost of the asset This would require the auditor to obtain documentary evidence of price changes This could be more easily verified for recent revaluations

Where the replacement cost method is used, documentary evidence is required by the government to justify the valuation used Therefore evidence should exist which would allow the auditor to verify the amount used in the revaluation

c) The cost and related depreciation applicable to all sold, abandoned damaged or obsolete property have been properly removed from the accounts and PPE is properly classified in the balance sheet

Due to the technical nature of a large portion of Telasi s assets it would be necessary for a valuation specialist in utility company assets to examine assets on hand to determine their condition and operability Based on previous studies of the Georgian utility sector and admissions to us by Telasi management, it is expected that a large portion of the fixed assets are non-operable This would require a substantial adjustment to the values of the assets, a re-classification of the assets in the balance sheet and substantial footnote disclosure The cost of retaining valuation specialists calculating the amount of the required adjustment and reclassifying the accounts would be substantial

d) Depreciation charged to income during the period is adequate but not excessive and has been computed on an acceptable and consistent basis The balances in the depreciation allowance accounts are reasonable considering the expected useful lives and salvage values

The method utilized by Telasi is an acceptable method under IAS The auditor would need to determine that the useful life used in the calculation is reasonable and that the arithmetic accuracy is acceptable It would also be necessary to determine that depreciation calculations properly reflect revaluation adjustments made in the current and prior years It is expected that there would be no difficulties in performing the necessary procedures

e) Property is properly classified in the balance sheet and fully depreciated assets idle property and property held for investment are properly disclosed The financial statements include disclosures of major classes of depreciable assets, accumulated depreciation, depreciation methods and amounts, based on valuation

Telasi's statutory balance sheet does not breakdown fixed assets into majors classes (such as buildings, meters, heavy equipment, land etc The accounting records provide enough detail to determine which assets belong to each category As discussed in Objective 3 above a large portion of Telasi's assets are damaged or inoperable and therefore should not be included in PPE and should be separately shown and revalued The accounting

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records do not identify these assets so an inventory would need to be taken and inspections would need to be made by valuation specialists

Conclusion Fixed assets make up a material portion of Telasi s assets Audit risk is increased due to the poor condition of a large portion of the assets poor internal control of the "custody and stewardship functions' difficulties in determining appropriate valuation due to revaluation rules inadequate repairs and maintenance and the large portion of barter transactions The cost of reducing audit risk to an acceptable level is hampered by the very high cost of inventorying assets located in scattered locations the cost of using technical experts to inspects a large number of assets the cost of reconstructing price indexes to test revaluation amounts and the cost of testing values used in barter transactions

D Accounts Payable and Other Liabilities

1) Overview

The primary obligation is for electricity purchased from Sakenergo which accounted for 88% of all liabilities at the end of 1997 Other payables include accrued wages As of June 1998 employees had not been paid for five months

Internal control over accounts payable is reasonably good as documentation requirements include purchase and receiving documents which allow determination of amounts owed Other than the purchase of electricity most other purchases are for cash or barter therefore the amount of other payables is not significant

2) Audit Objectives

a) Accounts payable represents a complete presentation of authorized current obligations that arose from purchased goods or services Accounts payable are properly classified as current liabilities and disclosure is made of related party payables and payables with explicit payment terms

Since a very large portion of payables is owed to one vendor, the most efficient audit procedure would be to confirm the balance due with Sakenergo and reconcile any difference between the amount recorded in the accounting records and the amount confirmed

Due to the poor controls over cash and the large number of cash and barter transactions it would be preferable to confirm balances due to large vendors and agree the amounts to company records

A search for unrecorded liabilities would also include an examination of bank transfers after the balance sheet date to determine if the items paid represent obligations that should have been included in payables at the balance sheet date

In addition the auditor should check goods received both the month before and the month after the balance sheet dates and supporting documents to determine when the liability should have been recorded

All of the procedures listed above do not appear to offer the probability of high audit risk primarily due to the low level of payables other than the amount owed to Sakenergo and the ability to confirm the amount due to Sakenergo

b) Accrued and other liabilities represent a complete presentation of unpaid cost and expenses and the amounts owed are computed, classified and described in a consistent manner

Wage accruals could be tested by recalculation to the amounts not paid and examination of payroll records and bank records Some "spot checking" should be performed by direct confirmation from employees of amounts owed

Taxes payable in association with wage payments and for value added tax can be checked against tax returns and proof of payment from bank records

Other liabilities are immaterial

Conclusion Audit risk is reasonably low for accounts payable and other liabilities The effort and cost of determining the fairness of presentation in the financial statements is modest

Recommendations

Based on our conclusions as expressed above in the areas of Cash, Receivables Fixed Assets and Payables we believe that it is highly unlikely that a financial audit conducted using International Standards of Auditing would lead to an unqualified audit opinion that the financial statements of Telasi are fairly presented in accordance with International Accounting Standards

The most likely result of such an audit would be either a disclaimer of opinion due to limitations of scope caused by poor internal controls and lack of sufficient competent evidential matter In the event that a financial audit could be performed, the cost of the procedures necessary to reduce audit risk to an acceptable level, may be prohibitive

Finally any opinion given on the financial statements would be tempered by wording in the report that would indicate that the Company may not be able to continue as a going concern due to liquidity problems and the size of the investment necessary to ensure adequate operations and control over those operations

APPENDIX B

REPORT ON SAKENERGO GENERATSIA

APPENDIX B

Georgia Scoping Study

for Financial Evaluation of Energy Enterprises

REPORT ON SAKENERGO GENERATSIA

Description and Background of the Company

After Georgia received its independence from the Soviet Union Sakenergo Consolidated (SakCon) was established It consisted of the generation and transmission capacity of electricity in Georgia and was the largest power sector company in the country A subsequent restructuring plan called for the Company to split into Sakenergo Generation (SakGen) and Sakenergo Transmission and Dispatch (SakTrans), with further separation of the Gardabani Thermal Power Station Gardabani has its own balance sheet and is a joint stock company The plant uses gas to generate power and the tariff of about 5 0 Tetri is the highest among the major producers The plant operates only in winter and meets increased seasonal demand

SakGen is a state owned company with two major hydro power stations Enguri and Vardnili SakGen is the management company to eleven different hydro plants Generally operating budgets are transferred to the locations and expense summaries with appropriate documentation are reconciled in accounting monthly SakGen also maintains a regular business management relationship with some twenty-five other joint stock companies The Ministry of State Property Management and the Ministry of Fuels and Energy is involved in the planning of the stages of privatization During 1994 activities included the privatization of small hydro plants under 10 Megawatts It is the governments intention to privatize SakGen as soon as conditions are favorable

SakGen s major customer is Sakenergo Dispatch and Sales (SakDis) with over 95% of volume Technical losses at the power plants are 0 3% and SakDis absorbs the transmission losses with purchases Collections are approximately 80% of amount billed Of this amount 20% is received in barter, 40% in offsets, and 40% in cash Around 20% of amounts billed are considered uncollectible

Cash flow problems exist at the company and the government froze the home office bank account during the second week of June 1998 for non-payment of debts owed to the authorities for taxes and social insurance This freeze did not include the bank accounts at branches and the company has directed debtors to forward funds to a different account for operating purposes to avoid the seizure of funds by the government As of the date of this report salaries are four months in arrears

An audit of SakGen for the 1996 fiscal year was conducted by the local firm Consaudit Other than a comment as to the non-verification of the balances at the split of SakCon the opinion indicated that the financial statements represented a fair financial summary of the company It should be noted that this was an audit under local requirements and is not in accordance with ISA

The governmental Chamber of Control conducted an audit of the financial records for the years 1994-1996 and the first quarter of 1997 Six months of fieldwork was conducted and the subsequent reports indicated deficiencies over cash control, sales recognition, depreciation of fixed assets, expense control, foreign loan recognition, tax payments accounting systems, and internal control review procedures

Prior Donor Work and Due Diligence

The Government of Georgia (GoG) requested the help of the World Bank in privatizing the power sector, and Kantor Management Consultants were selected to lead the effort of assisting in

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the financial restructuring task and to coordinate the work of other contributing consultants Kantor selected KPMG as their subcontractors with responsibility for the accounting work

Kantor and KPMG issued a Final Draft Report in December 1996 which presented the initial recommendation for the capital restructuring of Sakenergo The report presented the consolidated financial statements restated according to International Accounting Standards for SakCon at the end of 1995 and as of June 30, 1996 A subsequent report handles the deconsolidation of Sakenergo into Sakenergo Generation Sakenergo Transmission and Dispatch and Gardabani Thermal Power Station

Summary of Meetings with Company and Analysis of Transaction Cycles

A Introduction

Our fieldwork was conducted on June 15 and 16 1998 when we visited the SakGeneratsia administrative offices During our visit, we interviewed and obtained information from the following people

Nugzar Chokheli, Deputy for Economic Issues

Goderdzi Khiasashvili, Head of Technical Department

Lena Burduli, Accountant

Nodar Tukhashvili, Finance and Economic Department

Temur Mamiashvili, Procurement Department

Iago Valishvili, Procurement of Gas and Oil Products

Valeri Lomtatitdze, Sales Department

B Acquisition and Production Cycle

1) Power is generated by Sakenergo primarily through two hydro stations and technical losses are 0 3% in the plants Transmission losses are absorbed by the buyer

2) Purchases of material and equipment is the responsibility of the Director of Procurement Required items are listed on a schedule which is approved by the General Director before a vendor is sought Recently, only minor purchases have been made—20% for cash and

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the rest bv barter Purchase orders are not normallv prepared unless required by the vendor

3) Purchase documents normally include an agreement signed by the purchaser and supplier an invoice, a receiving report and payment documents In barter transactions documents confirming receipt of services and products are present And in the case of offset involving several enterprises, agreements bills and payment orders from companies participating in the transaction are present It was noted that barter transactions are sometimes negotiated without the knowledge of the sales department

C Fixed assets subsequent to acquisition

1) Fixed assets include power plants and machinery office buildings and equipment ancillary electrical devices, autos and other items Depreciation is calculated by applving a fixed rate to the net book value of major asset categories

2) Asset revaluation Assets have been revalued three times based upon historical value Assets were increased by an indexation method In 1992 the value of fixed assets increased by a multiple of 35, in 1993 by a multiple of 300, and in 1995 by a multiple of 12 7 The multiple was determined by Presidential Decree in each case According to the instruction, assets must be revalued by one of three methods 1) ratio 2) market price or 3) mixed method

3) A fourth revaluation is currently underway The revaluation of home office assets has been completed and their value has decreased from 369129 GEL to 110221 GEL Most fixed assets were revalued by the indexation method Autos were valued according to market prices Assets at other locations are in the process of being revalued

4) Revaluations are allowed under IAS under certain conditions and utilizing certain methods Without knowing the basis for the calculation of the multiple it is not possible to determine if the valuation is in accordance with IAS

5) The upkeep and safeguarding of company assets is often referred to as management s stewardship and custody function Management has the responsibility to ensure that assets are properly used properly maintained and properly guarded against theft This is accomplished by internal controls that provide appropriate "tagging" of the assets so they can be located, proper documentation so movement of the asset can be tracked and so that only authorized individuals have access to the assets Internal control also requires keeping maintenance records and having a system that flags assets for required maintenance

D Revenues and Accounts Receivable

1) Billing is provided to the major customer Sakenergo Dispatch and Sales (SakDis) through invoices created at metered transmissions which are verified by parties from both companies Meters are read monthly to bill the industrial customers All payments are received via cash transfers, barter and offsets

2) SakDis' inability to pay the full amount billed is attributed to the non-payment from distribution companies and a significant amount of the receivables is uncollectible No reserves have been established on the books for uncollectible accounts

3) No attempt is made to control the delinquency of SakDis which purchases 95% of the power generated by the company Three industrial customers can be controlled through disconnection and barter arrangements are included in the agreements with commercial customers pending approval This unusual customer/approval process requires SakDis to receive approval from SakGen before making direct customer sales

4) The current Accounts Receivable balance of 24M GEL from SakDis is being disputed due to a disputed 4M GEL exchange factor

E Payroll

1) The Planning and Economic Department determines the average number of employees of the divisions and the average salary Average salary depends upon the financial plan and the amount of salaries for the top managers are assigned by the Ministry of Fuel and Energy

2) Salary payments to some employees are four months behind schedule and payment is made through bank transfers to employee accounts There are no regular bonuses but sometimes premiums are paid to employees Salaries are revised once a year when the annual budget is prepared and any other employee increases are approved by the General Director

3) Payroll is an automated function and the system provides for the calculation and payment of salaries, as well as accruals of payments due and journal entries

F Disbursements and Accounts Payable

1) Almost all purchases are paid for in advance or through barter arrangements Any purchases made on account require receiving report and purchase document to be matched before disbursement is made through bank transfers

2) The current Accounts Payable of 27M GEL includes 18M GEL payable to vendors and a 9M GEL liability for Payroll and taxes The 3 6M GEL payable to the GoG Budget caused the authorities to freeze SakGen's bank account during the second week of June The company has directed SakDis to send payments to a divisional bank account in order

to maintain cash for operating purposes This process violates the intent of authorities in freezing the main bank account and may represent a violation of the law

G Budgeting and Financial Planning

1) The budget is prepared by the Planning and Economic Department and the Financial Department SakGen sales forecasts are based upon 100% capacity production and delivery from the hydro plants Sales forecasts are based upon the tariff set by the Regulatory Commission but the timing and type of payment receipts are not planned

2) Separate sales forecasts are prepared for each plant and expenses are budgeted for all 11 divisions Main groups of planned expenses are

- Equipment repairs
- Auxiliary materials based upon the plan for repairs
- Depreciation according to ratios
- Accrued salaries based upon the planned activity at all divisions
- Interest on loan agreements

3) The consolidated financial plan is prepared and submitted to the Financial Director for approval The budget is the basis for information submitted to the Regulatory Commission for the determination of tariff

4) SakGen participates in the preparation of budgets for other joint stock, power generation companies managed by the company These plants submit budgets to the Planning and Economic Department each year for change recommendations and revisions Also, actual and budgeted data are compared annually but no analysis or report is created to guide management

H Accounting Function

1) SakGen maintains the consolidated accounting records at the administrative headquarters in Tbilisi, although operating budgets are transferred to cost center locations Location expense summaries, with appropriate documentation, are reconciled in central accounting monthly Journals and a general ledger are manually prepared and provide a mechanical summary of financial records The Personnel interviewed did not appear to be well-trained and knowledgeable of the operations

2) The financial statements are prepared in accordance with legislation and as directed by the Ministry of Finance Legislation permits either cash or accrual basis presentations, but the traditional method is cash The statements include a Balance Sheet and Income

Statement with other reports and supporting schedules as required under the circumstances Cash flow statements are not prepared by SakGen See Exhibit 6 for the information flow in the accounting department

3) The company prepares financial statements on a cash basis Note that VAT is required to be accrued and paid within 90 days for all companies except some troubled utilities like SakGen which have been given special status to pav on a cash basis However the pavment requirement for VAT necessarily causes companies to mix cash and accrual accounting methods

4) The Company reports a profit but has cash flow problems due to barter transactions and uncollectible accounts

I Information System

1) Computers are available at the company but automation of anv business functions is not a priority Management hopes that some international donor funds will be forthcoming to assist in this process Currently, personnel use the Payroll program from SakDis to process SakGen's payroll They also plan to soon begin using the Balance Sheet program to prepare a consolidated balance sheet Simple reports are being prepared in MS Word and Excel

J Internal Control

1) The Internal Control Department at SakGen has 3 employees Their work includes review of branch activities but not the home office where a centralized accounting function is maintained Consequently, the reviews are incomplete and cannot be considered effective to ensure proper controls and financial presentations

Findings and Auditability

A Cash

1) Overview

Customers are required to make payment for amounts due by bank transfers unless barter arrangements are made Small cash funds, which lack proper controls, are used for small purchases Most purchases are made by bank transfer with a small percentage by barter

2) Audit Objectives

a) Cash exists and is owned by the client

Cash in bank – Cash in bank accounts can easily be confirmed by bank personnel and adequate documentation exists to prepare and audit bank reconciliations Company documentation exists for each bank transaction Adequate controls exist over the authorization and execution of bank transactions

b) Cash balances reflect a proper cutoff of receipts and disbursements

A proper cutoff at the balance sheet date is determinable for cash in the bank

c) Cash balances as presented in the balance sheet properly reflect all cash and cash items on hand, in transit or on deposit with third parties

Cash balances as presented in the balance sheet can be confirmed with the bank Petty cash funds are not material

d) Cash balances are properly classified in the financial statements and any restrictions on the availability of funds are properly disclosed

A 3 6M GEL debt to the GoG Budget caused the company's bank account to be frozen during the second week of June 1998 The company has directed cash payments from debtors to another bank in order to continue operations

The resolution of this issue will determine whether there is a restriction on cash that would result in a separate financial statement classification At this point in time more evidence would be needed to determine the appropriate classification and required disclosures to be included in the financial statements

Conclusion It appears that adequate procedures and controls exist to make a determination whether cash is fairly presented The uncertainty regarding the legal action freezing the bank account would need to be disclosed

B Accounts Receivable

1) Overview

Monthly billing is provided to SakDis through invoices created at metered transmissions This represents 95% of power generated by the company

No attempt is made to control the delinquency of SakDis because non-payment is attributed to the inability of the distributors to collect from their residential customer base Uncollectible accounts were estimated to be approximately 20% However, due to old

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receivables still being on the books it is estimated that 55% of total receivables at this time may be uncollectible

2) Audit Objectives

a) Accounts Receivable are authentic obligations owed to the company at the balance sheet date

The authenticity of accounts receivable are generally determined by sending confirmation letters to customers who are asked to acknowledge the amount of their debt at the balance sheet date This procedure could be accomplished via fax requests Considering the dependence on one customer, it would not be difficult to confirm the balance and examine the signed invoices and meter reading records

b) Accounts Receivable includes all amounts owed to the company at the balance sheet date

The inclusion of all valid receivables requires a proper sales cutoff and assurance that all of the transactions have been posted This can be accomplished by examining meter readings

c) The allowance for doubtful accounts is adequate but not excessive

The adequacy of the Allowance for Doubtful Accounts is generally determined by

- Reviewing cash receipts subsequent to the balance sheet date
- Preparing and reviewing an ' aging ' of accounts receivable to determine how long individual amounts have been outstanding and applying estimated percentages of uncollectibility to individual receivables It is assumed that the longer a receivable is outstanding, the lower its probability of collection The percentage applied is based on the experience of the enterprise as well as current economic circumstances

Based on a single customer's consumption of 95% of the power generated, plus the current economic situation in Georgia, a conservative approach would be necessary This would probably result in establishing the Allowance for Doubtful Accounts, according to management's estimates, at an amount equal to at least 60% of receivables

d) Accounts Receivable are appropriately classified in the balance sheet and required disclosures are made

Accounts receivable that are due and collectible within one year should be classified as current assets The Allowance for Doubtful Accounts should be separately shown The method for determining the amount of the Allowance and bad debts expense should be disclosed None of these items should cause significant audit problems

Conclusion Audit risk is moderate for receivables due to the difficulty in determining an adequate Allowance for Doubtful Accounts This risk is due to the current economy potential government interference, and the difficulty of motivating SakDis to pay due to the current legal environment

This would most likely lead to one of the following

- A qualified opinion or a disclaimer of opinion due to limitations of scope due to the uncertainty of receivables collections
- The possibility of the ' going concern assumption' no longer being appropriate Due to the high probability that a large percentage of receivables are uncollectible there is a high degree of risk that the company is not a going concern This requires additional audit procedures to determine the amount of risk This may lead to a required inclusion in the audit report that emphasizes the possibility that the company would not be able to continue as a going concern

C Fixed Assets

1) Overview

Fixed assets include power plants and machinery office buildings and equipment ancillary electrical devices, autos and other items

According to Georgian accounting law, purchased fixed assets are stated at historical cost Historical cost under IAS and Georgian law is calculated differently The primary difference is that under IAS, historical cost includes the amount paid for the asset plus additional costs required to obtain the asset and to get the asset ready for use These costs include taxes installation, freight and insurance Under Georgian accounting these costs would be treated as period costs or overhead

Self-constructed assets are valued at the total of direct costs (materials and labor) plus an allocation of overhead It is standard practice in Georgia to include all indirect costs in the calculation of overhead, which is then allocated to the cost of self-constructed assets Under IAS, for the purpose of calculating construction costs, only indirect construction costs are allocated to the cost of the asset

Since 1989 fixed assets have been revalued three times The revaluations were required based on a Presidential decree Companies were allowed to choose any of three methods in calculating the revalued amount These methods were

a) Indexation Method – historical cost was multiplied by an index specified by the government The index varied based on the type of asset and its date of purchase In 1992 under this method assets were increased by an average multiple of 35 In 1995 the average multiple was 300 In 1997, the average multiple was 12 7

b) Direct Valuation Method – assets were valued at their replacement cost

c) Combined Method – assets were valued by a combination of the above methods

Under IAS, companies may revalue assets under certain conditions and using certain allowed methods An indexation method is allowed where the index is based on a reliable measure of the change in prices over time Replacement cost is also an allowable method subject to consideration of technological change

Tax law prescribes depreciation rates A fixed percentage, specified by law is applied to the undepreciated cost of the asset This is similar to the declining balance method which is allowed under IAS However, under IAS the rate allowed must be calculated based on the estimated life of the asset The rate prescribed by law may not approximate the rate allowed under IAS

Under IAS fixed assets are generally classified under the title of property, plant and equipment To be included in this classification assets must be in use in the operations of the business Telasi has a large percentage of fixed assets that are currently damaged to the point that they are not operational These assets must not be shown under the classification of property, plant and equipment but should be segregated and listed under a separate category such as Other Assets If the assets will not be repaired they should be written down to their salvage value

2) Audit Objectives

a) Property, plant and equipment (PPE) reflected in the accounts represent a complete listing of capitalizable cost of assets purchased, constructed or leased by the company and such assets are physically on hand

This objective requires the following procedures to be performed

- Preparation of a schedule of all PPE in existence at the balance sheet date based on physical observation of those assets

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This schedule could easily be prepared by company personnel and the accuracy of the schedule could be verified by applying appropriate sampling techniques

- Comparison of the schedule to assets included in the accounting records

The comparison could be performed by accounting department personnel who do not have direct responsibility for fixed asset accounting

- Preparation of a schedule of existing assets not included in the accounting records and preparation of a schedule of assets included in the accounting records that were not physically observed

The schedules could be prepared by accounting department personnel who do not have direct responsibility for fixed asset accounting

b) PPE is valued at cost in accordance with IAS Accordingly noncapitalizable costs are properly expensed and capitalizable costs are excluded from maintenance or other expense accounts

This objective requires the following procedures to be performed

- Vouching of the historical costs to supporting documentation and to determine that non-capitalizable costs have not been included

  Company procedures do require source documents to be maintained for all purchases This could be verified on a test basis

  For cash purchases, differences between the calculation of historical cost under IAS and Georgian law should not be material

  For barter transactions (defined as exchanging an asset for a "dissimilar" asset), purchased fixed assets should be valued at their fair value A gain or loss would be recognized for the difference between the book value of the asset given up and the value of the asset received

  Barter transactions present a significant audit problem in cases where the value of the asset received is not readily determinable The auditor would also need to verify gains and losses on barter transactions which may be difficult and costly due to the sheer volume of barter transactions

- Examination of repairs and maintenance accounts to determine that account balances do not include costs that should have been capitalized

This procedure should be able to be performed in a reasonable amount of time It is probable that extraordinary repairs that would be capitalizable under IAS have been charged to overhead

- Recalculation of the components of the cost of self-constructed assets

This procedure requires the restatement of historical cost to exclude non-construction overhead items that have been allocated to asset cost This may be a difficult and time consuming procedure depending on the age of the asset and the available records that support the original calculation A first step would be an estimate of the materiality of expected adjustments If adjustments are expected to be material and adequate evidence is not available this could potentially preclude an unqualified opinion However, subsequent revaluation procedures could make this calculation irrelevant

- Review of methods used in revaluation of PPE to determine if in accordance with IAS

As discussed above, the methods of revaluation prescribed by law would be in accordance with IAS depending on the measurement techniques adopted and applied

- Test of revaluation calculations for reasonableness

Where the indexation method has been used it would be necessary to determine if the index used approximates price changes in the cost of the asset This would require the auditor to obtain documentary evidence of price changes This could be more easily verified for recent revaluations

Where the replacement cost method is used, documentary evidence is required by the government to justify the valuation used Therefore evidence should exist which would allow the auditor to verify the amount used in the revaluation

c) The cost and related depreciation applicable to all sold, abandoned, damaged or obsolete property have been properly removed from the accounts and PPE is properly classified in the balance sheet

Due to the technical nature of a large portion of SakGen's assets, it would be necessary for a valuation specialist in utility company assets to examine assets on hand to determine their condition and operability Based on previous studies of the Georgian utility sector, it is expected that a significant portion of the fixed assets are non-operable For example, the largest powerplant, Enguri, with a capacity of 1300 MW, has only four of five units currently mechanically operable which results in 800 MW available In addition SakGen lacks political control of Enguri's powerhouse which is located in the Abkhazia region Separatist groups deny access to the powerhouse and, on occasion have threatened to blow it up Therefore, a substantial adjustment to the values of the assets may be necessary including re-classification of the assets in the balance sheet and substantial footnote disclosure The cost of retaining valuation specialists calculating the amount of the required adjustment and reclassifying the accounts could be substantial

d) Depreciation charged to income during the period is adequate but not excessive and has been computed on an acceptable and consistent basis The balances in the depreciation allowance accounts are reasonable considering the expected useful lives and salvage values

The method utilized by SakGen is an acceptable method under IAS The auditor would need to determine that the useful life used in the calculation is reasonable and that the arithmetic accuracy is acceptable It would also be necessary to determine that depreciation calculations properly reflect revaluation adjustments made in the current and prior years It is expected that there would be no difficulties in performing the necessary procedures

e) Property is properly classified in the balance sheet and fully depreciated assets idle property and property held for investment are properly disclosed The financial statements include disclosures of major classes of depreciable assets accumulated depreciation, depreciation methods and amounts, based on valuation

SakGen s statutory balance sheet does not break down fixed assets into majors classes (such as buildings, meters, heavy equipment land etc The accounting records provide enough detail to determine which assets belong to each category As discussed in Objective 3 above, a significant portion of SakGen s assets are damaged or not under the company s control and therefore need to be re-classified and possibly revalued The accounting records do not identify these assets so an inventory would need to be taken and inspections would need to be made by valuation specialists

Conclusion Fixed assets make up a material portion of SakGen's assets Audit risk is increased due to the poor condition and political problems associated with a large portion of the assets, poor internal control of the "custody and stewardship functions", difficulties in determining appropriate valuation due to revaluation rules and inadequate repairs and maintenance The cost of reducing audit risk to an acceptable level is hampered by the cost of using technical experts to inspect a large number of assets, the cost of reconstructing price indexes to test revaluation amounts and the cost of testing values used in barter transactions

D Accounts Payable and Other Liabilities

1) Overview

Account Payables arise primarily for the cost of generating electricity However, relatively few purchases are made on credit Confirmations could probably be sent by fax, but this should only be necessary for the largest and most active creditors Supporting

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documentation on most purchases is adequate Other payables include accrued wages As of June 1998 employees had not been paid for four months There is also an outstanding loan from EBRD for 6 5M DM

Internal control over accounts payable is reasonably good as documentation requirements include purchase and receiving documents which allow determination of amounts owed Other than the purchase of fuel, most other purchases are for cash or barter therefore the amount of other payables is not significant except for the 3 6M GEL that is currently in arrears to the GoG Budget

2) Audit Objectives

a) Accounts payable represents a complete presentation of authorized current obligations that arose from purchased goods or services Accounts payable are properly classified as current liabilities, and disclosure is made of related party payables and payables with explicit payment terms

Due to the large number of cash and barter transactions it would be preferable to confirm balances due to large and active vendors and agree the amounts to company records

A search for unrecorded liabilities would also include an examination of payments by bank transfers after the balance sheet date to determine if the items paid represent obligations that should have been included in payables at the balance sheet date

In addition, the auditor should check goods received both the month before and the month after the balance sheet dates and supporting documents to determine when the liability should have been recorded

b) Accrued and other liabilities represent a complete presentation of unpaid cost and expenses and the amounts owed are computed, classified and described in a consistent manner

Wage accruals could be tested by recalculation to the amounts not paid and examination of payroll records and bank records Some "spot checking" should be performed by direct confirmation from employees of amounts owed

Taxes payable in association with wage payments and for value added tax can be checked against tax returns and proof of payment from bank records

The loan to EBRD could also easily be confirmed and accrued interest could be calculated

Other liabilities are immaterial

Conclusion Audit risk is reasonably low for accounts payable and other liabilities The effort and cost of determining the fairness of presentation in the financial statements is modest

Recommendations

Based on our conclusions as expressed above in the areas of Receivables and Fixed Assets we believe that it is highly unlikely that a financial audit conducted using International Standards of Auditing would lead to an unqualified audit opinion that the financial statements of SakGen are fairly presented in accordance with International Accounting Standards

The most likely result of such an audit would be either a disclaimer of opinion due to limitations of scope caused by poor internal controls and lack of sufficient competent evidential matter especially regarding the political risk associated with Enguri In the event that a financial audit could be performed, the cost of the procedures necessary to reduce audit risk to an acceptable level, may be prohibitive

Finally, any opinion given on the financial statements would be tempered by wording in the report that would indicate that the Company may not be able to continue as a going concern due to liquidity problems and the size of the investment necessary to ensure adequate operations and control over those operations

APPENDIX C

REPORT ON SAKENERGO

Georgia Scoping Study

for Financial Evaluation of Energy Enterprises

REPORT ON SAKENERGO

Dispatch and Sales

Description and Background of the Company

After Georgia received its independence from the Soviet Union Sakenergo Consolidated was established It consisted of the generation and transmission capacity of electricity in Georgia and was the largest power sector company in the country A subsequent restructuring plan called for the Company to split into Sakenergo Generation (SakGen) and Sakenergo Transmission and Dispatch (SakTrans), with further separation of the Gardabani Thermal Power Station into a joint stock company SakTrans had responsibilities for deliveries to 60 distribution companies and 10 large industrial concerns SakGen was the primary source of electricity purchased

Effective April 1 1998, the Ministry of Fuel and Energy directed that SakTrans be further split into two companies with separate management groups—Sakenergo Transmission and Sakenergo Dispatch and Sales (SakDis)

The selling price for electricity to distribution companies and commercial companies has been set by the Regulatory Commission Management believes this tariff is insufficient to operate profitably and a proposal has been made for raising the rates supported by Kantor a Greek consulting firm

Collections have improved from1995 through 1997 to a rate of 68%, which includes approximately 20% cash and the balance in offsets Distribution companies may be disconnected for non-payment but this option is rarely utilized due to the effect on residential customers Collections are easier to enforce with commercial and industrial customers Cash flow problems exist and salaries have not been paid since July 1997

There is a 50% deficiency in capacity and the delivery of power to customers on demand as mandated by a Presidential Decree (to become effective July 1, 1998) cannot be assured Per 24 hour period in winter, 40M kWh should be delivered and only 27-28M kWh is available A capacity of 2000 MW is needed in winter, while only 1300MW is available Further, there are no reserves to protect from a generating plant ceasing operations Hydro plants provide 40% of the electricity purchased in winter and 100% in the summer

Financial records for 1996 were audited by the Georgia Audit Corporation and a report was issued that indicated no major weakness were found The governmental Chamber of Control conducted an audit of the financial records for the years 1994-1996 and the first quarter of 1997 Six months of fieldwork was conducted and the subsequent reports indicated deficiencies over cash control, sales recognition, depreciation of fixed assets expense control foreign loan recognition tax payments accounting systems and internal control review procedures

After the split of Sakenergo Transmission into two companies on April 1 1998, the Dispatch and Sales company retained responsibility for all operations except transmission for which it is to pay a fee to Sakenergo Transmission for physical delivery of the energy to customers Accordingly, Dispatch and Sales received all the Accounts Receivable and Accounts Payable at the split while the Transmission company was given a relatively clean Balance Sheet

Prior Donor Work and Due Diligence

The Government of Georgia (GoG) requested the help of the World Bank in privatizing the power sector, and Kantor Management Consultants were selected to lead the effort of assisting the Commission in the financial restructuring task and to coordinate the work of other contributing consultants Kantor selected KPMG as their subcontractors with responsibility for the accounting work

Kantor and KPMG issued a Final Draft Report on 24 December 1996 which presented the initial recommendation for the restructuring of capital The report presented the consolidated financial statements, restated according to International Accounting Standards at the end of 1995 and as of June 30, 1996 A subsequent report unbundled the consolidated report into Sakenergo Generation, Sakenergo Transmission and Dispatch and Gardabani Thermal Power Station

Summary of Meetings with Company and Analysis of Transaction Cycles

A Introduction

Our fieldwork was conducted on June 10 and 11, 1998 when we visited the Sakenergo Dispatch and Sales administrative offices During our visit we interviewed and obtained information from the following people

Tamaz Lomadze, First Deputy Director

Otar Gamkrelidze Head of Financial Department

Iuri Toloraia, Chief Accountant

Iulia Ruzhanskaia, Deputv Accountant

Guram Javakhadze, Head of Sales and Energy Supervision Department

Mikheil Samkharad, Administration Departmen

Marina Maisuradze Legal Specialist

B Acquisition and Production Cycle

1) Power deliveries from Sakenergo Generation are verified through check-meters with employees from both companies present A sales document is created and normal technical losses are absorbed by Sakenergo Dispatch and Sales and included in the rate cost calculations submitted to the Commission

2) Other purchases are restricted to operating supplies and small capital items since the split when Sakenergo Dispatch and Sales became a sales company with a service orientation

3) Cash purchases are approved by the Financial Director and some barter transactions are negotiated with third parties Barter transactions were approximately 10% of volume in 1997 and less than 6% during the first quarter of 1998

4) Relatively all power purchases are paid by bank transfer Since the split on April 1, Dispatch and Sales is to pay a fee to Transmission for delivery to its distribution and industrial customers Since the Commission has yet to set a rate for this transmission fee, nothing has been accrued for this liability

C Fixed assets subsequent to split

1) Fixed assets include office buildings equipment and furniture Depreciation is calculated by applying a fixed rate to the net book value of major asset categories

2) Asset revaluation Assets have been revalued three times based upon historical value Assets were increased by an indexation method In 1992 the value of fixed assets increased by a multiple of 35, in 1993 by a multiple of 300, and in 1995 by a multiple of 12 7 The multiple was determined by Presidential Decree Another revaluation is scheduled during the Summer of 1998 Personnel remarked that the asset values were below their actual worth, but there is no known market for used equipment to verify Revaluations are allowed under IAS under certain conditions and utilizing certain methods Without knowing the basis for the calculation of the multiple, it is not possible to determine if the valuation is in accordance with IAS

3) The upkeep and safeguarding of companv assets is often referred to as management s stewardship and custodv function Management has the responsibilitv to ensure that assets are properly used properly maintained and properly guarded against theft This is accomplished by internal controls that provide appropriate ' tagging' of the assets so they can be located proper documentation so movement of the asset can be tracked and so that only authorized individuals have access to the assets Internal control also requires keeping maintenance records and having a system that flags assets for required maintenance

D Revenues and Accounts Receivable

1) Invoices are created monthly for power transmission and monthly statements are provided to all distributors and industrial customers The collection rate from distributors has increased steadily as follows 1991-11% 1995-19 5% 1996-54% and 1997-68% Distributors are required to pay 70% of collections toward their balance for electricity transmitted This percentage was increased to 85% by Presidential Decree in 1998 However, in reality the amounts paid are usually less

2) Accounts receivable were 274M GEL at the April 1, 1998 split and this included 80M GEL from Abkhazia which is totally uncollectable Approximatelv 60% of the total (or 164M) is considered uncollectable Delinquent distributor accounts are difficult to collect because the residential customer base precludes power shut-off in most cases Payment can be readily enforced with industrial customers by threat of disconnection

3) According to management, barter transactions are not the norm and accounted for about 10% of revenues in 1997 Barter revenues were calculated to be 5 9% during the first quarter of 1998 Sometimes these transactions involve third party transfers which are fully documented as to receipt and amount

E Payroll

1) Employee hires are infrequent and occur only when a vacancy appears Prospective employees are approved by the General Director or a Deputy Director Salary level is determined by the Planning and Economic Department based upon job classification There is no significant differentiation between groups and salary ranges from 50 GEL per month for a general employee to 250 GEL per month for an administrative employee

2) Administrative personnel of the enterprise appears to be double the amount needed, while there is a shortage of several technical specialties

3) Salary payments to employees are 6-12 months behind schedule When payment is made, normal procedure is to pay by bank transfer, although some special payments are made by the company cashier Salaries are scheduled to be paid monthly and unpaid

amounts are accrued No bonuses and penalties exist although the General Director can authorize discretionary premiums

4) Payroll accounting is computerized Input documentation is prepared in the accounting department from time cards Written documentation is required for premiums loan deductions etc The system provides for the calculation and payment of salaries as well as accruals of payments due Separate journal entries must be manually prepared and posted to the general ledger

F Disbursements and Accounts Payable

1) Essentially there is no financing of regular purchases Receiving report and purchase document are matched before payment transfer is made through the bank

2) Payables include a 6 5M DM note for financing through EBRD

G Budgeting and Financial Planning

1) The Planning and Economic Department is responsible for the annual plans which are based upon applications submitted by customers Distributors and Industrial companies represent the two basic types of customers which account for 80% and 20% of the demand, respectively The selling prices determined by the Regulatory Commission are 3 1 tetri per kWh for Telasi 3 3 tetri for other wholesale purchasers and 4 5 tetri for direct customers No estimates are made for the collectability of amounts billed nor for the percentage of cash and barter sales

2) The majority of electricity purchases are made from SakGen and its subsidiaries with any supplemental requirements met by private or foreign companies Import prices are not controlled by the Regulatory Commission and are subject to negotiated agreement The timing and form of payment are also negotiated Expense forecasts are based upon the previous year

3) The annual planning document consists of the following items by quarter

- Forecast of electricity demand
- Forecast of supply in kWh and GEL
- Forecast of purchases in kWh and GEL
- Forecast of expenses

4) Budgets are not used as a management tool and while quarterly planning data is compared with actual in the accounting office, management/operating decisions do not

follow from the analysis Considerable quarterly differences are required to be reported to the Regulatory Commission

H Accounting Function

1) SakDis maintains a centralized accounting function at the administrative headquarters in Tbilisi, although branch location personnel process routine operating transactions for monthly entry into the system Staff interviewed appeared to be conscientious and knowledgeable Payroll and some sales functions are currently automated with plans to computerize the accounting functions by the end of 1998 with the help of a EU Tacis program

2) Journals and a general ledger were manually prepared and appeared to provide the basis for a mechanical summary of financial records Entries in the ledger are made from journals or other supporting documents Proper approvals were noted, but also several incorrect journal entries and other clerical errors

3) The financial statements are prepared in accordance with legislation and as directed by the Ministry of Finance The statements include a Balance Sheet and Income Statement, with other reports and supporting schedules as required under the circumstances Cash flow statements are not prepared

4) The Company reports a loss and has no income tax Carryforwards are allowed

I Information System

1) The automation of recordkeeping at SakDis is progressing very slowly because of management's lack of understanding of the benefits of a computerized information system and the absence of qualified personnel to implement the change All computers are located in the Information Systems Department where all data is prepared for entry

2) Currently, only three areas have been partially automated payroll, financial statements (balance sheet only) and sales (including bank cash receipts and customer accounts receivable) Sales information includes actual electricity delivered to customers, bank cash receipts, and an updated accounts receivable which includes barter payments received The value of this information is considered low because of a lack of controls over the processing to ensure accuracy and reliability

3) Soviet era software has been modified to support the automated applications to date, but a proposal has been prepared to purchase new software

Findings and Auditability

A Cash

1) Overview

Customers are required to make cash payment for amounts due by bank transfers unless barter arrangements are made Small cash funds, which lack proper controls are used for small purchases Most purchases are made by bank transfer, with a small percentage by barter

2) Audit Objectives

a) Cash exists and is owned by the client

Cash in bank – Cash in bank accounts can easily be confirmed by bank personnel and adequate documentation exists to prepare and audit bank reconciliations Company documentation exists for each bank transaction Adequate controls exist over the authorization and execution of bank transactions

b) Cash balances reflect a proper cutoff of receipts and disbursements

A proper cutoff at the balance sheet date is determinable for cash in the bank

c) Cash balances as presented in the balance sheet properly reflect all cash and cash items on hand, in transit, or on deposit with third parties

The cash balances presented properly reflect all cash in bank Petty cash funds are not material

d) Cash balances are properly classified in the financial statements, and any restrictions on the availability of funds are properly disclosed

SakDis currently owes its major suppliers in excess of 219 million GEL Due to the size of the debt, the suppliers have begun legal action to allow it to attach the bank account of the company The success of any legal action is unclear at this time The company is also 6-9 months behind schedule with salary payments

The resolution of these issues will determine whether there is a restriction on cash that would result in a separate financial statement classification At this point in time, more evidence would be needed to determine the appropriate classification and required disclosures to be included in the financial statements

Conclusion It appears that adequate procedures and controls exist to make a determination whether cash is fairly presented The uncertaintv regarding the legal action would need to be disclosed Its resolution could threaten the ability of the company to continue as a going concern

B Accounts Receivable

1) Overview

Invoices are created monthly and monthly statements are provided to all distributors and industrial customers Collections have increased steadily since 1991 to a rate of 68% in 1997

Delinquent distributor accounts are troublesome because the residential customer base precludes disconnection, while this option is readily used to solicit payments from industrial customers

Payments are received via bank transfers, offsets and a small percentage (10%) in barter

2) Audit Objectives

a) Accounts Receivable are authentic obligations owed to the company at the balance sheet date

The authenticity of accounts receivable are generally determined by sending confirmation letters to customers who are asked to acknowledge the amount of their debt at the balance sheet date This procedure could be accomplished by alternative means via fax requests The response rate from customers is likely to be poor, however alternative procedures such as examination of meter readings signed by the customers, should provide the required assurance

b) Accounts Receivable includes all amounts owed to the company at the balance sheet date

The inclusion of all valid receivables requires a proper sales cutoff and assurance that all of the transactions have been posted This is possible by verification of meter readings of electricity actually transmitted

c) The allowance for doubtful accounts is adequate but not excessive

The adequacy of the Allowance for Doubtful Accounts is generally determined by

- Reviewing cash receipts subsequent to the balance sheet date

- Preparing and reviewing an "aging of accounts receivable to determine how long individual amounts have been outstanding and applying estimated percentages of uncollectibility to individual receivables It is assumed that the longer a receivable is outstanding, the lower its probability of collection The percentage applied is based on the experience of the enterprise as well as current economic circumstances

Based on recent experience and the current economic situation in Georgia a conservative approach would be necessary This would probably result in establishing the Allowance for Doubtful Accounts according to management s estimates at an amount equal to at least 60% of receivables

d) Accounts Receivable are appropriately classified in the balance sheet and required disclosures are made

Accounts receivable that are due and collectible within one year should be classified as current assets The Allowance for Doubtful Accounts should be separately shown The method for determining the amount of the Allowance and bad debts expense should be disclosed None of these items should cause significant audit problems

Conclusion Audit risk is high for receivables due to the difficulty in determining an adequate Allowance for Doubtful Accounts due to the current economy, potential government interference and the difficulty of motivating customers to pay due to the current legal environment

These difficulties would most likely lead to one or both of the following

- A qualified opinion or a disclaimer of opinion due to uncertainties regarding the collection of receivables

- The possibility of the "going concern assumption" no longer being appropriate Due to the high probability that a large percentage of receivables are uncollectible, there is a high degree of risk that the company is not a going concern This requires additional audit procedures to determine the amount of risk This may lead to a required inclusion in the audit report that emphasizes the possibility that the company would not be able to continue as a going concern

C Fixed Assets

1) Overview

Fixed assets include office buildings equipment and furniture

According to Georgian accounting law purchased fixed assets are stated at historical cost Historical cost under IAS and Georgian law is calculated differently The primary difference is that under IAS, historical cost includes the amount paid for the asset plus additional costs required to obtain the asset and to get the asset ready for use These costs include taxes installation, freight and insurance Under Georgian accounting these costs would be treated as period costs or overhead
Self-constructed assets are valued at the total of direct costs (materials and labor) plus an allocation of overhead It is standard practice in Georgia to include all indirect costs in the calculation of overhead which is then allocated to the cost of self-constructed assets Under IAS for the purpose of calculating construction costs only indirect construction costs are allocated to the cost of the asset

Since 1989 fixed assets have been revalued three times The revaluations were required based on a Presidential decree Companies were allowed to choose any of three methods in calculating the revalued amount These methods were

a) Indexation Method – historical cost was multiplied by an index specified by the government

The index varied based on the type of asset and its date of purchase In 1992 under this method, assets were increased by an average multiple of 35 In 1995 the average multiple was 300 In 1997, the average multiple was 127

b) Direct Valuation Method – assets were valued at their replacement cost

c) Combined Method – assets were valued by a combination of the above methods

Under IAS, companies may revalue assets under certain conditions and using certain allowed methods An indexation method is allowed where the index is based on a reliable measure of the change in prices over time Replacement cost is also an allowable method subject to consideration of technological change

Tax law prescribes depreciation rates A fixed percentage, specified by law, is applied to the undepreciated cost of the asset This is similar to the declining balance method which is allowed under IAS However, under IAS the rate allowed must be calculated based on the estimated life of the asset The rate prescribed by law may not approximate the rate allowed under IAS

Under IAS, fixed assets are generally classified under the title of property, plant and equipment To be included in this classification assets must be in use in the operations of the business Telasi has a large percentage of fixed assets that are currently damaged to the point that they are not operational These assets must not be shown under the classification of property, plant and equipment but should be segregated and listed under a separate category such as Other Assets If the assets will not be repaired they should be written down to their salvage value

2) Audit Objectives

a) Property, plant and equipment (PPE) reflected in the accounts represent a complete listing of capitalizable cost of assets purchased, constructed or leased by the company and such assets are physically on hand

This objective requires the following procedures to be performed

- Preparation of a schedule of all PPE in existence at the balance sheet date based on physical observation of those assets

  This schedule could easily be prepared by company personnel and the accuracy of the schedule could be verified by applying appropriate sampling techniques

- Comparison of the schedule to assets included in the accounting records

  The comparison could be performed by accounting department personnel who do not have direct responsibility for fixed asset accounting

- Preparation of a schedule of existing assets not included in the accounting records and preparation of a schedule of assets included in the accounting records that were not physically observed

  The schedules could be prepared by accounting department personnel who do not have direct responsibility for fixed asset accounting

b) PPE is valued at cost in accordance with IAS Accordingly, noncapitalizable costs are properly expensed and capitalizable costs are excluded from maintenance or other expense accounts

This objective requires the following procedures to be performed

- Vouching of the historical costs to supporting documentation and to determine that non-capitalizable costs have not been included

  Company procedures do require source documents to be maintained for all purchases This could be verified on a test basis

  For cash purchases, differences between the calculation of historical cost under IAS and Georgian law should not be material

For barter transactions (defined as exchanging as asset for a dissimilar asset) purchased fixed assets should be valued at their fair value A gain or loss would be recognized for the difference between the book value of the asset given up and the value of the asset received

Barter transactions present a significant audit problem in cases where the value of the asset received is not readily determinable The auditor would also need to verify gains and losses on barter transactions which may be difficult and costly due to the sheer volume of barter transactions

- Examination of repairs and maintenance accounts to determine that account balances do not include costs that should have been capitalized

  This procedure should be able to be performed in a reasonable amount of time It is probable that extraordinary repairs that would be capitalizable under IAS have been charged to overhead

- Recalculation of the components of the cost of self-constructed assets

  This procedure requires the restatement of historical cost to exclude non-construction overhead items that have been allocated to asset cost This may be a difficult and time consuming procedure depending on the age of the asset and the available records that support the original calculation A first step would be an estimate of the materiality of expected adjustments If adjustments are expected to be material and adequate evidence is not available this could potentially preclude an unqualified opinion However subsequent revaluation procedures could make this calculation irrelevant

- Review of methods used in revaluation of PPE to determine if in accordance with IAS

  As discussed above, the methods of revaluation prescribed by law would be in accordance with IAS depending on the measurement techniques adopted and applied

- Test of revaluation calculations for reasonableness

  Where the indexation method has been used, it would be necessary to determine if the index used approximates price changes in the cost of the asset This would require the auditor to obtain documentary evidence of price changes This could be more easily verified for recent revaluations

  Where the replacement cost method is used, documentary evidence is required by the government to justify the valuation used Therefore, evidence should exist which would allow the auditor to verify the amount used in the revaluation

c) The cost and related depreciation applicable to all sold abandoned damaged or obsolete property have been properly removed from the accounts and PPE is properly classified in the balance sheet

The assets of SakDis are primarily office buildings office equipment and other items of a non-technical nature Verification of amounts related to assets that have been disposed of or that are damaged should not pose an audit problem, nor are the amounts expected to be material

d) Depreciation charged to income during the period is adequate but not excessive and has been computed on an acceptable and consistent basis The balances in the depreciation allowance accounts are reasonable considering the expected useful lives and salvage values

The method utilized is an acceptable method under IAS The auditor would need to determine that the useful life used in the calculation is reasonable and that the arithmetic accuracy is acceptable It would also be necessary to determine that depreciation calculations properly reflect revaluation adjustments made in the current and prior years It is expected that there would be no difficulties in performing the necessary procedures

e) Property is properly classified in the balance sheet and fully depreciated assets idle property and property held for investment are properly disclosed The financial statements include disclosures of major classes of depreciable assets accumulated depreciation, depreciation methods and amounts, based on valuation

The statutory balance sheet does not breakdown fixed assets into majors classes (such as buildings, meters, heavy equipment land etc The accounting records provide enough detail to determine which assets belong to each category

Conclusion Fixed assets do not make up a material portion of the assets of SakDis Audit risk is considered low for this class of asset

D Accounts Payable and Other Liabilities

1) Overview

The vast majority of payables is to SakGen for electricity purchased Confirmation should be no problem for this account, but the verification of other balances owed to vendors could also be confirmed Other payables include accrued wages and as of June, 1998 employees had not been paid for 6-9 months There is also an outstanding note payable to EBRD for 6 5M DM

Internal control over accounts payable is reasonably good as documentation requirements include purchase and receiving documents which allow determination of amounts owed

Other than the purchase of electricity, most other purchases are for cash or barter therefore the amount of other payables is not significant

2) Audit Objectives

   a) Accounts payable represents a complete presentation of authorized current obligations that arose from purchased goods or services Accounts payable are properly classified as current liabilities, and disclosure is made of related party payables and payables with explicit payment terms

Since a very large portion of payables is owed to one vendor, the most efficient audit procedure would be to confirm the balance due with SakGen and reconcile any difference between the amount recorded in the accounting records and the amount confirmed

In addition, balances due to large vendors should be confirmed

A search for unrecorded liabilities would also include an examination of payments after the balance sheet date to determine if the items paid represent obligations that should have been included in payables at the balance sheet date

In addition, the auditor should check purchases received both the month before and the month after the balance sheet dates and supporting documents to determine when the liability should have been recorded

All of the procedures listed above do not appear to offer the probability of high audit risk primarily due to the low level of payables other than the amount owed to SakGen and the ability to confirm the amount due to SakGen

   b) Accrued and other liabilities represent a complete presentation of unpaid cost and expenses and the amounts owed are computed classified and described in a consistent manner

Wage accruals could be tested by recalculation of the amounts not paid and examination of payroll records and bank records Some "spot checking" should be performed by direct confirmation from employees of amounts owed

Taxes payable in association with wage payments and for value added tax can be checked against tax returns and proof of payment from bank records

The loan to EBRD could also easily be confirmed and accrued interest could be calculated

Other liabilities are immaterial

Conclusion Audit risk is reasonably low for accounts payable and other liabilities The effort and cost of determining the fairness of presentation in the financial statements is modest

Recommendations

Based on our conclusions as expressed above in the area of Receivables we believe that it is unlikely that a financial audit conducted using International Standards of Auditing would lead to an unqualified audit opinion that the financial statements of SakDis are fairly presented in accordance with International Accounting Standards

The most likely result of such an audit would be either a qualified opinion or disclaimer of opinion due to limitations of scope caused by the lack of sufficient competent evidential matter in verifying the amount of the Allowance for Doubtful Accounts

Any opinion given on the financial statements would be tempered by wording in the report that would indicate that the Company may not be able to continue as a going concern due to liquidity problems

APPENDIX D

REPORT ON SAKTRANSGASMRETSVI (SAKTRANSGAS)

Georgia Scoping Study

for Financial Evaluation of Energy Enterprises

REPORT ON SAKTRANSGASMRETSVI (SakTransGas)

Description and Background of the Company

Saktransgasmretsvi is an old-line company that has been responsible for the pipeline structure and transmission of gas to industrial commercial and distribution customers throughout Georgia Formerly, more that forty cities and two hundred villages consumed natural gas through a pipeline network which exceeded 10 000 kilometers in length Approximately one half of the gas pipeline in Georgia is in use today Before 1993 the entire country received gas but today only Rustavi, Gardabani and some residents in Tbilisi use gas SakTransGas delivers gas to about three dozen customers who have their own meters The western part of the country is not served now

The management rights of SakGas was transferred to Georgia International Gas Company (GIC) almost two years ago, but just recently have negotiations begun regarding the transfer of pipeline assets to GIC On November 29, 1997 SakTransGas submitted a signed schedule of assets to GIC for transfer Another signed document presents a schedule of assets for physical transfer to the books of GIC beginning on July 1 and to be concluded by September 1 1998 The Director of GIC has indicated that he expects the asset transfer to be made on the books of both companies to coincide with the June 30, 1998 fiscal and tax reporting period Management of SakTransGas believes the determination as to which company should hold the assets should be the subject of the negotiations The final outcome of this matter is not determinable at this time

The fixed assets of SakTransGas, which are primarily the gas pipelines throughout Georgia are valued at approximately 84M GEL on the books Note that the asset values more than doubled with the most recent valuation Approximately 3M GEL of assets were transferred to GIC in 1997

The Ministry of State Property announced a tender for part of the assets of SakTransGas and the international group, Interpak, bid and won the management rights to the service stations which is approximately 25% of the company (or 21M GEL of the assets) These assets are the buildings, storage equipment, gas stations, and other ancillary devices that surround the pipeline operation Interpak controls this operation through the subsidiary, Intergas, which also controls six Municipal distribution companies in large Georgian cities

GIC management believes that SakTransGas has become very inefficient and loses 8% of the transmitted gas This loss rate is exceptionally high when compared with the American company ENRON where physical losses are 0 25% Actual loss is also very significant when the 10% gas tariff for delivered Armenian gas and the resulting lost sales of 8% is considered The lost sales total $16M annually

GIC also believes that SakTransGas would be a viable entity even with only 60% collection of billings if the 8% gas transmission loss was brought under control with better and more frequent maintenance Under the Soviet system, approximately $10M was spent annually on pipeline repair and maintenance, but these activities were halted in 1991 Intergas has agreed to reduce these transmission losses as part of their current contract, but there are no specific amounts of loss reduction or capital investment stated

GIC now manages 63M GEL of the assets of SakTransGas, represented by the pipeline while Intergas manages 21M GEL of the assets Management estimated that the 63M GEL of pipeline assets would cost about $1 5B in today's market

The sales price of gas is 97 4 GEL per 1000 cubic meters, which consists of gas price of 84 5 GEL and transportation tariff of 12 9 When the cost of gas or the tax on gas changes new tariffs are recalculated by the company Currently the company is working on a price increase prompted by the Russian implementation of a VAT on the gas that it exports to Georgia

As the result of a merger in 1997, SakTransGas' Accounts Receivable more than doubled on the consolidated balance sheet to 137M GEL Of this receivable balance, 112M GEL has already been written-off by the debtors through governmental decree This included 81M owed by Sakenergo and 31M GEL owed by the Municipal gas distribution companies Despite this write off by the debtors, SakTransGas is still carrying these amounts in Accounts Receivable and will do so until notification from the government to remove it from its financial statements

Consolidated Accounts Payable likewise almost doubled to 113M GEL due to the merger Of this amount, SakTransGas owes 60M due to Turkmenistan Gas which resulted from transmissions received from 1990-93 SakTransGas has been waiting for the GoG to transfer this amount to Budget for settlement with Turkmenistan officials

In connection with the merger, SakTransGas assumed a tax liability that the court awarded for a 1992 infraction This raises a concern for potential unrecorded liabilities on the books of the consolidated company

Alexander, a respected Georgian audit firm issued a favorable audit report for the 1997 financial statements of SakGas, which included the merger The report did not discuss the uncollectible Accounts Receivable of 112M GEL in the financial statements This local audit included only document verification and is in no way comparable to an audit under International Standards of Audit

Summary of Meetings with Company and Analysis of Transaction Cycles

A Introduction

Our fieldwork was conducted on June 19 and 22, 1998 when we visited the Saktransgasmretsvi administrative offices During our visit we interviewed and obtained information from the following people

Ivan Zazashvili, General Director

Goderdzi Kiknavelidze Deputy Director for Finance and Economy

T Gagua, Chief Engineer

M Antelava, Deputy Director for General Construction

Neparidze Nugrar, Dispatching Service

Neli Tushurashoili Chief Accountant

Irakli Antelava, Head of Computer Department

David Pasurishvili, Chief Economist

B Acquisition and Production Cycle

1) All gas purchases are made from ITERA, a gas marketer According to personnel there are other suppliers available but ITERA offers the best price at $60 5 per 1000 cubic meters In addition, ITERA supplies gas to Armenia and pays transport fees to SakGas

2) Gas purchases are measured each month when engineers go to the border to view the meter and reconcile the amount received with the amount they have delivered to customers Most purchases are made by bank transfer upon verification and proper approval

3) Purchases of material and equipment are made from the major supplier, Rustransgaz Most purchases are made by bank transfer, but some are made in cash Department Heads prepare written requests for purchase approval by the General Director and invoice documents are required from the supplier

4) Purchase documents normally include an agreement signed by the purchaser and supplier an invoice a receiving report and payment documents In barter transactions documents confirming receipt of services and products are present And in the case of offset involving several enterprises, agreements bills and payment orders from companies participating in the transaction are present

C Fixed assets subsequent to acquisition

1) Fixed assets include office buildings and equipment, the gas pipeline throughout Georgia and related ancillary assets such as storage devices and stations etc Depreciation is calculated by applying a fixed rate to the net book value of major asset categories

2) Asset revaluation Assets have been revalued four times based upon historical value Assets were increased by an indexation method In 1992 the value of fixed assets increased by a multiple of 35, in 1993 by a multiple of 300, and in 1995 by a multiple of 12 7

The multiple was determined by Presidential Decree in each case The fourth revaluation ordered by Presidential Decree in July 1997 was completed in 1998 and the value of assets more than doubled—from $30M to $64 3 M The replacement cost for the pipeline was estimated by management to be about $1 5B

Revaluations are allowed under IAS under certain conditions and utilizing certain methods Without knowing the basis for the calculation of the multiple it is not possible to determine if the valuation is in accordance with IAS

3) Capital assets are built by the construction department and separate financial records are maintained to control this operation Under IAS self-constructed assets should be initially measured at direct cost plus production overhead No amount should be included for general and administrative costs or interest expense In Georgia it is typical to include non-production overhead (i e general and administrative expenses) in the cost which is a violation of IAS

4) The upkeep and safeguarding of company assets is often referred to as management's stewardship and custody function Management has the responsibility to ensure that assets are properly used, properly maintained and properly guarded against theft This is accomplished by internal controls that provide appropriate "tagging" of the assets so they can be located, proper documentation so movement of the asset can be tracked and so that only authorized individuals have access to the assets Internal control also requires keeping maintenance records and having a system that flags assets for required maintenance

D Revenues and Accounts Receivable

1) SakTransGas has five major customers which include Gardabani and Rustavi Other customers consist of commercial and industrial companies for a total base of less than 40 concerns Company and customer representatives agree to actual metered deliveries and a sales document is created and forwarded to the sales department where a monthly summary is prepared The accounting department records amounts by customer on ledger cards and a sales journal is prepared with totals posted to the general ledger

2) Customer payments are received primarily through bank transfers Collection percentages have improved steadily from a low of 35% in 1994, to 50 3% in 1996 to 61 4% in 1997 Some customers prepay and others pay by barter The Ministry of Economics has decided that the price of gas shall be the same for all customers

E Payroll

1) Employee hires are based upon requests of Department Heads and salary level is based upon job classification The main requirement for new employees is experience in the gas field The company fills jobs though word of mouth and has no advertisements for competitive hiring

2) Monthly salary ranges from 73 to 143 GEL Some bonuses are paid Each employee has a contract and all wages are paid in cash The company offers regular salary increases and employee training programs

3) Salary forecasts are based upon revenue forecasts

4) Salary payments were 2-3 months behind in 1997, but are now current The company maintains a petty cash fund of 900 GEL

F Disbursements and Accounts Payable

1) Essentially, there is no financing on purchases When credit purchases occur receiving report and purchase documents are matched and forwarded to the General Director for approval before payment via bank transfer If funds are not available for settlement, amounts are recorded in Accounts Payable for payment within 90 days

2) The company uses a Power of Attorney form to ensure that the delivery of goods for "prepaid purchases" is made to authorized personnel

3) Cash payments are prioritized by management according to the following guidelines a) payments to Budget, b) salaries, c) all other liabilities Payments to Budget include amounts for VAT, withholding tax, profit tax-20%, property tax, land tax, and entrepreneurial tax from realization (sales) road tax and custom's duty

G Budgeting and Financial Planning

1) The Financial Planning Department forecasts the following

- Purchases of gas
- Technological losses of gas
- Gas for internal usage
- Transportation of natural gas
- Revenues
- Expenses
- Budget/Tax payments
- Capital Investments

Forecasts are presented to the Ministry of Fuel and Energy Capital Investment forecasts are presented to the Statistical Department of Georgia

2) Quarterly, forecasts are compared with actual performance for management information

3) The Finance Department prepares the calculations for the tariff and submits to the Ministry of Economics

H Accounting Function

1) SakTransGas maintains a centralized accounting function at the administrative headquarters in Tbilisi and staff appeared to be conscientious and knowledgeable There are plans to automate the accounting system but currently, only fixed assets, inventory and bank operations are computerized

2) Journals and a general ledger were manually prepared and appeared to provide the basis for a mechanical summary of financial records However, it was noted that the Income Statement was prepared on a cash basis, while the Balance Sheet included accruals Thus, the Financial Statements are not being prepared in accordance with IAS, but should be convertible without major effort

3) Accruals are made monthly All entries in the ledger are made from journals or other supporting documents Journal entries are approved

4) The financial statements are prepared in accordance with legislation and as directed by the Ministry of Finance The statements include a Balance Sheet and Income Statement,

with other reports and supporting schedules as required under the circumstances Cash flow statements are not prepared

5) The Company reports a loss and has no income tax Carryforwards are allowed

I Information System

1) Three areas in the SakTransGas accounting department have been automated as follows

- Fixed Assets—Listed by identification number with provisions for additions dispositions and scheduled amortization
- Inventory—Listed with provisions for purchases, sales, use and write-offs
- Bank transactions—Amounts received by customer with provisions for transfer payments

Findings and Auditability

A Cash

1) Overview

Customers are required to make payment for amounts due by bank transfers unless barter arrangements are made Small cash funds, which lack proper controls, are used for small purchases Most purchases are made by bank transfer with a small percentage by barter Payroll is paid in cash

2) Audit Objectives

a) Cash exists and is owned by the client

Cash in bank accounts can easily be confirmed by bank personnel and adequate documentation exists to prepare and audit bank reconciliations Company documentation exists for each bank transaction Adequate controls exist over the authorization and execution of bank transactions Customer payments are primarily by bank transfer Payroll should also be paid by bank transfer to improve internal control and reduce the risk of error or irregularity

b) Cash balances reflect a proper cutoff of receipts and disbursements

A proper cutoff at the balance sheet date is determinable for cash in the bank Cash funds are not material

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c) Cash balances as presented in the balance sheet properly reflect all cash and cash items on hand, in transit or on deposit with third parties

The cash balances presented reflect all bank balances Cash funds could be counted on the balance sheet date

d) Cash balances are properly classified in the financial statements and any restrictions on the availability of funds are properly disclosed

SakGas did not appear to have any restrictions on funds Liquidity problems could potentially result in restrictions due to actions brought by creditors

Conclusion It appears that adequate procedures and controls exist to make a determination whether cash is fairly presented

B Accounts Receivable

1) Overview

SakTransGas has a total of approximately 40 customers, which include five major purchasers Company and customer representative agree to actual metered transmissions and a sales document is created

Customer payments are received primarily through bank transfers and collection percentages have improved steadily to 61 4% in 1997 Uncollectible accounts are estimated to be approximately 40% now, but no reserves have been established on the books

2) Audit Objectives

a) Accounts Receivable are authentic obligations owed to the company at the balance sheet date

The authenticity of accounts receivable are generally determined by sending confirmation letters to customers who are asked to acknowledge the amount of their debt at the balance sheet date This procedure could be accomplished most efficiently via fax requests Alternative procedures include verification by review of metering records and "cash received" records

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Accounts Receivable includes all amounts owed to the company at the balance sheet date

The inclusion of all valid receivables requires a proper sales cutoff and assurance that all of the transactions have been posted This is possible except for the unknown reliability of manual records kept by the accounting department

A ' reasonableness test" could be performed to determine that gas distributed to customers after an allowance for technical and commercial losses, was billed to customers Such a test could provide evidence that billings were accurate *in total* but would not provide evidence that individual accounts were accurately billed

A cutoff could be performed to determine if gas delivered but not billed was properly included in receivables

b) The allowance for doubtful accounts is adequate but not excessive

The adequacy of the Allowance for Doubtful Accounts is generally determined by

- Reviewing cash receipts subsequent to the balance sheet date
- Preparing and reviewing an "aging" of accounts receivable to determine how long individual amounts have been outstanding and applying estimated percentages of uncollectibility to individual receivables It is assumed that the longer a receivable is outstanding, the lower its probability of collection The percentage applied is based on the experience of the enterprise as well as current economic circumstances

With a small customer base and the current economic situation in Georgia, a conservative approach would be necessary This would probably result in establishing the Allowance for Doubtful Accounts, according to management's estimates, at an amount equal to at least 40% of receivables

c) Accounts Receivable are appropriately classified in the balance sheet and required disclosures are made

Accounts receivable that are due and collectible within one year should be classified as current assets The Allowance for Doubtful Accounts should be separately shown The method for determining the amount of the Allowance and bad debts expense should be disclosed None of these items should cause significant audit problems

Conclusion Audit risk is moderate The primary risk area is the difficulty in determining an adequate Allowance for Doubtful Accounts due to the current economy, potential government interference and the difficulty of motivating customers to pay due to the current legal environment

C Fixed Assets

1) Overview

Fixed assets include office buildings and equipment the gas pipeline throughout Georgia and related ancillary assets such as storage devices and stations

There is some confusion about the ownership of pipeline assets between SakGas and GIC

According to Georgian accounting law, purchased fixed assets are stated at historical cost Historical cost under IAS and Georgian law is calculated differently The primary difference is that under IAS, historical cost includes the amount paid for the asset plus additional costs required to obtain the asset and to get the asset ready for use These costs include taxes installation, freight and insurance Under Georgian accounting these costs would be treated as period costs or overhead

Self-constructed assets are valued at the total of direct costs (materials and labor) plus an allocation of overhead It is standard practice in Georgia to include all indirect costs in the calculation of overhead, which is then allocated to the cost of self-constructed assets Under IAS, for the purpose of calculating construction costs, only indirect construction costs are allocated to the cost of the asset

Since 1989, fixed assets have been revalued three times The revaluations were required based on a Presidential decree Companies were allowed to choose any of three methods in calculating the revalued amount These methods were

a) Indexation Method – historical cost was multiplied by an index specified by the government The index varied based on the type of asset and its date of purchase In 1992 under this method, assets were increased by an average multiple of 35 In 1995 the average multiple was 300 In 1997, the average multiple was 12 7

b) Direct Valuation Method – assets were valued at their replacement cost

c) Combined Method – assets were valued by a combination of the above methods

Under IAS, companies may revalue assets under certain conditions and using certain allowed methods An indexation method is allowed where the index is based on a reliable measure of the change in prices over time Replacement cost is also an allowable method subject to consideration of technological change

Tax law prescribes depreciation rates A fixed percentage, specified by law, is applied to the undepreciated cost of the asset This results in assets being depreciated over a period of time which may not approximate the useful life of the asset Under IAS the rate allowed must be calculated based on the estimated life of the asset The rate prescribed by law may not approximate the rate allowed under IAS

Under IAS, fixed assets are generally classified under the title of property plant and equipment To be included in this classification assets must be in use in the operations of the business Telasi has a large percentage of fixed assets that are currently damaged to the point that they are not operational These assets must not be shown under the classification of property, plant and equipment but should be segregated and listed under a separate category such as Other Assets If the assets will not be repaired they should be written down to their salvage value

2) Audit Objectives

a) Property, plant and equipment (PPE) reflected in the accounts represent a complete listing of capitalizable cost of assets purchased, constructed or leased by the company and such assets are physically on hand

This objective requires the following procedures to be performed

- Preparation of a schedule of all PPE in existence at the balance sheet date based on physical observation of those assets

  This schedule could easily be prepared by company personnel and the accuracy of the schedule could be verified by applying appropriate sampling techniques

- Comparison of the schedule to assets included in the accounting records

  The comparison could be performed by accounting department personnel who do not have direct responsibility for fixed asset accounting

- Preparation of a schedule of existing assets not included in the accounting records and preparation of a schedule of assets included in the accounting records that were not physically observed

  The schedules could be prepared by accounting department personnel who do not have direct responsibility for fixed asset accounting However, the current uncertainty of ownership of a material amount could be a major audit problem

b) PPE is valued at cost in accordance with IAS Accordingly noncapitalizable costs are properly expensed and capitalizable costs are excluded from maintenance or other expense accounts

This objective requires the following procedures to be performed

- Vouching of the historical costs to supporting documentation and to determine that non-capitalizable costs have not been included

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Company procedures do require source documents to be maintained for all purchases This could be verified on a test basis

For cash purchases, differences between the calculation of historical cost under IAS and Georgian law should not be material

For barter transactions (defined as exchanging as asset for a "dissimilar' asset) purchased fixed assets should be valued at their fair value A gain or loss would be recognized for the difference between the book value of the asset given up and the value of the asset received

Barter transactions present a significant audit problem in cases where the value of the asset received is not readily determinable The auditor would also need to verify gains and losses on barter transactions which may be difficult and costly due to the sheer volume of barter transactions

- Examination of repairs and maintenance accounts to determine that account balances do not include costs that should have been capitalized

  This procedure should be able to be performed in a reasonable amount of time It is probable that extraordinary repairs that would be capitalizable under IAS have been charged to overhead

- Recalculation of the components of the cost of self-constructed assets

  This procedure requires the restatement of historical cost to exclude non-construction overhead items that have been allocated to asset cost This may be a difficult and time consuming procedure depending on the age of the asset and the available records that support the original calculation A first step would be an estimate of the materiality of expected adjustments If adjustments are expected to be material and adequate evidence is not available this could potentially preclude an unqualified opinion However, subsequent revaluation procedures could make this calculation irrelevant

- Review of methods used in revaluation of PPE to determine if in accordance with IAS

  As discussed above, the methods of revaluation prescribed by law would be in accordance with IAS depending on the measurement techniques adopted and applied

- Test of revaluation calculations for reasonableness

  Where the indexation method has been used it would be necessary to determine if the index used approximates price changes in the cost of the asset This would require the auditor to obtain documentary evidence of price changes This could be more easily verified for recent revaluations

Where the replacement cost method is used, documentary evidence is required by the government to justify the valuation used Therefore, evidence should exist which would allow the auditor to verify the amount used in the revaluation

c) The cost and related depreciation applicable to all sold abandoned damaged or obsolete property have been properly removed from the accounts and PPE is properly classified in the balance sheet

Due to the nature of a large portion of SakTransGas' assets it would be necessary for a valuation specialist to examine the assets on hand to determine their condition and operability

d) Depreciation charged to income during the period is adequate but not excessive and has been computed on an acceptable and consistent basis The balances in the depreciation allowance accounts are reasonable considering the expected useful lives and salvage values

The method utilized by SakTransGas is an acceptable method under IAS The auditor would need to determine that the useful life used in the calculation is reasonable and that the arithmetic accuracy is acceptable It would also be necessary to determine that depreciation calculations properly reflect revaluation adjustments made in the current and prior years It is expected that there would be no difficulties in performing the necessary procedures

e) Property is properly classified in the balance sheet and fully depreciated assets idle property and property held for investment are properly disclosed The financial statements include disclosures of major classes of depreciable assets, accumulated depreciation, depreciation methods and amounts, based on valuation

SakTransGas' statutory balance sheet does not breakdown fixed assets into majors classes (such as buildings, meters heavy equipment land, etc The accounting records provide enough detail to determine which assets belong to each category

Conclusion Fixed assets may make up a material portion of SakTransGas' assets depending on the outcome of the ownership dispute of pipeline assets Audit risk is increased due to uncertainty over asset ownership, difficulties in determining appropriate valuation due to revaluation rules, inadequate repairs and maintenance and the use of barter transactions The cost of reducing audit risk to an acceptable level is hampered by the cost of using technical valuation experts, the cost of reconstructing price indexes to test revaluation amounts, and the cost of testing values used in barter transactions

D Accounts Payable and Other Liabilities

1) Overview

Account Payables arise primarily for the cost of gas purchased Relatively few purchases are made on credit Confirmations could probably be sent to vendors by fax but this should only be necessary for the largest and most active creditors Supporting documentation on most purchases is adequate Other payables are immaterial

Internal control over accounts payable is reasonably good as documentation requirements include certified meter readings and purchase and receiving documents which allow determination of amounts owed Other than the purchase of gas most other purchases are for cash or barter therefore the amount of other payables is not significant

A potential problem could be unknown claims from vendors resulting from the recent merger

2) Audit Objectives

a) Accounts payable represents a complete presentation of authorized current obligations that arose from purchased goods or services Accounts payable are properly classified as current liabilities, and disclosure is made of related party payables and payables with explicit payment terms

Since a large portion of payables is owed to one vendor, the most efficient audit procedure would be to confirm the balance due and reconcile any difference between the amount recorded in the accounting records and the amount confirmed

Due to the large number of barter transactions it would be preferable to confirm balances due to large vendors and agree the amounts to company records

A search for unrecorded liabilities would also include an examination of bank transfers to creditors after the balance sheet date to determine if the items paid represent obligations that should have been included in payables at the balance sheet date

In addition, the auditor should check goods received both the month before and the month after the balance sheet dates and supporting documents to determine when the liability should have been recorded

All of the procedures listed above do not appear to offer the probability of high audit risk, primarily due to the low level of payables and the ability to confirm the amounts due

b) Accrued and other liabilities represent a complete presentation of unpaid cost and expenses and the amounts owed are computed, classified and described in a consistent manner

Wage accruals could be tested by recalculation to the amounts not paid and examination of payroll records and bank records Some ' spot checking' should be performed by direct confirmation from employees of amounts owed

Taxes payable in association with wage payments and for value added tax can be checked against tax returns and proof of payment from bank records

Other liabilities are immaterial

Conclusion Audit risk is reasonably low for accounts payable and other liabilities The effort and cost of determining the fairness of presentation in the financial statements is modest

Recommendations

Based on our conclusions as expressed above in the areas of Receivables and Fixed Assets we believe that audit risk is moderate It is highly unlikely that a financial audit conducted using International Standards of Auditing would lead to an unqualified audit opinion that the financial statements of SakTransGas are fairly presented in accordance with International Accounting Standards

The most likely result of such an audit would be either a disclaimer of opinion due to limitations of scope caused by the lack of sufficient competent evidential matter The main areas of uncertainty are pipeline ownership and collection of receivables

Finally, any opinion given on the financial statements may be tempered by wording in the report that would indicate that the Company may not be able to continue as a going concern due to liquidity problems

APPENDIX E

REPORT ON SAKNAVTOBI

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Georgia Scoping Study

for Financial Evaluation of Energy Enterprises

REPORT ON SAKNAVTOBI

Description and Background of the Company

Saknavtobi was established in 1930 and has been involved in the geological exploration for oil reserves for over 65 years The company was financed by the Soviet budget and controlled by Moscow until the collapse of the Communist regime in 1991 The company came under the control of the GoG and became the State Department of Oil in 1992 and finally, a state enterprise under the Ministry of Fuel and Energy in 1997 No financing has been provided from the GoG and the company began joint venture operations in 1991 as a means of survival There was a Presidential Decree in February 1998 which stated that Saknavtobi should become a joint stock company with 100% of ownership controlled by the GoG

There are 580M tons of proven oil reserves in Georgia now 200M tons on the Black Sea shelf and 380M tons within the territory of Georgia Of this amount, only 7% or 27M tons have been extracted The same is true for gas with only 300M cubic meters extracted from 98B of proven reserves The company's production reached a high of 3M tons annually but has fallen off to 200,000 tons annually due to lack of financial resources Saknavtobi completed an oil pipeline (with an annual capacity of 5-7M tons per year) in 1977 that stretches from Azerbaijan to the port city of Batumi on the Black Sea

The company derives its revenues from joint venture operations There are currently 4 joint ventures with two new contracts almost ready Probably 2-3 more years with adequate financing are necessary to fully explore potential reserves in Georgia The production sharing of each joint venture to date has been established by Presidential Decree, although a law is currently pending in the legislature

The company had a profit in 1996 and 1997 but is experiencing cash flow problems As of the date of this report, the Company is 6-7 months in arrears with salary payments to its 2000 plus employees Reasons provided for the cash shortage included Gardabani's inability to make payment for the 1 8M GEL of mazut that was purchased for (and sold to) the company by Saknavtobi as a result of a 1996 Presidential Decree In addition to the uncollectible Gardabani sale, the company must also now prepay profit tax of 20% on the transaction as the result of recent legislation

Another major contributor to the cash squeeze was the Ioris Valley joint venture which had declining production from 1995 to 1997 returning $5 8M less than scheduled Particularly dismal was production in 1997 which was less than 30% of planned output in this Georgian-Swiss deal Representatives of the Ministry of Fuel and Energy have been investigating the situation and both GoG and the Swiss company plan to install new management in the joint venture It appears that the problems resulted from operational incompetence in the field and mismanagement by both joint venture partners

The Georgian British Oil Company joint venture has had a high return, with the actual 1997 production slightly exceeding the planned 85 000 tons, and also marking a 16 700 ton increase over the previous year Normally petroleum contracts are written for five years to allow time to decide on the extent of exploration, and another twenty years for production Saknavtobi pays the royalty (5-10%) and property taxes on the GBOC joint venture, but does not pay the royalty taxes on the Ioris Valley JV Each joint venture differs and the terms of all have been set by Presidential Decree New legislation is pending for future "production sharing"

Summary of Meetings with Company and Analysis of Transaction Cycles

A Introduction

Our fieldwork was conducted on June 25-26 1998 when we visited the Saknavtobi administrative offices During our visit we interviewed and obtained information from the following people

- Revaz Tevzadze, President
- Gogi Beraia, Deputy President
- Ivan Lobzhanidze, Vice President
- Vakhtang Sakvarelidze Vice President
- Otar Tetvadze, Head of Financial-Economic Department
- Tamaz Keratishvili, Chief Accountant
- Ketevan Jighauri, Deputy Accountant
- Jermal Bokhua, Head of Commercial Department (Dispatch/Sales)

B Acquisition and Production Cycle

1) Saknavtobi is essentially a service company with the departments billing the Joint Venture operations for services provided Currently the Department of Oil and Gas Production provides product separation services to the Joint Venture operations Subsequently, bills are forwarded for product costing

2) The process begins when Joint Venture management agrees to the physical production and sends control documents with the oil to the Department of Oil and Gas Production for processing Control documents are also forwarded to Saknavtobi headquarters where amounts are reconciled monthly

3) After the oil, gas and water are separated at the Production Department, tankers are loaded nearby Oil is also transported by rail to Batumi for storage and shipment via the Black Sea The Sales and Dispatch group compares rail transit documents with receipt summaries prepared by Saknavtobi at the destination location and ensures that losses during transit are reasonable Up to three months production may be required to load a tanker with 25-28,000 tons of oil

4) Dispatch orders and sales documents are created from contracts negotiated at Saknavtobi headquarters and shipments originate from the appropriate location Maritime consignment documents are created when the oil is loaded into the tanker and 50% of the shipment price is then transferred by the buyer Contract price is established by the world price of oil after the tanker is loaded and copies of all shipping and final customer receipt/payment documents are sent to the accounting department

5) A Georgian-American joint venture refinery company recently began operation and is processing 20 tons per day now, with the capacity to do 100-120 tons per day Routing and control documentation have been established to ensure proper flow of raw materials and products

6) Cash purchases are disbursed from headquarters accounting after appropriate documents are forwarded for payment No determined procedure for purchases could be ascertained but management at the Department has the authority to approve routine or necessary purchases There are no barter transactions

C Fixed assets subsequent to acquisition

1) Fixed assets include office buildings and equipment, oil processing devices and storage containers Note that almost two thirds of the Fixed Assets account (19M GEL) are in Construction in Process Depreciation is calculated by applying a fixed rate to the net book value of major asset categories

2) Asset revaluation Assets have been revalued three times based upon historical value Assets were increased by an indexation method In 1992 the value of fixed assets increased by a multiple of 35 in 1993 by a multiple of 300 and in 1995 by a multiple of 12 7 The multiple was determined by Presidential Decree in each case and another revaluation is scheduled during the Summer of 1998

3) Revaluations are allowed under IAS under certain conditions and utilizing certain methods Without knowing the basis for the calculation of the multiple it is not possible to determine if the valuation is in accordance with IAS

   Under IAS self-constructed assets should be initially measured at direct costs plus production overhead No amount should be included for general and administrative costs or interest expense

4) The upkeep and safeguarding of company assets is often referred to as management s stewardship and custody function Management has the responsibility to ensure that assets are properly used, properly maintained and properly guarded against theft This is accomplished by internal controls that provide appropriate "tagging" of the assets so they can be located, proper documentation so movement of the asset can be tracked and so that only authorized individuals have access to the assets Internal control also requires keeping maintenance records and having a system that flags assets for required maintenance

D Revenues and Accounts Receivable

1) Oil export sales from Joint Venture production are partially prepaid and fully collectible All collections are by bank transfer

2) Saknavtobi's Accounts Receivable does include 1 2M GEL owed by Gardabani for mazut and 335,000 GEL advanced to the Ioris Valley JV for Budget payments The Gardabani transaction was ordered by the Government and payment is questionable, while the loan to Ioris Valley should be collectible

E Payroll

1) Salary level is determined by the Financial Planning Department based upon job classification The pay for workers is production-oriented, while administrative work has an hourly base Wages range from 96 GEL per month for a general employee to 120 GEL per month for an administrative person Joint Venture workers receive 335 GEL per month

2) Salary payments to employees are 6-7 months behind schedule due to the potentially uncollectible receivable from Gardabani and the poor operating performance of the joint venture Ioris Valley

3) Payroll is automated for the administrative and headquarters staff at the company

F Disbursements and Accounts Payable

1) A formal purchasing procedure has not been established and documents are submitted from the Departments and Limited Companies to headquarters accounting where they are reviewed and paid

2) Current Accounts Payable outstanding include 1M GEL for salaries and Budget 1M owed to creditors and 2M owed to Sakenergo Generatsia for mazut supplied/sold to Gardabani

G Budgeting and Financial Planning

1) Financial forecasts and budgets are prepared for the planned volume of company oil production in addition to some forecasts for joint ventures The finance department calculates the unit cost of the oil and the selling price of export crude is determined in accordance with the international rules of oil trading For sales within Georgia the price must be determined by the Ministry of Economics Approximately 97% of total volume of oil production in Georgia is from four joint ventures

2) Forecasts and budgets of service work and construction are also prepared Reviews of actual vs budget are made in the accounting department for control and management information Strategic plans are also prepared

H Accounting Function

1) Accounting operations are decentralized and each Limited company within the Saknavtobi regime prepares and submits accounting records monthly for consolidation Joint Venture companies also maintain their own records and periodically, the Saknavtobi audit group reviews pertinent records

2) Joint Venture profits are shared according to the contractual agreement established Saknavtobi records its share of the profits as income and also accounts for revenues from fixed assets leased to the JV

3) Journals and a general ledger were manually prepared and appeared to provide the basis for a mechanical summary of financial records However, several clerical errors were noted on the accounting records examined

4) Accruals are made monthly All entries in the ledger are made from journals or other supporting documents The Deputy Accountant prepares the consolidated financial statements using the one personal computer at the company

5) The financial statements are prepared in accordance with legislation and as directed by the Ministry of Finance The statements include a Balance Sheet and Income Statement, with other reports and supporting schedules as required under the circumstances Cash flow statements are not prepared by Saknavtobi

6) The Company reports a profit and pays profit tax Taxes that the company pays include the following

- Profit tax - 20%
- VAT for non-export operations - 20%
- Tax for using natural resources (royalty fees) - 5% of total price
- Social tax - 27% of gross salary
- Unemployment fund - 1% of gross salary
- Medical fund - 3% of gross salary
- Property tax - 1%of total fixed assets

I Internal Control

1) One person in the accounting department reviews the other departments and the Limited companies that are accountable to Saknavtobi in order to ensure proper controls and financial presentations Records at Joint Venture companies are periodically reviewed also

2) Because JV's are not required to submit their financial statements to Saknavtobi monthly, serious operating problems at Ioris Valley went unchecked This is a serious control weakness and proper financial reporting and operating information requirements should be established and continuously monitored

Findings and Auditability

A Cash

1) Overview

JV's are required to make payment for amounts due to Saknavtobi by bank transfers The JV's themselves receive 50% downpayments on sales through bank transfers with supporting

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documentation Payments are generally made by bank transfer Cash payments require signed documentation

2) Audit Objectives

a) Cash exists and is owned by the client

Cash in bank – Cash in bank accounts can easily be confirmed by bank personnel and adequate documentation exists to prepare and audit bank reconciliations Company documentation exists for each bank transaction Adequate controls exist over the authorization and execution of bank transactions Customer payments are primarily by bank transfer

b) Cash balances reflect a proper cutoff of receipts and disbursements

A proper cutoff at the balance sheet date is determinable for cash in the bank

c) Cash balances as presented in the balance sheet properly reflect all cash and cash items on hand, in transit or on deposit with third parties

The cash balances presented reflect all cash items Petty cash funds are not reconciled but the amounts are immaterial

d) Cash balances are properly classified in the financial statements and any restrictions on the availability of funds are properly disclosed

It does not appear that there are any restrictions on cash at this point in time Any restrictions would be determinable through confirmation with the bank

Conclusion It appears that adequate procedures and controls exist to make a determination whether cash is fairly presented

B Accounts Receivable

1) Overview

Oil export sales from Joint Venture production are partially prepaid and fully collectible All collections are by bank transfer

Almost 50% of the current Accounts Receivable is from Gardabani and resulted from a fuel purchase transaction ordered by the GoG A determination cannot be made at this time as to the ultimate collectibility of this amount At this time Gardabani would appear to have no way to pay this off without assistance from the government or donor agencies

2) Audit Objectives

a) Accounts Receivable are authentic obligations owed to the company at the balance sheet date

The authenticity of accounts receivable are generally determined by sending confirmation letters to customers who are asked to acknowledge the amount of their debt at the balance sheet date This procedure could be accomplished via fax requests Almost all revenues are from joint ventures and the Company has the authority to examine the books of the JV's Therefore, authenticity should be able to be verified

b) Accounts Receivable includes all amounts owed to the company at the balance sheet date

The inclusion of all valid receivables requires a proper sales cutoff and assurance that all of the transactions have been posted This is possible except for the unknown reliability of manual records kept by the accounting department As specified above the ability to examine the books of each JV should provide assurance regarding proper inclusion

c) The allowance for doubtful accounts is adequate but not excessive

The adequacy of the Allowance for Doubtful Accounts is generally determined by

- Reviewing cash receipts subsequent to the balance sheet date

- Preparing and reviewing an "aging" of accounts receivable to determine how long individual amounts have been outstanding and applying estimated percentages of uncollectibility to individual receivables It is assumed that the longer a receivable is outstanding, the lower its probability of collection The percentage applied is based on the experience of the enterprise as well as current economic circumstances

With almost 50% of the Accounts Receivable from one customer whose operations and financial transactions are influenced by the GoG, a conservative approach is suggested This would result in establishing the Allowance for Doubtful Accounts equal to the entire amount due from Gardabani and a small percentage based on historical evidence for the remainder

d) Accounts Receivable are appropriately classified in the balance sheet and required disclosures are made

Accounts receivable that are due and collectible within one year should be classified as current assets The Allowance for Doubtful Accounts should be separately shown The method for determining the amount of the Allowance and bad debts expense should be disclosed None of these items should cause significant audit problems

Conclusion Audit risk is relatively low for receivables due to

- The ability to verify the receivables through the joint ventures If the joint ventures are themselves audited (by other auditors), the cost of verification would be low If the JV's are not audited, this step could be costly

- The good experience in collecting receivables (other than Gardabani) results in a low risk and low audit cost to establish an adequate Allowance for Doubtful Accounts

C Investments in Joint Ventures

1) Overview

Under IAS, the accounting treatment for investments in JV's depends on the degree of control the partner has over the JV's operations Control is defined as the ability to make management decisions that affect operations including purchases sales financing investing and dividend payments Control usually requires having more than a 50 percent ownership interest in net assets and profit of the venture If the Company has "control" of the venture the assets, liabilities revenues and expenses of the JV should be consolidated with the Company's other operations Therefore the receivables, fixed assets, payables, etc of the JV's would be included in the balance sheet of the Company

It is possible for a company to lack control, but to have "significant influence" on the JV This would mean that the Company would have influence in management decision making but would not be able to make those decisions unilaterally "Significant influence" is determined by the facts and circumstances of each JV If the partner is deemed to have significant influence, the investment should be accounted for using the "equity method" Under this method, the assets liabilities, revenues and expenses are not consolidated Instead, the balance sheet will include an asset labeled "Investment in Joint Venture" and will record that investment initially at cost including cash paid as well as the bookvalues of other net assets contributed Subsequent to the initial investment, the account will be increased by additional assets contributed and also by the partner's share of the JV's net profit The asset will be reduced by any dividends paid to the partner since this will be a return of the investment to the partner

If the partner has neither control nor significant influence the asset is carried at its historical cost until it is eventually sold or abandoned Dividends received would be treated as Investment Revenue on the income statement

Saknavtobi's primary activity is its investment in JV s The auditor would have to determine the the extent of control or influence in each case and verify that the accounting is appropriate Saknavtobi does not account for the investments based on control or influence Assets transferred to joint ventures remain on Saknavtobi s books unless the JV transfers cash or other assets in return in which case it is treated as a sale Any cash invested is reported as investment asset on the books Distribution of profits from the JV is treated as profit to Saknavtobi

2) Audit Objectives

a) Investments in Joint Ventures actually exist and recorded transactions actually occurred

Existence would be determined by examination of the legal documents establishing the venture and by visiting the premises and viewing the assets and operations on a test basis This would be time consuming and would involve travel costs but would not pose a problem in verifying existence

b) All investment transactions are recorded

A review of the audited financial statements of the JV would be the best evidence available If these are not available the auditor would need to obtain the unaudited financial statements, determine that they were in accordance with IAS and then utilize them to determine that all investment transactions have been properly recorded

c) Investments are valued in accordance with IAS

Each JV would need to be evaluated to determine in there is control or significant influence being exerted by Saknavtobi In any of the three possible scenarios described in the Overview (above), adjustments would need to be made to the Company's financial statements It should be relatively easy to determine if Saknavtobi has control by determining whether there is more than 50% ownership Significant influence will be more difficult to determine The adjustments required in either of these cases may be very difficult or costly to determine

d) All disclosure required by IAS have been made

Required disclosures include the amount of control, the accounting method used, related party transactions between the Company and the JV After the previous objectives are achieved, the Company will have the necessary information for disclosure purposes

Conclusions

This is the major area of audit risk for Saknavtobi since this the major activity of the company If the JV's are preparing financial statements in accordance with IAS and they have been audited in accordance with International Standards of Auditing audit risk will be low and the cost of auditing this area will be reasonably low If IAS has been used but there has not been an audit of the JV, it is likely that the JV will have to be audited in order to gain reasonable assurance that Saknavtobi's financial statements are in accordance with IAS As there are several JV s, this could make the cost of audit prohibitive If the JV's financial statements are not in accordance with IAS this would add even more cost to the audit

D Fixed Assets

1) Overview

Fixed assets include office buildings and equipment oil processing devices and storage containers Almost two thirds of the Fixed Assets account, or 19M GEL are in Construction in Process

According to Georgian accounting law, purchased fixed assets are stated at historical cost Historical cost under IAS and Georgian law is calculated differently The primary difference is that under IAS, historical cost includes the amount paid for the asset plus additional costs required to obtain the asset and to get the asset ready for use These costs include taxes, installation, freight and insurance Under Georgian accounting, these costs would be treated as period costs or overhead

Self-constructed assets are valued at the total of direct costs (materials and labor) plus an allocation of overhead It is standard practice in Georgia to include all indirect costs in the calculation of overhead, which is then allocated to the cost of self-constructed assets Under IAS, for the purpose of calculating construction costs, only indirect construction costs are allocated to the cost of the asset

Since 1989, fixed assets have been revalued three times The revaluations were required based on a Presidential decree Companies were allowed to choose any of three methods in calculating the revalued amount These methods were

a) Indexation Method – historical cost was multiplied by an index specified by the government The index varied based on the type of asset and its date of purchase In

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1992 under this method assets were increased by an average multiple of 35 In 1995 the average multiple was 300 In 1997 the average multiple was 12 7

b) Direct Valuation Method – assets were valued at their replacement cost

c) Combined Method – assets were valued by a combination of the above methods

d) Under IAS companies may revalue assets under certain conditions and using certain allowed methods An indexation method is allowed where the index is based on a reliable measure of the change in prices over time Replacement cost is also an allowable method subject to consideration of technological change

e) Tax law prescribes depreciation rates A fixed percentage, specified by law is applied to the undepreciated cost of the asset This is similar to the declining balance method which is allowed under IAS However, under IAS the rate allowed must be calculated based on the estimated life of the asset The rate prescribed by law may not approximate the rate allowed under IAS

2) Audit Objectives

a) Property, plant and equipment (PPE) reflected in the accounts represent a complete listing of capitalizable cost of assets purchased, constructed or leased by the company and such assets are physically on hand

This objective requires the following procedures to be performed

- Preparation of a schedule of all PPE in existence at the balance sheet date based on physical observation of those assets

  This schedule could easily be prepared by company personnel and the accuracy of the schedule could be verified by applying appropriate sampling techniques

  Assets owned by joint ventures may have to be included in Saknavtobi's financial statements under IAS This depends on the amount of "control" that Saknavtobi has over each venture This is explained in the preceding section

- Comparison of the schedule to assets included in the accounting records

  The comparison could be performed by accounting department personnel who do not have direct responsibility for fixed asset accounting

- Preparation of a schedule of existing assets not included in the accounting records and preparation of a schedule of assets included in the accounting records that were not physically observed

The schedules could be prepared by accounting department personnel who do not have direct responsibility for fixed asset accounting

b) PPE is valued at cost in accordance with IAS Accordingly noncapitalizable costs are properly expensed and capitalizable costs are excluded from maintenance or other expense accounts

This objective requires the following procedures to be performed

- Vouching of the historical costs to supporting documentation and to determine that non-capitalizable costs have not been included

  Company procedures do require source documents to be maintained for all purchases This could be verified on a test basis

  For cash purchases, differences between the calculation of historical cost under IAS and Georgian law should not be material

- Examination of repairs and maintenance accounts to determine that account balances do not include costs that should have been capitalized

  This procedure should be able to be performed in a reasonable amount of time It is probable that extraordinary repairs that would be capitalizable under IAS have been charged to overhead

- Recalculation of the components of the cost of self-constructed assets

  This procedure requires the restatement of historical cost to exclude non-construction overhead items that have been allocated to asset cost This may be a difficult and time consuming procedure depending on the age of the asset and the available records that support the original calculation A first step would be an estimate of the materiality of expected adjustments If adjustments are expected to be material and adequate evidence is not available this could potentially preclude an unqualified opinion However, subsequent revaluation procedures could make this calculation irrelevant

- Review of methods used in revaluation of PPE to determine if in accordance with IAS

  As discussed above, the methods of revaluation prescribed by law would be in accordance with IAS depending on the measurement techniques adopted and applied

- Test of revaluation calculations for reasonableness

Where the indexation method has been used it would be necessary to determine if the index used approximates price changes in the cost of the asset This would require the auditor to obtain documentary evidence of price changes This could be more easily verified for recent revaluations

Where the replacement cost method is used documentary evidence is required by the government to justify the valuation used Therefore evidence should exist which would allow the auditor to verify the amount used in the revaluation

c) The cost and related depreciation applicable to all sold abandoned damaged or obsolete property have been properly removed from the accounts and PPE is properly classified in the balance sheet

Due to the technical nature of a large portion of Saknavtobi's assets it would be necessary for a valuation specialist in utility company assets to examine assets on hand to determine their condition and operability The cost of retaining valuation specialists, calculating the amount of any required adjustment and reclassifying the accounts could be substantial

d) Depreciation charged to income during the period is adequate but not excessive and has been computed on an acceptable and consistent basis The balances in the depreciation allowance accounts are reasonable considering the expected useful lives and salvage values

The method utilized by Saknavtobi is an acceptable method under IAS The auditor would need to determine that the useful life used in the calculation is reasonable and that the arithmetic accuracy is acceptable It would also be necessary to determine that depreciation calculations properly reflect revaluation adjustments made in the current and prior years It is expected that there would be no difficulties in performing the necessary procedures

e) Property is properly classified in the balance sheet and fully depreciated assets, idle property and property held for investment are properly disclosed The financial statements include disclosures of major classes of depreciable assets, accumulated depreciation, depreciation methods and amounts based on valuation

Saknavtobi's statutory balance sheet does not breakdown fixed assets into majors classes (such as buildings, meters, heavy equipment land, etc The accounting records provide enough detail to determine which assets belong to each category

Conclusion Fixed assets make up a material portion of Saknavtobi's assets Audit risk is increased due to difficulties in determining appropriate valuation due to revaluation rules and the difficulty in auditing fixed assets included in joint ventures The cost of reducing audit risk to an acceptable level may be hampered by the potentially high cost of inventorying JV assets located in scattered locations, the cost of using technical experts to inspect assets, and the cost of reconstructing price indexes to test revaluation amounts

E Accounts Payable and Other Liabilities

1) Overview

Amounts are owed to SakGen for the special mazut purchase to other vendors and to the GoG Other payables include accrued wages and as of June 1998 employees wages were 6-7 months in arrears

Internal control over accounts payable is reasonably good as documentation requirements include purchase and receiving documents which allow determination of amounts owed Most purchases are for cash and the amount of other payables is not significant

2) Audit Objectives

a) Accounts payable represents a complete presentation of authorized current obligations that arose from purchased goods or services Accounts payable are properly classified as current liabilities, and disclosure is made of related party payables and payables with explicit payment terms

Large payables, such as the amount owed to SakGen should be confirmed Others can be verified to source documents on a test basis

A search for unrecorded liabilities would also include an examination of bank transfers after the balance sheet date to determine if the items paid represent obligations that should have been included in payables at the balance sheet date

In addition, the auditor should check goods received both the month before and the month after the balance sheet dates and supporting documents to determine when the liability should have been recorded

All of the procedures listed above do not appear to offer the probability of high audit risk, primarily due to the low volume of payables and the ability to confirm the amounts due

b) Accrued and other liabilities represent a complete presentation of unpaid cost and expenses and the amounts owed are computed, classified and described in a consistent manner

Wage accruals could be tested by recalculation to the amounts not paid and examination of payroll records and bank records Some "spot checking" should be performed by direct confirmation from employees of amounts owed

Taxes payable in association with wage payments and for value added tax can be checked against tax returns and proof of payment from bank records

Other liabilities are immaterial

Conclusion Audit risk is reasonably low for accounts payable and other liabilities The effort and cost of determining the fairness of presentation in the financial statements is modest

Recommendations

The primary audit risk is in the valuation of the joint ventures and fixed assets While evidence is available to perform an audit, it could be very expensive to obtain in both of these areas The major variable affecting the cost of the audit is the condition of the accounting records at the joint ventures and whether Saknavtobi has "control" or "significant influence' over the JV s operations

If the JV accounting records are in accordance with IAS and they have been audited in accordance with ISA, the cost of auditing Saknavtobi s share of assets liabilities, revenues and expenses will be low and it should be able to arrive at an unqualified opinion if Saknavtobi s accounts are restated Since the joint venture partners are primarily from Western countries, it is quite possible that ISA audit's have been completed

If the JV accounting records are in accordance with IAS and they have *not* been audited in accordance with ISA, an audit would need to be undertaken of the JV's The cost of this depends on the availability of documents and other audit evidence for each JV

If the JV accounting records are not in accordance with IAS they would need to be restated and audited This would be very time consuming and expensive

APPENDIX F

REPORT ON GIC (GEORGIAN GAS INTERNATIONAL CORPORATION)

Georgia Scoping Study

for Financial Evaluation of Energy Enterprises

REPORT ON GIC (Georgian Gas International Corporation)

Description and Background of the Company

Georgian Gas International Corporation was established in 1996 by Presidential Decree The stated purpose of the company was to provide for the organized transit of natural gas from the territories of Russia, Turkmenistan, Kazakhstan and others through the territory of Georgia GIC was organized as a joint stock company

Management explained that all trunk gas transmission lines were given to the company in another Presidential Decree for the purpose of carrying out its mission That is, the company needs to have a substantial balance sheet in order to be considered a proper participant in international contract negotiations These fixed assets are currently on the books of Saktransgasmretsvi and there has been some disagreement over the transfer of the fixed assets to GIC

On June 20, 1997, the assets were transferred by Decree of the Ministry of State Property Management

On November 29, 1997 Saktransgasmretsvi submitted a signed schedule of assets to GIC for transfer Another signed document presents a schedule of assets for physical transfer to the books of GIC beginning on July 1 and to be concluded by September 1, 1998 The Director of GIC has indicated that he expects the asset transfer to be made on the books of both companies to coincide with the June 30, 1998 fiscal and tax reporting period History indicates that these expectations may be overly optimistic

The Ministry of State Property previously announced a tender for part of the assets of Saktransgasmretsvi An international group, Intergas bid and won the management rights for five years to 100% of the pipeline assets that are not gas trunk transmission lines These assets are the buildings, storage equipment, gas stations, and other ancillary devices that surround the pipeline operation Intergas is a subsidiary of Interpak, which also controls six Municipal distribution companies in large Georgian cities

Saktransgasmretsvi is a service company and GIC negotiated an agreement to ensure the transmission of gas for the population during the last winter period However, Management indicated that this company has become very inefficient and loses 8% of the transmitted gas This loss rate is exceptionally high when compared with the American company ENRON where physical losses are 0 25% Actual loss is also very significant when you consider the 10% gas tariff for delivered Armenian gas and the resulting lost sales of 8%, or $16M annually GIC believes that Saktransgasmretsvi would benefit from competition

GIC also believes that Saktransgasmretsvi should be a viable entity even with only 60% collection of billings if the 8% gas transmission loss was brought under control Under the Soviet system, approximately $10M was spent annually on pipeline repair and maintenance, but these activities were halted in 1991 Intergas has agreed to reduce these transmission losses as part of their current contract with Saktransgasmretsvi, but there are no specific amounts of loss reduction or capital investment stated GIC expects to have a new contract with Intergas by July 15, 1998 and wishes to have specific amounts allocated to pipeline rehabilitation

The company has two main objectives and is involved in negotiations accordingly First, there is the construction of pipelines to serve Turkey (via Russia) and Turkmenistan GIC has a principle agreement with Russia and a 10 -point plan of action to be completed by year end The companies, Gazprom and Enron both want to participate in the modernization of the pipeline serving Georgia, as well as the ownership Second, GIC seeks to promote the cooperation of domestic companies in the sale of gas

It should be noted that GIC has not developed an operating plan or budget to guide and control its activities during two years of existence Some equipment and vehicles were transferred to the company's books during 1997, and a stream of revenues from pipeline usage fees in 1998 has funded minimal operating expenses and some salaries Management is confident that the provisions for all decrees will be implemented in the immediate future or the issues will be settled in court

Summary of Meetings with Company and Analysis of Transaction Cycles

Our fieldwork was conducted on July 1 and 2, 1998 when we visited the Georgia Gas International Corporation (GIC) administrative offices During our visit, we interviewed and obtained information from the following people

Dr Alexei Gotsindze, President

Gia Itovishvili, Director for Financial and Economic Department

Anbergi Albekioni, Chief Accountant

Levan Menagarishvili, Director International Relations Department

Because the company currently has nominal assets and revenues as a result of the long period required to implement the Presidential Decrees during 1996-97 further investigation was halted Matters relating to the asset transfer from Saktransgasmretsvi are scheduled to be concluded no later than September 1, 1998 Management is hopeful that all will be resolved before then but concedes that legal action may be required

Findings and Auditability

GIC has had very few transactions to date and there is uncertainty about which assets it will eventually receive as well as their condition While an audit could be completed of transactions to date, they would not provide any revealing information

Due to the lack of activity, there has not been much effort in setting up appropriate accounting

Recommendations

We would recommend having GIC keep its books on an IAS basis from the beginning This would provide financial statements which could then be audited without first having to convert them to IAS It would not be difficult or costly to keep dual sets of books There is also a very strong possibility that the GoG will mandate IAS for all enterprises before the end of 1998