

GUID 5320

GUIDANCE ON PERFORMANCE AUDIT ON PRIVATISATION



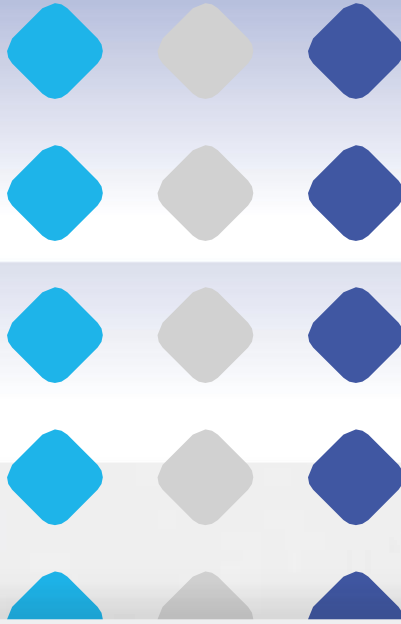
INTOSAI

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INTOSAI, 2021

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- 1) Independent public-sector auditing may serve to enhance the transparency and accountability of privatisation processes and obtain the lessons learned in order to provide recommendations for improvement in future privatisations. By carrying out performance audits SAIs can provide insights into whether the privatisation has been completed and the expected goals achieved in an economical, efficient and effective manner.
- 2) GUIDs (Guidance pronouncement) are non-mandatory guidelines for the use of the auditor when applying the International Standards of Supreme Audit Institutions (ISSAIs). This GUID provides guidance for conducting performance audit of privatisation, within the INTOSAI Framework of Professional Pronouncements (IFPP). This GUID is relevant for those with a mandate to do such audits.
- 3) This GUID is consistent with the Fundamental Principles of Public Sector Auditing (ISSAI 100¹), Performance Audit Principles (ISSAI 300²) and Performance Audit Standards (ISSAI 3000³).

¹ ISSAI 100 Fundamental Principles of Public-Sector Auditing, amongst other things, defines the purpose and authority of ISSAIs and the framework for public-sector auditing.

² ISSAI 300 - Performance Audit Principles builds on and further develops the fundamental principles of ISSAI 100 to suit the specific context of performance auditing.

³ ISSAI 3000 is the Performance Audit Standard and shall be read and understood in conjunction with ISSAI 100 and ISSAI 300. For each requirement set out in ISSAI 3000, supporting non-mandatory guidelines are provided in GUID 3910 Central Concepts for Performance Auditing, and in GUID 3920 The Performance Auditing Process.

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OBJECTIVES

- 4) The objective of this GUID is to provide guidance to the auditor on how to conduct performance audits related to the specific subject matter of privatisation of a government function, activity or public sector entity through various pathways.
- 5) ISSAI 300 provides the principles for Performance Auditing by SAIs while the ISSAI 3000 provides the requirements that the auditor must comply with in order to be able to assert that the audit has been conducted in accordance with the ISSAIs. As these ISSAIs are equally applicable to performance audits related to the specific subject matter of privatisation, this GUID refers to ISSAI 300 but without duplicating it.

DEFINITIONS

- 6) Privatisation refers to the transfer of public ownership or government functions to private entities. Privatisation is often undertaken with the expectation that it will result in higher quality of goods and services, lower costs, increased efficiencies or improvements in the performance and accountability of public sector management.
- 7) State-owned enterprises (SOE) are business enterprises where the government or state has significant control through full, majority, or significant minority ownership. SOEs may be known as Public Sector Units or Public Sector Enterprises elsewhere but their distinguishing features include their legal existence, form and operation in commercial affairs and activities. SOEs may be established, to varying degrees, with public policy objectives but they are to be differentiated from the pure public sector entities which are established to pursue sovereign, welfare or non-financial objectives.
- 8) There is no common definition for privatisation that is generally accepted and the specifics may vary from country to country. For the purposes of this GUID, privatisation may be considered as any material transaction or event by which the state's ultimate ownership of corporate entities is reduced⁴ or activities/functions traditionally undertaken by government, directly or through SOEs, are handed over (partially or completely) to private entities. Thus, although there is a common objective that public resources be utilised to maximise benefits to the public, privatisation practices themselves may vary across all levels of government, and may result in asset sales, public-private partnerships, or outsourcing⁵. These may take the form of
 - direct divestment by the state

⁴ Source: OECD document, Privatisation in the 21st Century: Recent Experiences of OECD Countries, Report on Good Practices, January 2009

⁵ A description of the various privatisation models, levels and stages of privatisation highlighting five major methods of privatisation and their characteristics and associated issues is given in Chapter 9.

- divestment of corporate assets by government-controlled investment vehicles
- the dilution of state positions in state-owned enterprises by secondary share offerings to non-state shareholders and
- shifting functions and responsibility, in whole or in part, from the state (or State Owned Enterprises (SOEs)) to private entities

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SCOPE

- 9) This GUID provides the auditor with supplementary guidance on the matters to consider when performing performance audits of privatisation. It is not intended to cover all items necessary to perform such audits and does not contain any further requirements for conducting the audit.

❖ Selection of audit topic

- 10) *Strategic planning*: Strategic planning for performance audits (ISSAI 300 (36)) of privatisation would involve understanding the privatisations undertaken by the government so as to allow an assessment of the risks involved (ISSAI 100 (46)) and the significance of the subject matter considered for audit as well as to decide the best possible stage of intervention. Identifying stakeholder expectations and defining the critical success factors while taking account of audit capacities (e.g. human resources and professional skills) helps to ensure that the topic selection process maximises the expected impact of the audit.
- 11) While selecting the individual topic for a performance audit of privatisation, the auditor should assess the auditability of the topic based on risk/problem assessment (ISSAI 300 (36)) and materiality of the privatisation. The significance of the entity/activity privatised would be another determining factor in the selection of a topic.
- 12) Relevant aspects for the auditor to consider in performance audits of privatisations are (i) the sharing of risks and benefits/ rewards from privatisation (ii) the privatisation scheme/modality chosen vis-à-vis the objective of the privatisation; (iii) the extent to which the privatisation objectives were achieved; and (iv) the effect of privatisation on the cost of services/facilities charged to the public or the users.
- 13) In shifting an activity from the government to the private sector, the nature of government oversight is transformed. As the components of government provision of goods and services are privatised, the jurisdiction or mandate of state oversight institutions including SAIs is reduced.
- 14) The SAI may need to consider whether and how it will have access to audit, at a later date, the resulting privatised entities or the activity which is being performed by a private agency. This is especially true for a performance audit, because in addition

to assessing whether the objectives of privatisation were achieved or not, auditing efficiency and effectiveness requires a long-term perspective. Thus, the SAI may require factoring in these aspects at an early stage in order to ensure that the SAI, does, indeed, have the possibility to audit at a later date.

- 15) *Risk/problem assessment:* In line with ISSAI 100 (46 and 47), risk areas and problems need to be assessed while identifying the topic for a performance audit of privatisation. Privatisation processes have several inherent risks and problems like wrong identification of a privatisation opportunity, competing objectives, improper valuation of assets, wrong selection of privatisation method, lack of competence in the privatisation team, non-transparency in the bidding process, the passing of undue benefits to parties involved, non-achievement of privatisation objectives and non-fulfilment of post-privatisation arrangements. As per ISSAI 300 (37), when planning an audit, the auditor should assess the risk of fraud. Besides knowledge of the internal controls, the auditor may like to utilise the internal auditor's risk assessment in this process.

❖ ***Designing the audit***

- 16) *Preliminary study:* After choosing the topic of performance audit of privatisation, the auditor should generally do a preliminary study (pre-study) (ISSAI 300 (37)). A pre-study will help the auditor to develop an understanding of the entity, e.g. its activities, financial situation, internal controls, finance and other systems, etc. as well as various aspects of the privatisation of the government activity /SOE. In addition to reviewing documentation related to the entity, the auditor may also examine earlier studies and other sources to gain a broad understanding of the subject and the regulatory environment in which it operates. Besides regular interaction with management, those charged with governance, internal audit and other relevant stakeholders, the auditor may consult subject matter experts, whenever required. The understanding gathered during the pre-study, is likely to highlight significant issues in the privatisation activity and help the auditor to design the specific performance audit in accordance with ISSAI 100 and 300.
- 17) During the pre-study, the auditor should also consider auditability (ISSAI 300 (36)) . This would involve considering whether sufficient, relevant and robust criteria are available for conducting a performance audit, for example, the government may not have an institutionalised system of post-privatisation reviews, which would have aided the auditor in having relevant criteria. At times, no reasonable basis may exist for developing audit criteria, for instance, lack of proper guidelines or a regulatory

framework on privatisation and how to utilise the proceeds would make it difficult to develop criteria. In some cases, even if criteria are available, obtaining the information or evidence required for comparison may be challenging, inefficient or may not be cost-effective. Another issue for consideration is whether it will be practically possible to have audit recommendations implemented.

- 18) *Understanding the SOE/activity being privatised and preparation for privatisation:* The auditor is expected to have a good understanding of the entity/activity being privatised. In the possible scenario that the SAI was the auditor of the SOE under state ownership before, the auditor already possess such knowledge institutionally. Nonetheless, the auditor may seek work of the internal auditors of the SOE to gain insights into the functioning of the entity.
- 19) It is generally an accepted good practice for valuations to be made before privatisations, in particular to value the business as a going concern so as to have a benchmark of likely proceeds against which to appraise bids. In such cases, the valuation - which can of course be a range of values, depending on the assumptions used - can also be used as a cross-check on the privatisation process itself when selective tendering processes are employed. Another important aspect is re-structuring of state-owned businesses or re-organisation of a publicly provided service / activity prior to privatisation. Such re-structuring or re-organisation ranges from putting the business into a legal form in which it can be sold to re-organising fundamentally the business / activity and its finances to fit better the long-term objectives of privatisation. The auditor needs to understand how and why the activity / entity was re-structured in order to make sense of the privatisation.
- 20) The auditor's understanding may be built on the following aspects and would include an awareness of the risks and problems associated with each:
- *Valuation of the business:* Correct valuation of the entity/activity to be privatised is essential to ensure most benefits to the executive. The auditor may understand the mode and methodologies involved in the valuation process to see if there are any risks and problems like incorrect choice or application of valuation methodology.

The assumptions used in the valuation have to be consistent with the purpose for which it is to be used. For example, if the SOE is being privatised through a competitive bidding process with end-result being a going concern then the valuation of the existing entity may be carried out on a going concern basis. The auditor may verify that the assumptions utilised in projections are based on a market participant view, rather than solely a company-specific view.

In addition, the auditor is to be aware that different measurement bases and valuation may be used for items like intangible assets, for instance, knowledge, goodwill and patents. Further, it is crucial that in these particular circumstances, i.e. of a public sector entity preparing for privatisation, the auditor have an increased awareness of the various risk hazards that are embedded in the financial reporting standards for reporting operating results. It is critical to see the extent of involvement of the Board of Directors and Audit Committees in subjective management decisions pertaining to the allocated values to various asset classes, including goodwill.

- *Re-structuring / re-organisation decision:* The auditor may attempt to develop a full understanding of any major re-structuring or re-organisation prior to privatisation. This will also help to identify the key factors influencing the decision to privatise, which may or may not have been set out in the stated objectives of the privatisation. Financial risks or problems identified may need to be resolved prior to privatisation and therefore, the auditor may take action to be aware of such issues and their likely and / or expected impact. For example, where the enterprise owed large debts to the government or other state-owned enterprises, to what extent these debts were written-off entirely or converted into equity or new debt, and what impact this had on the price the vendor was able to get for the business. It may happen that the vendor may conclude that the business will be unviable unless all, or a large proportion, of its debts are written off. The auditor would also like to be aware of the impact of the writing-off of debt on the overall financial condition of the government.

Another aspect of re-structuring activities will be regarding how the structure chosen for the enterprise can affect its marketability. Similarly, there may be conditions in the form of long-term contracts for maintaining turnover for the privatised entity or for prescribed investment levels.

Re-structuring activities are important because of the associated social costs, for instance, the government may have specified the levels of employment for post-privatisation but would have to bear the cost for employees being made redundant. Therefore, if this is a part of the audit objectives or scope, then the auditor may obtain an understanding of consequences for the personnel of the government entity that is to be privatised; and the financial consequences for the government when providing guarantees for employment and levels of salary.

- *Detailed financial analyses, implementation schedules, and technical reports, if any:* The auditor may review the detailed financial analyses and technical reports to

deepen their understanding of the business estimations. The understanding of implementation schedules will throw light on unrealistic projections, if any.

21) *Understanding the privatisation objectives:* Understanding the privatisation objectives and the risks/problems involved in them helps the auditor to develop the audit objectives. The auditor may note that contrary to popular assumptions, declining profitability of the privatised entity is not always the reason for privatisation. Even a profitable entity may be privatised considering other social or financial objectives, for instance,

- To improve overall efficiency of the SOE/entity;
- To encourage wider share ownership;
- To transfer commercial risks to the private sector;
- To secure investment (financial objectives);
- To enhance empowerment of citizens (social objectives);
- To release resources for priority social sectors (social objectives).

The auditor may ascertain the full implications of the privatisation objectives since these determine the focus areas in the performance audit of privatisation. For example, if the objective is to privatise the entity against a timetable rather than maximising proceeds, in order to establish investor confidence in the privatisation process, it may be outside the auditor's remit to say that the state could have delayed the privatisation in order to get a better price.

Awareness of the outcomes and consequences of the government's stated objectives will also help the auditor to identify any important unstated objectives. For example, even if not a stated objective, the auditor may still examine as to whether the privatisation resulted in maximum price benefits.

22) Knowledge of the origin of the privatisation provides an opportunity to understand the different incentives of the participants and, thereby, locate elements of risk, for instance, the risk of competing objectives. The auditor may find that the objectives and intentions of the government may be multiple and complex and consequently, the risk connected to the privatisation increases with the risk of competition between some of the objectives. To elaborate the example, there may be a time-line for the privatisation, which may be in conflict with the goal to obtain the maximum price as the market conditions may not be conducive. Similarly, the risks to the privatisation process may arise from the ministry's skills, knowledge and experience with regard to privatisation.

- 23) In order to assess the consequences of the privatisation process, in a holistic manner, the auditor may have a clear picture of the services provided by the government entity for the taxpayer, before and after privatisation. This will influence the assessment that the auditor makes of the extent to which objectives have been met, by not looking at the achievements in an isolated manner. Thus, the auditor may also focus on post-privatisation undertakings and events and assess the gap between the same. This will cast light on the extent to which the privatisation objectives were achieved.
 - 24) *Understanding the nature, process and mode of privatisation:* The auditor needs to examine the due diligence exercised by the state before deciding upon the privatisation. Therefore, the auditor will need to have knowledge of the possible ways of privatisation in different contexts. The auditor may look at the many resources examining aspects of privatisation for example, government research institutions, trade and advocacy organisations, and academia. The government may decide to adopt any one of the various methods of privatisation viz., trade sales, management and employee buy-outs, mass privatisations, auctions, contracting-out, outsourcing and flotations. Accordingly, the auditor may examine the specific options considered with their associated advantages and disadvantages, why the chosen route was selected, the criteria applied in deciding on the chosen privatisation method and whether these were impacted by the pursuit of any wider objectives of the privatisation programme.
 - 25) In one example, the government was required to dispose off the computer support services for a group of state-owned hospitals. This was an attractive business venture since the hospitals were anxious to secure continued support for their computer systems. Instead of marketing the business vigorously as a trade sale opportunity, the government treated it as a service procurement exercise and the SAI established, through a valuation, that as a result the government got a much less advantageous deal for the taxpayer. In the light of the SAI's report, the health department has undertaken to consider in future the case for trade sale in such disposals.
 - 26) While conducting research about the privatisation, the auditor may keep in mind the following, knowledge of which will eventually allow him to analyse the outcomes from the perspective of economy, efficiency and effectiveness.
- *Identification of privatisation opportunity:* Analysing how the executive arrived at the privatisation opportunity and the deliberations which led to the decision will throw light

on the intended privatisation objectives and expectations of the executive from the privatisation. The auditor may be able to notice the risks and problems in the identification stage itself, say for example, the incorrect assessment of the intended benefits/results of the privatisation which is most likely to result in non-achievement of the privatisation objectives at a later stage.

- *The regulatory environment requirements:* The auditor may understand the requirements of the regulatory environment to know the boundaries and limitations set by the requirements, on the privatisation process, if any.
- *Selection of personnel and experts:* The auditor may learn about the selection of members to be responsible for the privatisation, including the choice and employment of experts. This will not only throw light on whether the executive has exercised due diligence in the same but also shows if there is any conflict of interest, resulting in ethical risks and problems.
- *Demarcation of responsibilities of each involved party:* The auditor may understand the roles and responsibilities of the parties involved in the privatisation process. This may highlight probable conflicts in the roles, if any.
- *Decisions on privatisation mode and technique:* There are many modes and techniques of privatisation. Choosing the appropriate mode and technique is most likely to yield most benefits to the executive. The auditor may analyse the deliberations by the executive or by the experts involved, in arriving at the choice of mode and technique, to understand the intended benefits, problems in the choice, if any.
- *Business plan or other documents that include objectives of the privatisation:* The auditor may review any documents that contain the deliberations on the objectives of the privatisation and the business case/plans to understand the spirit of the intended benefits out of the privatisation.
- *Bid solicitation, evaluation process and negotiation process with winning bidder:* These are important components of the privatisation and it is essential that they happen in a transparent and fair manner. The auditor's understanding of the bid solicitation and evaluation process will throw light on risks and problems related to the government's management and oversight arrangements of the process. In some cases there may be requirements to negotiate with the bidders under certain circumstances, say for example, the most eligible bid does not match with the expected price/benefits and the executive may choose to negotiate with the eligible

bidder rather than repeating the entire process once again to be economical. The auditor may review such decisions to see how they impacted the achievement of objectives or efficiency of the privatisation process.

- *Resultant contractual arrangement and handing over to non-government entities:* The final contractual terms and conditions between the privatisation parties will highlight risks and problems in the achievement of intended objectives, if any, like lesser benefits received by the state, disadvantageous terms to the executive, compromises to the quality/quantity of public goods and services, monopoly to the private sector etc.,
 - *Post- privatisation arrangements and residual issues, if any:* The auditor may review the post-privatisation arrangements to see if there are apparent long term implications and disadvantages to the State as a result of the privatisation and if there are proper arrangements in place to ensure the economic and social interests of the state in the privatised sector.
- 27) *Defining the audit objectives:* The auditor should set clearly defined audit objective(s) that relate to the principles of economy, efficiency or effectiveness in line with ISSAI 300 (25). Audit objectives are then broken down into increasingly more detailed audit questions, thematically related, complementary, not overlapping and collectively exhaustive in addressing the overall audit objectives. The auditor may choose the audit objectives or a combination thereof. The list below is indicative in nature and is not meant to be an exclusive or exhaustive one.
- a) Whether the objectives of the privatisation process were defined in an objective and transparent manner and adequate action was taken to pursue these objectives;
 - b) Whether key preliminary issues related to the privatisation opportunity (like pre-privatisation valuation and assessment, restructuring etc,) were identified and addressed prior to privatisation;
 - c) Whether the privatisation partner was selected in a manner most beneficial for the objectives of privatisation and most likely to achieve the outcomes and whether adequate safeguards were put in place to ensure probity and transparency in the entire privatisation process;
 - d) Whether the long-term issues such as monopoly, loss of control in strategic areas, residual assets/liabilities etc. have sufficiently been addressed;
 - e) Whether the government had mechanisms in place to ensure compliance by private entity with the agreement conditions after the privatisation; and
 - f) Whether the objectives of privatisation were achieved and whether there was a mechanism in place to examine the same.

- 28) *Formulating the audit questions:* After the audit objectives are established, in accordance with ISSAI 300 (25), the auditor may develop audit questions which will address each of the audit objectives. The following is an indicative list of audit questions, relevant to the audit objectives illustrated in paragraph 27:
- a) *Objective: Whether the objectives of the privatisation process were defined in an objective and transparent manner and adequate action was taken to pursue these objectives?*
- Has the responsible party defined immediate objectives for the privatisation? Are these in line with the overall purposes as defined through law or parliament decisions on the privatisation?
 - Has the responsible party defined the longer term objectives and were the short-term and long term objectives in line with each other?
 - Did the short term and longer term objectives relate to the development of the market economy and social and environmental considerations?
 - Were all objectives explicitly stated? Did both stated and unstated objectives interact and affect the conduct of the privatisation?
 - Was the privatisation process designed to match the objectives for the privatisation?
- b) *Objective: Whether key preliminary issues related to the privatisation opportunity (like pre-privatisation valuation and assessment, restructuring etc.) were identified and addressed prior to privatisation?*
- Has a pre-privatisation feasibility study been conducted before deciding on privatisation and all the relevant factors (including correct financial information) were taken into account before deciding on privatisation?
 - Has the extent of pre-privatisation re-structuring been adequately investigated upon and carried out as per the requirement?
 - Was the need/requirement of advisors/specialists/experts to carry out privatisation initially assessed, and were suitable resources sourced?
 - Did government ensure no conflict of interest when identifying the specialist and impartial external advice they needed to carry out the privatisation, were the cost effective steps taken to secure such advice and were such advisors/specialists/experts appointed in a timely manner?
 - Was the pre-privatisation valuation efficient and effective by being based on appropriate assumptions and founded on accepted principles of business valuation?
 - Was the pre-privatisation valuation arrived at independently of the private party as well as the management of the public sector entity?

- Was the pre-privatisation valuation a useful guide in appraising bids and in negotiations leading to the final accepted bid, and how it compared to the privatisation price?
- Were all feasible privatisation methods sufficiently deliberated upon and if any method was excluded from such detailed deliberation, whether reasons and justifications for the same have been recorded; and whether such method chosen promoted economy and efficiency?
- c) *Objective: Whether the privatisation partner was selected in a manner most beneficial for the objectives of privatisation and most likely to achieve the outcomes and whether adequate safeguards were put in place to ensure probity and transparency in the entire privatisation process?*
 - Had the government established criteria for evaluating the bids received?
 - Were the criteria established with reference to the privatisation objectives and were they satisfactory to ensure that the best possible privatisation outcome will be achieved?
 - Was the appropriate criteria adopted for the particular stage of the entity being privatised?
 - Was the criteria unduly rigid so as to discourage innovative proposals?
 - Were the bid evaluations proper? Was the selection of private entity transparent? Was the integrity of the privatisation process maintained?
- d) *Objective: Whether the long-term issues such as monopoly, loss of control in strategic areas, residual assets/liabilities etc. have sufficiently been addressed?*
 - Did government have adequate structural arrangements in place to manage the residual issues?
 - Had government considered and taken adequate steps to address monopoly of the private sector in the concerned business sector?
 - Had government considered the strategic impact of such privatisation on important aspects like defence, national security, food security etc., in the long term?
 - Does the public or national accounts adequately reflect (including quantification where possible) any residual assets and liabilities, actual or contingent?
 - As per the privatisation terms and conditions, has the state been able to detach itself from all the activities or obligations of the enterprise / activity being privatised or are they still obligations, outstanding litigation issues, or residual employee or property obligations for those items not included in the privatisation?

- Have appropriate arrangements been made for on-going management of residual assets like leased property etc?
- e) *Objective: Whether the government had mechanisms in place to ensure compliance by private entity with the agreement conditions after the privatisation?*
 - Has the purchaser met the terms of any agreement allowing for all or part of the payment for the business to be deferred for a specified period?
 - Has the purchaser fulfilled the undertakings given as regards employment or investment levels in the business?
 - Has the Parliament established a legal and regulatory framework for the resultant private entities within which they are required to operate and whether the regulatory framework is operating as intended?
 - Has the government sought to protect the interests of the taxpayer by, for example, establishing time limits, financial limits or other termination arrangements?
- f) *Objective: Whether the objectives of privatisation were achieved and whether there was a mechanism in place to examine the same?*
 - Were immediate goals of high value of proceeds, targeted share price after flotation, etc achieved?
 - Were broader goals related to economic, social and environment concerns achieved?
 - Was any particular objective (example: fast-track privatisation) achieved at the cost of another objective (example: business was not correctly valued)?
 - Were the privatisation objectives reached in the given time-frame?
 - Were the privatisation objectives achieved qualitatively?
 - Did the citizens receive the similar or better quality services after privatisation?
- 29) *Defining the scope of the audit:* The scope of the performance audit of privatisation is determined by the audit objectives and audit questions. Privatisation is a complex and a wide activity. To avoid an overly complex or expensive audit, the audit scope may exclude certain activities or entities from the audit, based on the risk-assessment and problem identification, even if the activities or entities in principle would be relevant to the audit objective. If the privatisation under audit is one of the first such by the executive, it is possible that the executive may also expect the auditor to highlight the lacunae in it as a value addition. Thus, it is useful to discuss the audit scope with the audited entity and seek their views and inputs whilst avoiding undue influence by the audited entity regarding changes to the audit scope.

- 30) *Setting the audit criteria:* The auditor should establish audit criteria in line with ISSAI 300 (27) addressing the audit objectives and questions. The auditor can use many different sources to identify audit criteria. An indicative list of such sources of audit criteria, in relationship with the audit objectives, which may be used in the performance audit of privatisation is given below:
- The legislation enabling the privatisation, related cabinet decisions, minutes of cabinet meetings, ministerial directives etc. would indicate the privatisation objectives and the issues related thereof to the auditor. They may also assist the auditor in understanding the rationale behind the decision to privatise the SOE, pre-privatisation, re-structuring, privatisation method adopted, etc.
 - SOE's mission statement, strategic plan, corporate plan, management plan, annual reports; Performance statements of the SOE; Planning documents, contracts and budgets from the audited entity, Internal guidelines and procedures established by the SOE including organisation charts, etc., would indicate the pre-privatisation structure of the SOE and may be considered for validating the external advisor's recommendations regarding SOE's commercial viability and growth prospects,
 - Evaluation of the internal control system and internal audit related to the privatisation process would assist the auditor in the reliance to be placed on the integrity of the privatisation process.
 - Case studies of privatisation process in other countries; International benchmarks of good performance; Standards from research, literature or professional and/or international organisations, International benchmarks of good performance, General management and subject-matter literature, Criteria used previously in similar audits or by other SAIs, Standards set by the auditor, possibly after consultation with subject matter experts may all serve as audit criteria for the audit of the privatisation process.
 - Returns filed by the SOE, external advisors, and the private entities who participated in the privatisation process would aid in assessing their competence and absence of conflict of interest.
 - Key performance indicators set by the audited entity or the government.
- 31) Since the privatisation itself will have its own objectives and outcomes like the achievement of investment and efficiency gains, these may also be adopted by the auditor as the source of criteria/criteria themselves. This will be particularly relevant for objectives which are observable only during post-privatisation undertakings and events, for instance, regarding increasing productivity and raising the level of service

quality; impact on unemployment; impact on the financial market; extent of its impact on the reserves, linkages to the position of deficits or surpluses in government budgets etc.

- 32) *Audit approach:* The audit approach will describe the nature and extent of the procedures to be used for gathering audit evidence and also determine the necessary knowledge, information and data needed.
- 33) The auditor may choose a problem-oriented approach or result-oriented approach depending on the risks and problems identified during the pre-study. The auditor is expected to adopt a result-oriented approach in the performance audit of privatisation, if the objective is to measure the outcome in terms of economy, efficiency and effectiveness and also comment on better practices. However, if the preliminary study indicates significant instances of deviant practices in the privatisation process or if the outcome is already known to be less than optimum and there is dissatisfaction among stakeholders, which is a problem in itself, the auditor may adopt a problem-oriented approach in line with the risks and problems identified. Such an approach will also comment on the lessons learned for future privatisations. While both approaches can be pursued from a top-down or bottom-up perspective (ISSAI 300 (26)), the auditor would have to choose the perspective based on its relevance to the expectations of the stakeholders, implications for future decision-making and reporting requirements. Since the top-down perspective concentrates mainly on the requirements, intentions, objectives and expectations of the legislature and central government, it may be more in line with the problem-oriented approach. A bottom-up perspective focuses on problems of significance to people and the community and may, therefore, be more applicable for the result-oriented approach.
- 34) As per ISSAI 300 (26), performance auditing can also follow a systems-based approach, i.e. this approach examines the proper functioning of management systems, e.g. financial management systems. Adding elements of such an approach in the audit design may be useful when the auditor is auditing the functioning of a department responsible for privatisation or is looking at multiple privatisations in the same sector or at mass privatisations.
- 35) *Audit procedures / choosing methods to gather audit evidence:* In conducting the audit, the auditor chooses relevant audit procedures, i.e. interview of key personnel, review of documents, analysis of financial statements, etc. However, there may be

some procedures specific to the performance audit of privatisation, e.g. the auditor may need to carry out valuation of the SOE through viable alternative methods/experts, if the same was not carried out by the state.

- 36) *Good project management and review and approval of the plan by audit management.* The auditor designs the audit according to the requirements of ISSAI 300 (37). When making an audit plan, it is important to determine the timetable and the resources needed. Every privatisation is unique and has inherent complexities which may result in a complex audit project, if not planned well. It is of utmost importance that the auditor have a well-defined duly approved audit plan with a clear and realistic timetable, to ensure timely completion of a quality audit.
- 37) Further, privatisation involves a wide range of third parties in addition to the government and company management. Establishing the involved parties, their roles in the privatisation and feasibility of gathering evidence from such parties by gaining access to their records is an inherent risk in an audit of privatisation. Sometimes, for example in major share sales, the auditor may need to establish evidence on a global scale.
- 38) It could be advisable that the auditor may start the audit process soon after the privatisation to ensure adequate access to the audit evidence held by the government, management, their internal auditors and their advisers, and also to the views of key third parties with a close interest in the privatisation.
- 39) The auditor may assess the management's response to identified risks and problems, including utilising internal audit's risk assessment, and its implementation and design of internal controls to address them.
- 40) *Managing audit risks:* In line with the ISSAI 300 (28), the auditor may include the discussion of specific audit risks and plan to mitigate them in the preliminary study. These risks may differ from one privatisation to another and will vary depending on the audit objectives.
- 41) *Skills and knowledge required to conduct a performance audit:* Privatisation varies in complexity, scale and volume and audit of the same requires knowledge of topics related to corporate finances, accounting, law and business management, etc. Given the range of issues, it is necessary that the audit team collectively possesses the required knowledge and financial, analytic and technical skills to audit privatisation (ISSAI 300 (30)). The audit team is expected to possess knowledge about legal,

economic, commercial, political aspects of the privatisation in addition to the traditional audit skills. SAIs may like to create such institutional structures that would be a mix of internal and external resources which complement each other's efforts.

- 42) The SAI may also invest in capacity building that encourages specialisation in different areas of the privatisation process and is relevant for the SAI's mandate and kinds of audit that it takes up. As part of this learning process, SAIs may find it helpful to exchange experiences and information with other SAIs on completed audits. SAI may also consider sending some of its staff on secondment to external specialist firms to obtain the necessary expertise, and to participate in seminars, symposia and conferences focusing on privatisation themes.
- 43) *Use of external experts:* The auditor has to consider if there is a need to consult with internal or external experts (consultants, other auditors) in order to enhance the quality of the audit. If the requisite knowledge and skills could not be sourced internally, the same may be sourced from external agencies (ISSAI 300 (30)). For example, the pre- privatisation valuation of assets is a technically complex subject area for which the auditor may not be able to source in-house resources and, therefore, may involve external expertise for the assessment of such pre- privatisation valuation. Even otherwise, experts' perspective in this area will add value to the audit process. Thus, given the complexities involved and possible lack of prior experience, expert advice on several areas can be sought, which may include specific nuances of the sector and/or the enterprise, use of valuation methodologies and legal issues. Further, experts can be used in one or all stages of the audit such as planning, conducting and reporting. However, care may be taken that the experts engaged do not have any conflict of interest by virtue of their involvement with the audited entity or the private party, prior to the privatisation to ensure independence of the auditor.
- 44) *Fraud risk:* Privatisation involves fraud risks not just at the time of initial privatisation but also throughout the lifespan of activity/entity that has been privatised. In order to assess the same, the auditor may, in line with ISSAI 300 (37), assess whether adequate safeguards were in place to ensure that the privatisation was carried out in accordance with legal requirements and in a transparent manner. The auditor may ascertain if any allegations of improper practice were raised during the privatisation process. Another issue to be seen is the existence of conflicts of interest and whether decisions detrimental to the taxpayers' interest were taken so as to increase the chance of a successful privatisation. Similarly, the auditor may look at the post-privatisation scenario, for example, it may be seen whether the terms of

contract/agreement between the government and the private sector entity have been structured so as to minimise risk of fraud or compromising public interest. The auditor identifies and assesses the risks of fraud relevant to the audit objectives, for which they may maintain an attitude of professional scepticism and be alert to the possibility of fraud throughout the audit process.

- 45) *Communicating in the planning phase:* At the initial stages of the audit itself, the auditor, the audited entity's management, those charged with governance and others, as applicable, reach a common formal understanding of the terms of the audit and their respective roles and responsibilities. ISSAI 300 provides that this encompass the subject, scope and objectives of the audit, access to data, the report that will result from the audit, the audit process, contact persons, and the roles and responsibilities of the different parties to the engagement. In line with ISSAI 300 (29), the auditor shall initiate effective and proper communication right from the planning stage with the audited entities and relevant stakeholders and maintain the same throughout the audit process.
- 46) Specifically, for an audit of privatisation, the auditor may solicit due cooperation and support of the audited entity in arranging and providing access to the records and information of private entity/entities, who has/have acquired/invested in the state-owned enterprises (SOEs) or were involved in the process in any other way, viz., as intermediaries, consultants etc.

- 47) The performance audit would engage with a number of third parties with diverse outlook/objectives; these parties may include the management and internal audit of the SOE being privatised, private entities which invested in the SOE, government or institutional investors, other bidders, advisors, staff representatives/employee unions, domain experts, industry and academic experts and affected consumer groups. The audit may identify both potential and actual stakeholders.
- 48) The auditor, on the basis of identification of all the parties involved in the process of privatisation/disinvestment, after establishing their respective roles in the process, obtain information/evidence from all the parties. The nature and timing of the procedures, quality of evidence, etc would also depend upon the stage of privatisation. For instance, appraising the pre-marketing exercise and analysing the valuation procedure would have different procedures.
- 49) Similarly, the stage at which the auditor is making an intervention will influence the conduct of the audit, for instance, the auditor may carry out an assessment of the entire privatisation process or of only a part. If the auditor looks at a particular stage only, like the pre-privatisation re-structuring, the state's objectives will determine the focus and adequacy of actions taken. It is, however, possible that the auditor is looking at the privatisation policy or department from a systems perspective, then, the auditor is more likely to assess the controls including the adequacy of safeguards in place to ensure transparency in the selection of advisors, book-building exercise etc.
- 50) The auditor may face difficulties in obtaining sufficient and appropriate evidence and may encounter objections on grounds of commercial confidentiality over publishing key details, such as the identity of bidders and the amounts they bid or paid. In order to allay such concerns, the auditor should establish effective communication throughout the audit process with the audited entity and keep them informed of all matters relating to the audit (ISSAI 300 (29)). In audit of privatisation, various related parties such as

regulatory bodies etc. may also be informed simultaneously since their response could be essential while framing audit conclusions.

- 51) The assessment by the auditor and the evidence gathered by them would have to be sufficient to be able to form conclusions in line with the audit objectives. The complexity of the subject matter in privatisation cases may, often, lead to situations where the evidence is not immediately conclusive but rather persuasive. Therefore, it can be useful to have discussions at the beginning or during the conducting phase with the experts in the field. Thus, during the conduct of the audit, obtaining the evidence may involve the following procedures but analysis and interpretation will have to be a more sophisticated exercise:

Review of privatisation process and pre-privatisation activities

- i. The auditor may review the documents used by the state to arrive at the decision of privatisation to analyse the outcomes in order to see the balance achieved between various competing objectives and what was the impact upon benefits to Government, the private entity and the citizen;
- ii. The auditor may review the documents, information, data, evidence used by the state in selection of the privatisation method, and verify whether such information was validated, reliable and complete;
- iii. The auditor may review the list of personnel (of the government / SOE) involved for their skills and qualifications and assess the availability of the right skills with the SOE/government to carry out the process of privatisation. The quality of financial, legal and marketing skills will have to be reviewed against the impact on proceeds and also in the success in resolving difficult technical issues before bringing the business or service to the market.
- iv. Wherever, the assistance of external experts/advisors was opted for by the State in the privatisation process, the auditor may assess and analyse the relevant documents, correspondences and notings of the decision makers to know the extent to which the inputs of the advisors influenced the decisions of management, including the selection of privatisation approach or valuation methods etc. In assessing the quality of advice on offer, the auditor may examine the track record of the experts and manner in which they have adapted the appropriate techniques, number and level of potential investors, etc

- v. The auditor may verify whether appropriate legal advice and assistance was obtained throughout the privatisation process and, in case any such advice was discounted, documented reasons for doing so may be called for and scrutinised;
- vi. The auditor may assess the general market position and the relevant business environment of the privatised entity/activity and examine whether timing of privatisation was appropriate *vis a vis* the stage of the entity / activity.

Review of entity being privatised

- vii. Comparison of the financial indicators and ratios of similarly placed SOEs in the specific industry/business environment may provide the auditor with reliable estimates of the business value of the privatised entity/activity. The pre-privatisation re-structuring carried out by the SOE/government may be examined by the auditor to check if the re-structuring impacted the value of the entity in a negative manner, i.e. analysis would have to be more towards implications for the privatisation process than the outcome of re-structuring on the organisation in a silo.
- viii. The exercise of valuation of the enterprise may be carried out independently by the auditor for verification, and various different methods of valuation may also be adopted for comparison. Also, the authenticity of the data used by the audited entity for valuation, the assumptions and inputs applied in the valuation may be verified during the audit.

Review of bidding process

- ix. The documents related to the bidding process may be reviewed and analysed to see if the bids are appropriate, properly circulated and whether sufficient information were provided to all bidders, such as to ensure competitive and transparent bidding.
- x. The selection criteria, technical and commercial evaluation of bidders etc. may be examined for their reasonableness and appropriateness. The auditor may also check if the criteria have been applied uniformly and consistently with respect to all bidders.
- xi. The bid processing documents may be verified to see if the evaluation of offers included quantification of all aspects of the offer including post-privatisation liabilities, debt transfers, tax considerations etc. and guarantees/indemnities if any of the government;
- xii. The auditor may assess the delays, if any, in bid processing and the impact of such delay on performance of the SOE during this interim period, especially in relation to the terms and conditions of the privatisation.

- xiii. The terms of the agreement between government/SOE and private entity, including those regarding the undertakings given for employment or investment levels in the business, may be analysed to ascertain if the terms were in line with the established objectives of privatisation;

Review of achievement of objectives and post-privatisation events / impact

- xiv. The auditor may examine the arrangements which have been put in place to deal with any implications for the transfer of assets from the government with regard to state and local laws, to find if there are any gaps and shortcomings on the part of the state and also the resultant impact may be assessed.
 - xv. The auditor may arrive at a list of residual issues of a privatisation activity, both expected and unexpected by the State. The auditor may assess and enquire if the Government has established required mechanisms to address those issues and if there are any lacunae or gaps, resultant impact; and gather appropriate evidence to the effect.
 - xvi. The extent to which established timelines for the process were met may be ascertained and the auditor may compare the timelines with the previous privatisation processes, if any, to comment upon the practicality of the established timelines; auditor may also see whether the costs of privatisation did not exceed reasonable levels;
 - xvii. The auditor may investigate allegations of improper practice and establish whether there were any lapses in procedures. On the basis of evidence gathered, the auditor may assess the extent to which such lapses have adversely affected the achievement of intended objectives of privatisation;
 - xviii. The auditor may assess the extent to which the government has correctly and timely and fully informed parliament about the privatisation, in all stages.
 - xix. The auditor may assess the extent to which the long-term goals of privatisation have been achieved, by way of comparing the intended privatisation objectives, mentioned in the business case documents and the realised benefits.
- 52) In case of examination of technical reports prepared by government/SOE through a third-party on technical subject matters such as valuation of the assets of the SOE, the auditor may devise a methodology to place reliance on the contents of such reports to be adopted as evidence. This methodology may include the assessment of the selection process of the third party, scope of work, competence and capability of the team that worked on the project, their independence etc. The methodology may include

a test-check of the technical reports of third-parties to assess their accuracy and neutrality. The auditor may engage independent experts to assess the technical reports on a test-check basis. If, as a result of such checks, reliance is placed on the contents of such reports, the fact of reliance may be suitably disclosed.

- 53) Communication is essential in the analytical process because the auditor has to consider the context and all relevant arguments, and different perspectives before the audit conclusions can be finally drawn. For this reason, the auditor needs to maintain an effective and proper communication with the audited entity and relevant stakeholders. (ISSAI 300 (29))

- 54) The auditor while reporting upon a privatisation activity may consider the statutory and internal limitations on disclosure of financial and technical information of the SOE and private entities involved in the process of privatisation. Thus, in line with ISSAI 300 (41), the SAI should make its audit reports widely accessible taking into consideration regulations on confidential information, while following the proper procedures for clearance and fact validation with the audited entity.
- 55) As the subject matter of privatisation is complex and technical, the auditor may provide background information to establish the context for the overall message and to help the reader understand the findings and significance of the issues discussed (ISSAI 300 (39)).
- 56) ISSAI 300 (39) requires the auditor to prepare timely reports. Further, in order to provide balanced and comprehensive coverage, if in accordance with the SAI's procedures, the auditor may consider providing interim reports of significant matters to the audited entity. In such scenarios where the privatisation is being done in stages, and performance audit of initial stages has been initiated, timely reports would act as a feedback for the government and assist in deciding whether any course correction is required. Timely reports would also be helpful where privatisation of more than one SOEs has been planned by the government. The auditor also needs to explain the effects/impacts of the problems in the audit report because it will allow the reader to better understand the significance of the problem. This will in turn encourage corrective action and lead to improvements by the audited entity.
- 57) Simultaneously, the auditor may be aware of the sensitivity of the information presented in the report, especially if the SOE was dealing with matters of national importance or strategic issues or if the information relates to a trade secret etc., which is sensitive from a commercial aspect, and whose reporting may be detrimental to the entity investing in the SOE.

- 58) The SAI may therefore, encounter objections on grounds of commercial confidentiality over publishing key details, such as the identity of bidders and the amounts they bid or paid. SAI may have to consider the potential negative impact of disclosing such information in relation to the need or requirement for publishing the information. For example, if the report on the audit of privatisation highlights some crucial information about the commercial/strategic activity of the SOE, competitors may gain undue advantage of such information. In such a scenario, the auditor may consider options such as not reporting the sensitive information in full, in order to avoid potential adverse impact on the private entity which has invested, or the government. However, the SAI may consider whether there are any public interest arguments for keeping such details confidential. If the SAI concludes that such arguments are compelling, (for example in order not to discourage bidding in future privatisations) (s)he may wish to consider providing these details in a confidential report to Parliament.
- 59) As instances of privatisation are not frequent, the opportunities available with the state to improve on its own are restricted. Therefore, audit recommendations may be given high importance by the state. Thus, it is expected that the auditor is alert in identifying lessons from the privatisation process and may add value by giving practical recommendations so that subsequent privatisation events/processes are carried out more efficiently. According to ISSAI 300 (39), the auditor should prepare a complete and balanced report.

- 60) Typically, privatisation of a particular SOE would entail a one-time audit, and, therefore, follow-up audit may not be generally required. Nonetheless, wherever the audit report includes findings related to comparison of the performance of the entity and its operating environment before and after privatisation/disinvestment, a follow-up of these findings after a certain period of time may be considered by the SAI.
- 61) Follow-up audits may be both appropriate and necessary in those situations/entities/arrangements where the government maintains a financial liability and interest in the program, good, or service, that has been privatised, for example in the infrastructure sector, roads and highways, etc.
- 62) Further, the state may have similarly placed SOEs or it may have more than one company in that sector. For instance, many countries have multiple SOEs in the oil, transport or pharmaceutical sectors. There might be several future privatisations possible in that sector; and there are valid reasons for audit to perform a follow-up audit and subsequent examination of the weaknesses in the bodies involved, systems in operation, and changes made.
- 63) Also, privatisation in a single SOE can easily happen in multiple stages over a period of time. In such a scenario, follow up audits can be taken up of an earlier stage of privatisation. The findings of this follow up audit can inform executive decisions in planning and managing future privatisation stages in the given SOE.
- 64) Lastly, the privatisation/disinvestment of a particular entity may be a one-time activity. However, the government may pursue the disinvestment of other entities. Therefore, it is incumbent upon the auditor to derive best practices and lessons learned and ensure that these are being implemented by the State. Reliable information on the implementation status of recommendations, the impact of audits and the relevant corrective actions taken, can help demonstrate the value and benefit of the SAI.

VARIOUS PRIVATISATION MODELS

The main methods of privatisation are described below.

Trade sales

A trade sale is the sale of a business, or part of the business, to another business typically operating in the same industry or sector. Trade sales are a common form of exit for a company's management and investors. The acquiring company often makes a strategic decision to purchase the company to acquire the underlying intellectual property owned by, or the market share captured by, the company it is purchasing.

It is often the case that a business broker or independent intermediary acts on behalf of the owner/directors, making initial contact with parties interested in purchasing. Trade sales can take a number of different forms including the sale of the company's shares, or only underlying business assets such as stock, goodwill, or premises.

If a trade sale is being considered for a business which is solvent and is expected to continue operating, information about the company will need to be provided to interested parties in the form of a sales memorandum, including the reasons why it is being sold. But even if a business has entered insolvency or is facing legal action by creditors, a trade sale organised from within a formal insolvency process may still be a viable option and offer the best returns for the company's creditors.

Once one or two serious buyers are identified, in-depth negotiations take place and the due diligence process commences whereby the information provided is scrutinised in detail by potential purchasers.

A prospective buyer may insist that certain warranties and indemnities are provided to reduce their risk, so professional legal and financial assistance is required at intervals throughout the process.

Management and Employee Buyouts

A management and employee buyout (MEBO) is a restructuring initiative that involves both managerial and non-managerial employees buying out a firm in order to concentrate ownership into a small group from a widely dispersed group of shareholders.

MEBOs are generally used to privatise a publicly traded company but can also be used as an exit strategy for venture capitalists or other shareholders in an already private firm. MEBOs are often seen as a way to bring greater efficiency to a firm's production because they can provide added job security for employees – motivating them to give a stronger effort to improve company profitability.

MEBOs may be used by corporations that wish to pursue the sale of divisions which are not part of their core business, or by private businesses where the owners wish to retire. An internal team of management and employees will pool their resources to acquire a business they operate or manage. Funding often comes from a mix of personal savings and capital, seller financing or private equity financing.

This type of buyout is conducted by management and employee teams that want to more directly benefit from the growth and future direction of the company than they can do as employees-only. Although the potential to reap the rewards of ownership is significant, employees and managers must make the transition from being employees to owners, which requires more of an entrepreneurial mindset. This may not always be a smooth transition.

Mass Privatisations

Ownership diversification is typically a stated objective of mass privatisation. It is intended to address the perceived inequalities of ownership resulting from other forms of privatisation, especially given that workers and the public in general saw themselves as part of the collective ownership structure of former command economies. To that end, mass privatisation programmes seek to include the broadest participation of the public as investors. The public may, however, generally lack any significant experience of private ownership and may know little about the meaning and rights of share ownership. Yet the success of mass privatisation programmes is often judged on the percentage of participation by citizens as investors. Setting deadlines for completion is useful. Public relations campaigns are important to educate the

public about privatisation in general and about specific selling mechanisms. It is believed that mass privatisation programs are an effective way to privatise large numbers of enterprises in a short period of time. In addition, because these programs have spurred the development of capital markets and therefore the ability to buy and sell shares of enterprises, in some cases mass privatisation has proven to be effective in subjecting enterprises to the test and rigor of the market.

Contracting out and Outsourcing

A major privatisation device is "contracting out," i.e. when the government hires private firms to provide government services under contract services for some time have been provided by private contractors.

Utilisation of the private sector in producing services is an important element in the movement toward reforming government. The aim is to contain costs, increase productivity, or improve quality. There are choices as to the type of privatisation to be employed. Contracting out that involves retaining ownership and overall control but employs a private sector operator, is the dominant form. Although there is strong evidence of the benefits of privatisation, several important factors must be present for optimisation. In particular, the bidding process must be competitive, and the contract must be carefully structured.

The rationale for outsourcing is that there is a difference in principle between providing for a public service and producing that service. government may be responsible for maintaining highways, collecting garbage, or operating recreation centres, but just like any private company it is faced with a "make or buy" decision about that service. Economic theory suggests several reasons why outsourcing might be more cost-effective than in-house provision. First, the unit of government with responsibility for the service may not be of the optimum scale to provide the service efficiently. Second, it may lack the required expertise or technology, for various reasons. Third, and probably most important, a perpetual in-house monopoly will have weaker incentives to innovate in order to find more cost-effective ways to operate. Competition to be the service deliverer should produce stronger incentives.

Public Floation

Public floatation on stock exchange, either by a fixed price offer, a tender offer with a minimum bid or a combination of both is another way to privatise. This method is used for larger companies where the demand for their share was expected to be high. To encourage small

investors the government frequently sells some shares to them at a fixed price whereas the larger investors are asked to submit tenders.

Privatisation Auction

Auctioning public enterprises is a standard way to achieve a fundamental objective of privatisation: generating government revenue. Both theoretical and empirical work so far on the structure of auctions and competition among bidders suggests that more competitive auctions should lead to higher prices.

Other characteristics of the auction's structure, such as possibilities for renegotiation or for several rounds of bids when the initial offers do not reach the minimum price expected by the seller, also influence bidding strategies and, therefore, prices.

Another influence on competition in the auction process is participation by foreign investors. The government may favour domestic groups by isolating the auction from foreign bidders. But opening the process to foreign bidders should drive up prices by increasing competition and reducing scope for collusion, particularly in oligopolistic industries of developing countries. Insufficient domestic private savings may be another argument for allowing foreigners to bid. Auction requirements that serve to reduce participation, such as bidder prequalification and restrictions on the form of payment (for example, cash-only sales), can also affect prices.