The economic activities of E-Arsenal Ltd in 2003-2004

Audit report No OSII-2-5/05/22 of March 21, 2005

Executive summary

E-Arsenal Ltd is a government-owned company whose primary purpose is to meet the needs of the defence forces of the Republic of Estonia for the development and repair of arms. The State Audit Office (SAO), according to its work programme, audited in October and November 2004 the economic activities of E-Arsenal Ltd for the period from 1 January 2003 to 1 October 2004, focusing on the legality of economic transactions and their conformity with the principal goals of the company. The organisation of accounting and reporting in the company were also audited as well as the proper functioning of internal control systems. The rate of return from the main operations of the company has been assessed according to the indicators that characterize the entire operating period of the company.

Relevant observations and findings

The government's ownership interests in E-Arsenal Ltd (all shares belong to the Ministry of Defence) have caused loss to the state and do not comply with the State Assets Act.

- The accumulated loss of the company since its foundation is about EEK 5.4 million as at the end of 2004 (non-audited data).[1]
- The loss generating operations (as well as negative cash flows) of the company have been financed through the transfer to the ownership of the company, as a non-monetary contribution, of a registered immovable property belonging to the state and part of this property was later disposed of to the renters. The accumulated loss from continuing operations less the proceeds from the sale of assets amounts to nearly EEK 10.3 million. To sum up, this is detrimental to the government as an owner and does not conform to the provisions of the State Assets Act.

The products and services of E-Arsenal Ltd are not of strategic importance and can be replaced by other products and other service providers. The company does not trade in high technology products.

- According to the Ministry of Defence, the situation as to the defence policy is fundamentally different and today government ownership of the company is not necessary.
- According to the opinion of the core clientele (excl. the Logistics Department of the Defence Forces) of E-Arsenal Ltd, the products of E-Arsenal can be replaced by goods ordered from elsewhere and the Defence Forces are developing the capability to maintain and repair armament and other defence equipment.

In the opinion of the SAO, the strategic goals of E-Arsenal Ltd for 2003 and 2004 were overly ambitious and unrealistic. The Ministry of Defence has failed to direct the activities of the company to a necessary extent. The Council and the Board have not taken adequate action to improve the financial position of the company through its main operations.

- In line with the new strategy devised at the beginning of 2004, the 2004 turnover was projected to be EEK 15.7 million, but the turnover for the first nine months of 2004 was only EEK 6.8 million. The loss from continuing operations of the company has grown to EEK 4.9 million over the first nine months of 2004. The occurrence of loss is due to lower production volumes resulting from the reduction of production orders by the defence forces and the expenses persisting at the current levels (most expenses are the so-called fixed expenses).
- The Ministry of Defence has not sufficiently directed and controlled the activities of the company. The Council and the Board have not been given detailed instructions for improvement of operations of the company, although the Ministry was aware of the deteriorating financial condition and the poor prospects of the company.
- With reference to Protocol No 4-1/13 of the meeting of the Council of E-Arsenal Ltd on 20 September 2004, upon the sale of the company the Board of E-Arsenal intends participating in the competitive bidding, depending on the upset price. It follows from the above that the Directors of the company are interested in the acquisition of the stock of the state-owned company under their management.

On some occasions the resources have not been used prudently or in compliance with law.

- Despite the growing loss and lower production levels of E-Arsenal Ltd, the salaries expense has remained relatively flat.
- The members of the Council of E-Arsenal Ltd receive remuneration irrespective of their presence in the Council meetings where decisions have been made.
- The Manager of E-Arsenal Ltd, who is simultaneously the President of the Junior Chamber International Estonia, received reimbursement for travel expenses from the company when the Manager attended the JCI World Congress in Copenhagen and the national event organised in Estonia.

Proposals by the SAO

To the Minister of Defence

- Find the most appropriate way for the termination of the company and its sale and submit respective proposals to the Government of the Republic. The SAO supports the proposal of the Council of the company to terminate the operations of E-Arsenal Ltd.
- If it is decided that the government will retain ownership of the stock of E-Arsenal Ltd, the Minister should:
    - Together with E-Arsenal Ltd, draw up a production plan for a minimum of five years which is based on the orders put by the defence forces and a professional cost-benefit analysis; direct the activity of the company for the introduction of new products as ordered by the Estonian Defence Forces;
    - Instruct the internal audit department of the Ministry to monitor and analyse the economic activities of E-Arsenal Ltd and conduct regular audits, if necessary;
    - Appoint a representative of the Estonian Defence Forces to the Council of the company.

To the Council of E-Arsenal Ltd

- Improve supervision, especially of growth in revenues and cutback in expenses; require the management of E-Arsenal Ltd to submit information about matching costs against income;
- Ascertain if the fixed assets items serve the statutory activities of the company, identify and dispose of unneeded assets.

To the Board of E-Arsenal Ltd

- Together with the Ministry of Defence and the Council of the company, find new ways for income growth and containment of costs, especially with regard to orders originating from the Estonian Defence Forces.
- Review the terms and conditions of all rental contracts and their implementation by the renters and negotiate unfavourable terms, if necessary; on the basis of the 2004 results submit a report to the Council on rented assets.
- Discontinue the practice of reimbursing travel costs which are not directly related to the activity of the company.
- Analyse the timely payment of invoices sent to clients and renters; estimate the amount of uncollectible accounts receivable by invoices and by procurers; impose sanctions on those clients and renters whose payments are late.

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The **Minister of Defence** concurred with the audit findings and the recommendation that the company should undergo radical changes and he promised to seriously consider the proposal for the termination of the company.

The **Chief of the General Staff of the Defence Forces** noted that the defence forces are interested in the existence and development of a domestic arms industry, if domestic products are of high quality and offered at competitive prices and if the activities of a state-owned company are economically feasible for the state. The decline in orders for the products of E-Arsenal Ltd was explained by sufficient stockpiles, the poor quality and significantly higher prices of several product groups.

The main findings of the audit were discussed with the **Board and the Council of the company**. The Board and the Council accepted the comments in the report, for the most part, however, the parties had dissenting opinions about several issues concerning the management of the company.

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