



Municipal Asset Management especially real estate, property and apartments





Initial situation

- Within the scope of their organizational sovereignty the type of task accomplishment is at the discretion of municipalities and municipal associations (This organizational sovereignty is guaranteed right of municipalities and municipal associations, by the Constitution according to Art. 28 para 2 GG)
- Task performance by administration, legally dependent enterprises under public law, operationally autonomous (local) undertakings devoid of legal personality (Eigenbetrieb), municipal enterprises under private law, inter-communal cooperation
- Property management and housing businesses primarily in local undertakings and municipal companies in private legal form
- As a result: audit priorities focus on operationally autonomous (local) undertaking devoid of legal personality (Eigenbetrieb) and municipal enterprises in private legal form, especially private companies limited by shares (Ltd=GmbH)
- Law amendment 2003: immediate audit rights in private companies with > 75% local shareholding

Figures and types of municipal housing management

- Number and total assets of the operationally autonomous (local) undertakings devoid of legal personality → 18 companies € 108 mio.
- Number and total assets of private companies limited by shares (Ltd=GmbH) → 136 enterprises € 7,8 bn.
- Cross-sectional study: 56 % of operationally autonomous (local) undertaking devoid of legal personality in housing sector generate losses
- **1. Detailed economic examination: an overview of audit procedures and outcomes**
- **2. Exemplary findings: operating and company auditing of a city with a local property management Ltd. and a real estate and development Ltd.**



Digression: Operationally autonomous (local) undertaking devoid of legal personality (Eigenbetrieb)*

- Legally dependent, external liability of the municipality
- Organizational independent
- Independent, accounting, own economic plan
- Own annual account, annual audit by certified public accountant
- Property of the local undertaking is special fund of the municipality separated management
- Municipality must provide the undertaking with an adequate equity capital
- Budget of municipality: only profit transfer or loss compensation
- Mutual services must be paid

*in the following “Eigenbetriebe” referred to as local undertakings



Audit of local undertakings of housing sector

- 18 local undertakings chosen
- Housing management: Own stock management, management of residential property of others, survey period from 2002 to 2005
- **Problem areas**
 - High vacancy,
 - Surplus of apartments,
 - Population decrease
 - Tenant fluctuation because of labour market unattractiveness
- **Audit issues:** choice of company type, organization of task performance, analysis of the influences caused by the change in economic conditions, economic situation of the local undertaking



Audit methods

- Analysis of the current economic situation on the basis of key figures
- Development of key figures
- Overview of key figures in ranking table
- Overall comparison of the economic situation of local undertakings
- Analysis of previous managerial activities
- Development of hints to solutions for the in the overall comparison economically problematic local undertakings
- Specific instructions concerning the current need for improvement in individual local undertakings

Audit topics in detail

I Kind of organization:

- I Calculation of profitability in comparison with other forms of organization
- I Scope of the special fund (number of residential and commercial units)
- I State of redevelopment of the special fund
- I Planned or already decided changes of the organizational form

I Task accomplishment:

- I Independent **task accomplishment** by local undertaking
- I Management of non-company residential and commercial units
- I Transmission of task accomplishment to third parties
- I Comparison of administrative costs depending on the organizational form

Audit topics in detail

I Change in economic conditions

- I Population development, housing stock, living space per inhabitant, size of households in the particular municipality, comparison with the Saxon average
- I Effects on the vacancy rates, average rents; as far as non-company buildings are managed: comparison to the vacancy rates and average rents of those
- I Marketing of the managed portfolio
- I Size and measures of risk management
- I Scope and use of cost calculations of local undertakings

basis for key figures

- | based on tool "crisis management of housing companies and prevention of insolvency"
- | **economic situation:**
 - | Grants from the municipality
 - | Capital ratios
 - | Return on total assets
 - | Debt service coverage
 - | Redemption ability
 - | Interest expense, interest expense per m²
 - | Level of debt, indebtedness per m²
 - | Asset maintenance by generated depreciation
 - | Extent and causes of non-scheduled depreciation
 - | Development of the total cost
 - | Development of the headcount

Preparation of audit

Evaluated documents et. al.

- Information on own and external housing stock, rental situation, key figures of housing sector, key figures of assets and earnings position
- Reports of local audit
- Risk management reports
- Reports of the auditor of annual and management reports
- Calculations of own administrative costs
- Price calculations for external administration
- Questionnaire of the court of audit

Audit results

- Inadequate or lack of local audit
- Only approximately 22 % of the local audit reports in line with statutory requirements
- Only 3 of 18 local undertakings provided a risk report based on an early warning system
- Failures in risk management and related reports
- Evaluation of key figures



Audit results

Equity ratio (= equity/total assets)

Endangerment of the stock < 10 %

Impairment of the development 10-15 %

Cut off date of audit:

1 local undertaking < 10 %

2 local undertakings 10 – 15 %

15 local undertakings > 50 %

→ Good equity capital ratio of most of the local undertakings

Audit results

Return on total assets (= annual results + interest on borrowed capital/total assets)

Endangerment of the stock < 3 %

Impairment of the development 3 - 6 %

Cut off date for audit: **8 local undertakings < 3 %**

3 local undertakings 3 – 6 %

7 local undertakings > 6 %

→ Return on total assets inadequate

→ Urgent need for action, otherwise danger of equity consumptions in the medium-term



Audit results

Debt service coverage (= proceeds of basic rent/expenses for interest and scheduled repayments)

Endangerment of the stock > 65 %

Impairment of the development 50 - 65 %

Cut off date for audit:

8 local undertakings > 65 %

3 local undertakings 50 - 65 %

7 local undertakings < 50 %

- High binding concerning the use of proceeds of basic rent
- Limited freedom of action
- Creation of reserves not or only limited possible



Audit results

Redemption ability (cash flow from operating activities / scheduled repayment)

Endangerment of the stock < 100 %

Impairment of the development 100-150 %

Cut off date for auditing: **6 local undertakings < 100 %**

7 local undertakings 100 - 150 %

5 local undertakings > 150 %

- Repayment of bank loans only possible by using own reserves or grants of municipalities
- Local undertakings run the risk of financial incapacity

Audit results

Vacancy of apartments according to living space

Endangerment of the stock > 15 %

Impairment of the development > 10 %

Cut off date for audit: **7 local undertakings > 15 %**

11 local undertakings > 10 %

- Increase in vacancy since 2002
- Increase in vacancy rates not to the same extent as the depopulation
- Vacancy of apartments should be modified, especially by deconstruction



Rating factors

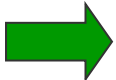
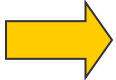
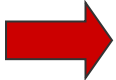
Rating factors:

█ Equity ratio	10
█ Return on assets	5
█ Debt service coverage	15
█ Redemption ability	5
█ Vacancy rate	<u>15</u>
maximum value	= 50

Multipliers:

Without complaint	0
Impairment of the development	1
Endangerment of the stock	2
Maximum value after multiplication =	100

Overall evaluation

GREEN	0-25 Points	 no urgent need for action
Yellow	26-50 Points	 individually check at which points action is necessary
RED	51-100 Points	 immediate action necessary

Evaluation covering the years from 2002 until 2005

Summary of audit results

- 5 local undertakings have no urgent need for action
- 6 local undertakings have individual need for action
- Immediate action is necessary in 7 local undertakings
- Special package of measures required
- Local audit must be ensured and quality improvement must be strived by Mayor
- Establishment and documentation of a risk management system
- Continuous critical examination of the economic situation by municipality



Economic activity of the municipality by legal persons of private law: approaches of audit

- Annual audit by certified public accountant → evaluated by court of audit
- Rotational audit of municipal activities of the municipality in private companies in the legal form of private law by state audit offices (assigned by the court of audit)
- New after law amendment 2003 : immediate audit rights in private companies with > 75% local shareholding → established a qualified audit team (two consultants, four examiners)

Object of audit

- 1. **holistic approach** of audit of the municipal activities in private companies, under evaluation of the budgetary situation of the municipality (stable, sufficiently stable, critical or unstable) and including the financial relationships between local authorities and companies



- corresponding to its capability the **liability** of the municipality must be limited to a reasonable amount
- nature and extent of the company** must be adequate to the capability of the municipality and to the **anticipated needs**



Object of audit

- 2. **selected main topics for auditing** of the company, also contract of the managing director, Sponsorship, control by supervisory board

- In this case: **assessment of the economic situation of companies in the housing economy - comparable to** operationally autonomous (local) undertaking devoid of legal personality : Income and capital position
 - Profitability and asset situation

 - Vacancy of apartments

 - Development of population

 - Overall evaluation based on key figures

Audit results (Municipality - Company)

- Critical budgetary situation of the municipality, leads to relocation of possible loss-making institutions (multi-purpose hall, public swimming pool, museums) in municipally owned companies
- High risk potential in the municipal company
- Depletion of the reserves of the municipality → examples:
 - Deficit guarantees for the municipal companies in the amount of € 8,5 million
 - Grants to cover investments and operating costs e.g. for a swimming pool amounting to 250 000 € p. a. until the year 2025
 - Grants for repayment of interest and liabilities of the company in the amount of € 360 000 p. a.
 - Capital contributions for a redemption of a buy back obligation in the amount of € 5.2 million, loan taken to finance replacement loan of € 1.7 million

Audit results (company)

- Permanently critical company situation
- Latent threat of insolvency for nearly two years, conclusion: identification of loss potential in accordance with reasons of insolvency
- Faulty business planning, conclusion: requesting a proper business planning
- High vacancy rates, high interest and depreciation, liquidity problems, poor rating
- In main business redevelopment over need
- Loans to other investment companies (not corporate purpose)
- Inappropriate granting of bonuses, orientation of bonuses on sales instead of the long-term success, faulty incentives in the development of business

Audit results (Breach of duty of the managing director)

- Unrealistic planning revenues, deviations between the economic plan and the net income of the year
- In case of imminent insolvency debt-distressed balance sheet too late created; shift of financial burdens between subsidiaries
- Risky security transactions, breach of loyalty and due care, especially the duty to inform the supervisory board
- Conclusions:
 - Checking of the misconduct in the corporate management of the companies
 - Checking of claims for damages against the managing director because of breach of statutory and contractual duties
 - checking the dismissal of the director

Audit results (breaches of duties of monitoring by supervisory board)

- Uncritical acknowledgment of the unrealistic and contradictory accounts given by managing director in the economic plans
- Acceptance of overly optimistic profitability prospect
- Failings in the supervision of the managing director concerning transactions which require approval
- No report on the annual audit



Thank you for your attention!