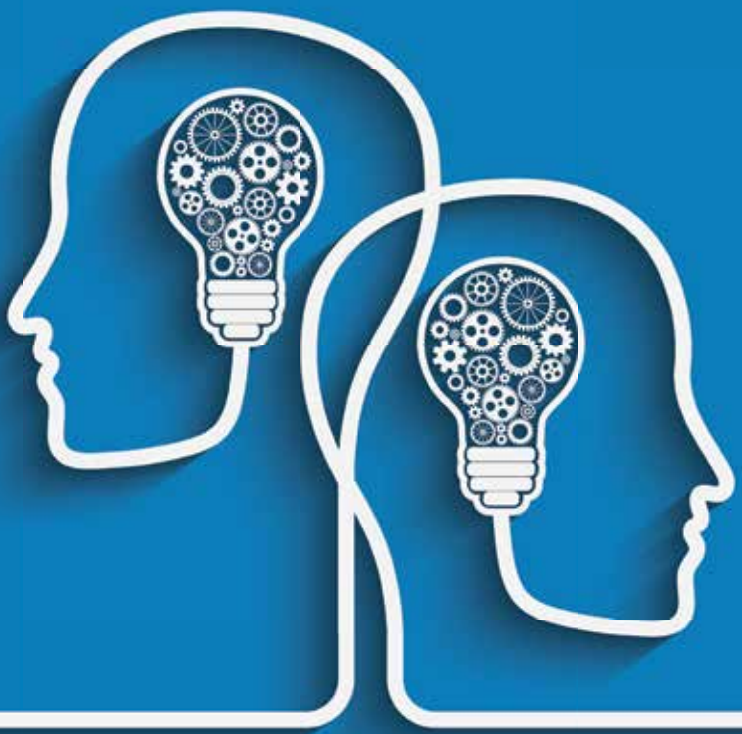
Leadership Training Toolkit for State-Owned Enterprises (SOEs)

Boards and Owners



WORLD BANK GROUP

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Acknowledgements

This Leadership Training Toolkit for State-Owned Enterprises (SOEs) was prepared by an interdisciplinary WBG team led by Fabian Seiderer (Lead Public Sector Specialist WB and Task Team Leader) with input from PwC. The core team comprised Sarah Cuttaree and Lopa Rahman from IFC; Alexander Berg, Natalia Manuilova, Manela Karunadasa, Asif Ali and Twity Mueni Musuva Uzele from WB, Ranen Banerjee, Bruce R. Macqueen, David D. Brunell, Anjan Kumar Roy, Harsh Vardhan Kabra, Paridhi Kothari, and Agastya Yeachuri from Price Waterhouse Coopers Private Limited (PwC).

The team would like to thank Alexandre Arrobbio, Adrian Fozzard, and Martine Valcin for their overall guidance and review. The team would also like to thank James Brumby, Tatiana Nenova, Sunita Kikeri, and Henri Fortin for their review and advice. Priyantha Jayasuriya Arachchi provided administrative support.

The team is grateful to the Australian Department for Foreign Affairs and Trade (DFAT) for their support.

List of Abbreviations

Acronym	Description
BSC	Balanced Scorecard
BCP	Business Continuity Planning
CPSE	Central Public Sector Enterprise (Government of India)
CVC	Central Vigilance Commission
CEO	Chief Executive Officer
CFO	Chief Financial Officer
COO	Chief Operating Officer
CRO	Chief Risk Officer
CSO	Civil Service Organization
CSR	Corporate Social Responsibility
DFI	Development Finance Institutions
ERM	Enterprise Risk Management
ESG	Environmental, Social, and Corporate Governance
EC	European Commission
EU	European Union
XBRL	eXtensible Business Reporting Language
FASB	Financial Accounting Standards Board
GSM	General Shareholders Meeting
GAAP	Generally Accepted Accounting Principles
GRI	Global Reporting Initiative
GRC	Governance and Risk Management
GCG	Governance Commission for GOCCs
GHG	Greenhouse Gas
GDP	Gross Domestic Product
HR	Human Resource
HRM	Human Resource Management
IAS	International Accounting Standard
IASB	International Accounting Standards Board
IDA	International Development Agency
IFC	International Finance Corporation

Acronym	Description
IFRIC	International Financial Reporting Interpretations Committee
IFRS	International Financial Reporting Standards
IIRC	International Integrated Reporting Council
IMF	International Monetary Fund
IOSCO	International Organization of Securities Commissions
IPCC	Intergovernmental Panel on Climate Change
IPO	Initial Public Offering
IPSAS	International Public Sector Accounting Standards
IPSASB	International Public Sector Accounting Standards Board
IR	Integrated Reporting
ISO	International Organization for Standardization
ITB	Invitation to Bid
KPI	Key Performance Indicator
KRA	Key Result Area
LDQ	Leadership Dimension Questionnaire
LTA	Long-term Agreements
MCPS	Management Commentary Practice Statement
MD&A/ MDA	Management Discussion and Analysis
MfD	Maximizing Finance for Development
MoA	Memorandum of Association
MOU	Memorandum of Understanding
MoF	Ministry of Finance
MIM	Ministry of Industry and Minerals, Government of Iraq
NVG SEE	National Voluntary Guidelines on Social, Environmental and Economic Responsibilities of Business
NPSV	Net Present Social Value

Acronym	Description
NGO	Nongovernmental Organization
OECD	Organisation for Economic Co-operation and Development
PEST	Political, Economic, Sociological, Technological
PESTEL	Political, Economic, Sociological, Technological, Environmental, Legal
PwC	PricewaterhouseCoopers/ PricewaterhouseCoopers Private Limited
PAC	Public Accounts Committee
PIM	Public Investment Management
PMA	Performance Management Agreement
PSA	Public Service Agreement
PSO	Public Service Obligation
PPP	Public-Private Partnership
RFP	Request for Proposals
RFQ	Request for Quotations
R&D	Research and Development
RBF	Results-Based Financing
SOW	Scope of Work
SME	Small and Medium Enterprise
SPV	Special Purpose Vehicle
SMART	Specific, Measurable, Achievable, Results oriented, and Time-based
SIC	Standards Interpretations Committee
SOE	State-Owned Enterprise
SBU	Strategic Business Units
SWOT	Strengths, Weaknesses, Opportunities, and Threats
SAI	Supreme Audit Institution
TOR	Terms of Reference
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
WBG	World Bank Group
WTO	World Trade Organization

Foreword

During the unprecedented COVID-19 pandemic, the state has become more prominent and its role has been tested. By necessity, the entire public sector mobilized to respond to and mitigate the severe socioeconomic impacts of this global health emergency and to support the recovery. In many countries, state-owned enterprises (SOEs) are at the forefront of this response, given their important roles in key public service and infrastructure sectors such as health and education, transportation, energy, and finance. Public health actions and travel restrictions affected not only SOE revenues but also expenditures, as a result of state fiscal relief and stimulus measures. This has had an adverse impact on the financial situation, and sometimes the viability, of many SOEs, thus exacerbating fiscal costs and risks already affecting governments and their stretched balance sheets.

THE SOE LEADERSHIP TOOLKIT, DEVELOPED JOINTLY BY THE WORLD BANK AND IFC THROUGH A MULTIDISCIPLINARY TEAM, LEVERAGES BOTH INSTITUTIONS' COMPLEMENTARY PERSPECTIVES, RESOURCES, AND EXPERIENCE IN WORKING WITH THE SOE SECTOR AND THE STATE AS AN OWNER.

The COVID-19 crisis has also tested the state's ownership role and the effectiveness of SOE management teams by exposing the underlying weaknesses in countries' and SOEs' corporate governance frameworks and capacity. The call to "rebuild better" post-pandemic will increasingly obligate SOEs to demonstrate sustainable approaches that take into consideration the management of environmental and social risks as well as the impact of their economic activity on climate change and communities.

Silver linings of this crisis include increased recognition of improved corporate governance standards, and practices and a sense of urgency to strengthen the performance of SOEs, to ensure their sustainability and mitigate mounting fiscal risks. The World Bank Group's new Integrated SOE Framework (iSOEF) responds to these developments and provides a holistic approach to SOE reform.

It is essential that the capacity of SOE leadership, as well as the capacity of policymakers and regulators be strengthened. Yet most developing and middle-income countries are not equipped with established SOE-specific training or capacity-building programs. Boards and senior management of SOEs require contextual training to help them effectively manage crises, improve the performance of their company, navigate the multiple principal-agent challenges, and balance competing commercial and noncommercial objectives in a transparent manner. There is also a pressing need for capacity building of government ownership and oversight entities and their staff, which often do not have the relevant business experience to effectively steer and supervise the SOE portfolio.

The Leadership Training Toolkit for State-Owned Enterprises (SOE Leadership Toolkit) serves to meet this growing demand for a practical SOE-specific training curriculum and teaching methodology. The SOE Leadership Toolkit, developed jointly

by a multidisciplinary team of the World Bank and IFC, leverages both institutions' complementary perspectives, resources, and experience in working with the SOE sector and the state as an owner.

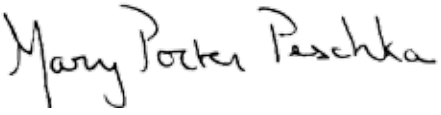
The SOE Leadership Toolkit was designed with a variety of training needs, priorities, and sponsoring organizations in mind. Using an experiential-learning delivery model, it offers executives and officials a flexible and modular approach that allows it to be readily customized to fit different country contexts and training needs. The Toolkit contains 15 modules covering 4 areas: 1) fundamentals of corporate governance (and the role of the state); 2) the board; 3) strategy, risk, and performance; and 4) control environment, transparency, and disclosure. It also includes 4 essential cross-cutting themes: (i) gender and diversity; (ii) climate risk and resilience; (iii) Maximizing Finance for Development; and (iv) corruption and integrity and proposes specific entry points and examples to mainstream these themes in any SOE training program.

We hope that this new SOE Leadership Toolkit will serve the needs of our clients and help equip SOE boards and senior management with the necessary knowledge and skills to effectively govern and improve the performance and sustainability of their organizations. The information in the SOE Leadership Toolkit should help improve the competitiveness of SOEs, leading to improved performance and financial health, and ultimately resulting in a positive impact on countries' balance sheets and growth.

The World Bank Group is committed to supporting its clients' efforts to enhance SOE competitiveness, transparency, and performance by strengthening their leadership and management. We are, therefore, pleased to make this comprehensive SOE Leadership Toolkit available as a public good and to support its customization and implementation through country programs and capacity building of ESG training providers.



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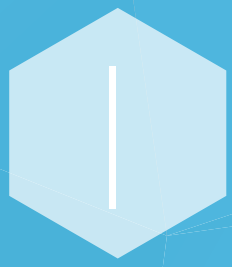
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Part I



Corporate Governance

Leadership Training Toolkit for SOEs

Introduction

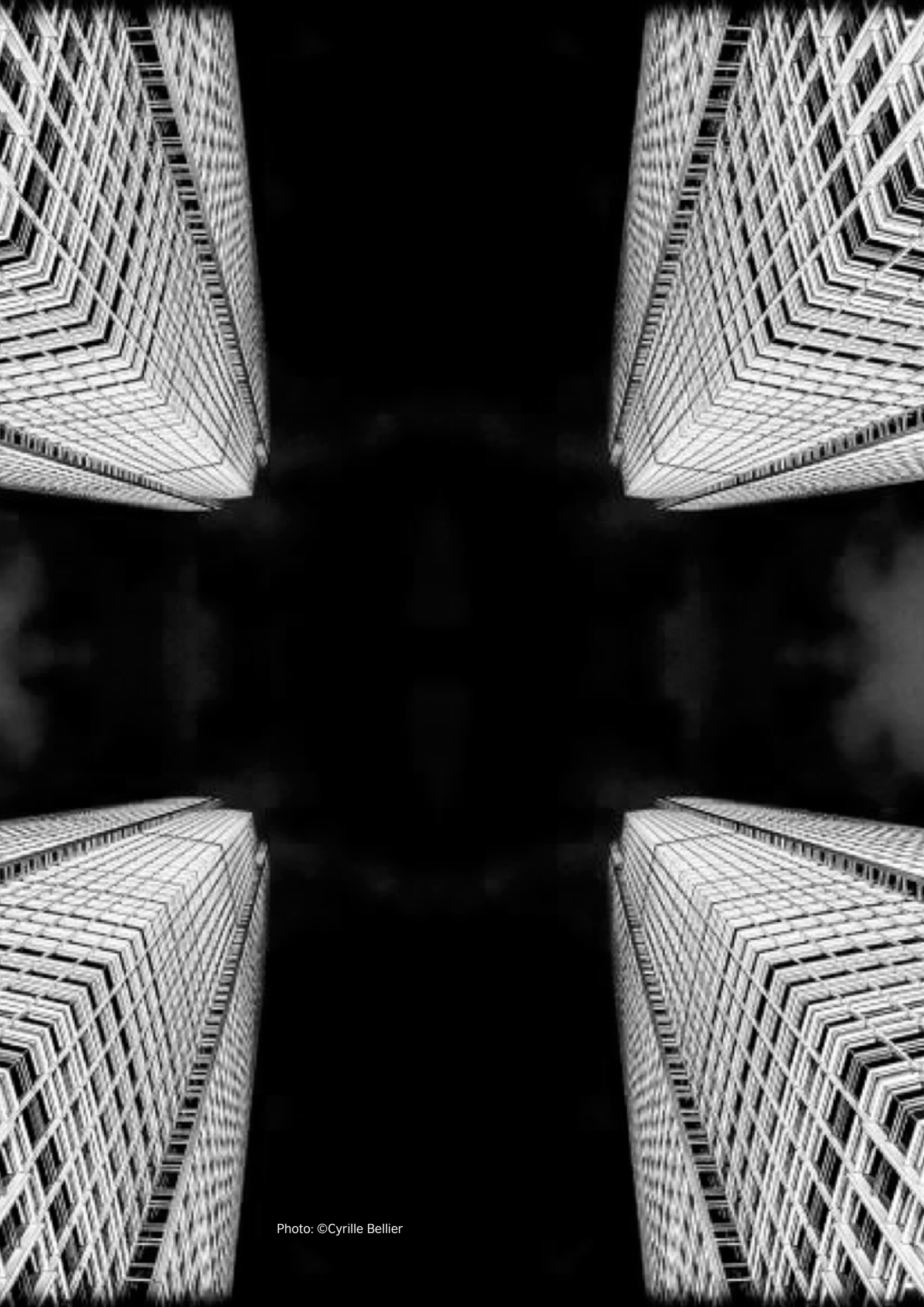


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Introductory Note

The Leadership Training Toolkit for State-Owned Enterprises ('SOE Leadership Toolkit') was developed jointly by the World Bank and IFC (World Bank Group) to support countries' efforts to build capacity of SOE boards and senior managers. It also endeavors to strengthen state ownership and oversight institutions, given the growing role and impact of SOEs on public finances, the economy, and delivery of services.

The SOE Leadership Toolkit addresses the growing need for curriculum content and teaching methodologies specifically adapted for SOEs. And it allows for use by different training providers, such as government training institutions, Institutes of Directors, corporate governance associations, and professional bodies or universities.

THE SOE LEADERSHIP TOOLKIT IS DESIGNED FOR EXPERIENTIAL LEARNING BY EXECUTIVES AND OFFICIALS AND CAN MEET A VARIETY OF TRAINING NEEDS AND PRIORITIES OF A RANGE OF SPONSORING ORGANIZATIONS.

The SOE Leadership Toolkit is designed for experiential learning by executives and officials and can meet a variety of training needs and priorities of a range of sponsoring organizations. Its flexible and modular approach can be readily customized to fit different country contexts and training needs. Its 15 modules cover 1) fundamentals of corporate governance (and the role of the state); 2) the board, 3) strategy, risk, and performance, and 4) control environment, transparency, and disclosure. Cross-cutting these modules are four themes: 1) gender and diversity, 2) climate risk and resilience, 3) Maximizing Finance for Development, and 4) corruption and integrity.

Besides building the capacity of the trainees, the SOE Leadership Toolkit aims to strengthen the expertise and skills of the public and private corporate governance trainers. Through the training, all of the parties—new and experienced directors, senior management, and the state as an ownership entity—gain a better understanding of their roles and of the value of adopting corporate governance best practices. The SOE Leadership Toolkit also includes the following features:

- **Engaging adult learners** through interactive exercises that draw on the diverse experiences of the participants
- **Providing maximum flexibility** through a modular curriculum that allows an institution to tailor programs to suit the needs of the directors it serves
- **Minimizing institutes' investment of time and resources for curriculum development** by providing a comprehensive, standardized curriculum that includes PowerPoint presentations and case studies to enhance the learning experience
- **Advancing corporate governance reforms by instilling in participants leadership values** that can help them work within their companies or organizations to adopt the best practices
- **Fostering long-term relationships** with those most likely responsible for implementing corporate governance best practices within their companies and organizations
- **Enhancing the training institution's brand and authority** in the policy-making process of developing national corporate governance codes
- **Encouraging participants to be "change agents" of corporate governance** by developing the knowledge and skills to build support within their boards for implementing best practices

Coverage of the toolkit

Stakeholder coverage

The SOE Leadership Toolkit is designed for three SOE stakeholder groups:

- **Ministry of Finance and Portfolio Ministry (PM)**—referred to as "state/ ownership entity" (also "policy makers") in the curriculum
- **Board of Directors (BOD)**—referred to as "board" in the curriculum
- **Senior Management (SM)**—referred to as "top management" or "management" in the curriculum

A training may involve a mix of these participants, so every topic in the curriculum has been assigned a degree of relevance to the different groups. Using this relevance guide, the trainer can further tailor the overall program to a particular group's needs and agenda.

Training framework coverage

The SOE Leadership Toolkit curriculum is divided into four parts, each including various modules that explore the topics shown in Figure 1.

Each of the four parts of the framework comprises three to five modules that address specific topics as outlined in Table 1.

Table 1: Structure of the Training Curriculum

Part I – Fundamentals of Corporate Governance
Introduction to corporate governance for SOEs
Role of the state as the owner
Protecting minority shareholder and stakeholder rights
Part II – The Board
Board composition and structure
Board's role, director's duties, and liabilities
Board practices and procedures
Improving the board's professionalism and effectiveness
Part III – Strategy, Risk, and Performance
Developing an effective business strategy
Financial planning and budgeting for SOEs
Financial oversight and decision-making
Risk governance
Part IV – Control Environment, Transparency, and Disclosure
Internal and external controls and compliance
Financial accounting and disclosure
Nonfinancial information reporting and disclosure
SOE procurement

Source: World Bank Group (2021)

Figure 1: Coverage of the Training Curriculum



Source: World Bank Group (2021)

See *Appendix A*: Detailed Training Curriculum for a framework of the specific topics explored in each module.

Training curriculum structure

Each module includes the following:

- **Contents and schedule**—a detailed lesson plan allocates time for each activity and directs the trainer to relevant material (PowerPoint slides, handouts, case studies, and so on).
- **Handouts** provide background material and source references.
- **PowerPoint slides** support the trainer's presentation and can be modified to match the branding identity of the institution sponsoring the training.
- **Group exercises** provide an interactive format for participants to apply learnings and share their views and experiences.
- **Case studies** (for certain modules) provide experiential learning and reinforce the key learnings from the module.
- **Trainer's notes** walk the trainer through the handout material, slides, exercises, and case studies to provide guidance in conducting the training session.

Duration of the training program

For each module, the time required to cover the topics adequately is 2–3 hours, depending on the complexity of the module.

The time required for the entire training program varies based on the makeup of the participant group (PM, BOD, SM, or a mix). Time allocated for each topic reflects the degree of relevance assigned to that topic for a particular group. For instance, based on 5 hours per day of classroom time, the duration of the training program for PM is 6 days, for BOD it is 7 days, and for SM it is 5 days. For directors or managers prior to their appointment, the delivery can take place over the period of one week. For senior officials and board members, it can be sequenced over a quarter.

If there is a mix of participants in the training, the trainer must appropriately design the training program to complete the series in 8 one-day sessions of 5 hours of classroom time per day.

The modular structure of the SOE Leadership Toolkit takes into consideration the potential time constraints for the target audience, and it allows for a customized/selective training delivery on specific topics relevant to the audience.

Training-curriculum design considerations

To cater to the specific training needs for the state, board members, and senior management of SOEs, the contents of the SOE Leadership Toolkit follow the Organisation for Economic Co-operation and Development (OECD) principles of corporate governance and, more specifically, the G-20/OECD Guidelines on Corporate Governance of State-Owned Enterprises, 2015. See Table 2.

Table 2: Coverage of the G-20/OECD Guidelines on Corporate Governance of SOEs, 2015

OECD Guidelines	Part I	Part II	Part III	Part IV
Rationale for state ownership	☑	NA	☑	NA
The state's role as an owner	☑	☑	☑	NA
State-owned enterprises in the marketplace	☑	NA	☑	☑
Equitable treatment of shareholders and other investors	☑	☑	NA	NA
Stakeholder relations and responsible business	☑	☑	☑	☑
Disclosure and transparency	NA	NA	NA	☑
The responsibilities of the boards of state-owned enterprises	NA	☑	NA	☑

Source: World Bank Group (2021)

References to the OECD Guidelines are included in the modules and subtopics, with necessary guidance on frameworks, best practices, tools, and techniques that can be leveraged to achieve compliance with the guidelines.

Development of the training curriculum **leveraged numerous information sources**— primarily the **World Bank's Toolkit for Corporate Governance of State-Owned Enterprises (2014)**, the **IFC Board Leadership Training Resources Kit**[1] **developed in 2008**, and the **G-20/OECD Guidelines.** It draws on other references—from the OECD, IFC, World Bank, among numerous others—for specific topics. A detailed list of these references is included in the module handouts by way of cross-referencing, and further reading material is listed under "References" for each module.

Incorporating emerging cross-cutting themes

The SOE Leadership Toolkit identifies and explores emerging themes that have an important place in today's corporate governance landscape. It incorporates these themes into the training curriculum, giving special attention to their relevance to each topic covered. These themes include the following:

1. Gender and diversity.

In keeping with the global focus on achieving gender equality and empowering women, as outlined in the United Nations Sustainable Development Goals, the SOE Leadership Toolkit incorporates this key theme into the training curriculum. In several emerging economies, employees at SOEs constitute a large segment of the overall workforce. Accordingly, there needs to be a strong leadership-driven focus on diversity and inclusion to ensure that SOEs are inclusive in their operations and board composition.

To sensitize the board leadership of SOEs on the issues of gender and diversity, the training curriculum incorporates, wherever applicable, a focus on the following:

- *Gender equality in HR policies and practices—recruitment, compensation, promotion, and so on*
- *Gender inclusiveness in board composition*
- *Gender-neutral perspectives for SOE operations and service delivery*

To support the understanding of the importance of this theme, the curriculum includes references to it throughout the coverage of topics and subtopics wherever applicable. Case studies further enhance the apprehension and retention of this knowledge.

2. Maximizing finance for development.

Several emerging economies see a future with limited foreign aid and unsustainable levels of public debt. Therefore, there is a renewed focus on domestic revenue mobilization and other innovative mechanisms to finance development outcomes. In several countries, SOEs are some of the largest commercial entities, making it imperative to recognize their potential as financing sources for development projects to drive sustainable economic growth. However, SOEs are often characterized by poor performance, unhealthy finances, and other challenges that prevent them from competing successfully with the private sector.

Given their importance, SOEs must recognize their potential role and contribution to the economy. To help SOEs recognize and realize their role in financing development outcomes and supporting economic growth, the training curriculum incorporates and emphasizes the following:

- *Understanding the importance of SOEs for financing development outcomes and driving economic growth*
- *Strategies for SOEs to create fiscal space to contribute toward financing developmental outcomes*
- *Impact of investment perspective in SOE project planning and implementation*

The key takeaways will be to understand the importance of leveraging the private sector, where there are clear-cut solutions available for doing so, and to optimize the use of scarce public sector resources. To encourage these takeaways, the curriculum includes references to these points throughout the coverage of topics and subtopics wherever applicable, along with case studies to further enhance the adoption and retention of this knowledge.

3. Climate change and resilience.

In today's world of accelerating global development, climate change and its economic, environmental, and social implications are fast becoming a paramount challenge in every country's growth, progress, and future well-being. It is a wide-ranging, complex, and multidimensional issue, which varies in nature, degree of impact, and consequences for each country, depending on the country's location, natural endowment, and stage of development, among other factors. Given this wide variation and the practical constraints of time, the main workshop curriculum is limited to the core high-level basics and principles of climate change that every state/ownership entity representative, board member, and key stakeholder needs to understand.

With increasingly unpredictable climate patterns and the growing number of extreme weather events seen across the world, particularly in developing countries, many investments in these countries are exposed to climate risks. Extreme weather events and gradual changes in climate cause damage to infrastructure and disrupt public services. This can have a severe negative impact on a country's development. Moreover, apart from the physical risks of climate change, inadequate or poorly planned transition to low-carbon technologies may also compound the overall risk and associated costs.

A significant portion of public investment (capital expenditure) is routed through various SOEs. Therefore, when planning public investment projects, SOEs need to be alert to climate risks and consider adaptation to climate change in the form of transition to low-carbon technologies. This helps reduce climate-related economic, social, and ecological damage through climate-resilient investments. The World Bank in collaboration with PwC (2019)[2] outlined corporate governance principles to address the risks related to climate change, including climate accountability, subject demand, board structure, materiality assessment, strategic integration, incentivization, reporting and disclosure, and exchange. (These principles are discussed in Part III, Module 4 - Risk governance.)

Consequently, considering the strategic importance of this theme, the necessary components of climate change and resilience are incorporated into the training material, which covers such aspects as the following:

- State climate policy and its role as a shareholder in promoting climate resilience
- Climate risk identification and vulnerability assessments for investment planning and project design (covering the physical and the transition risks)
- Making investments more climate resilient
- Financing climate-resilient investments

These aspects are embedded throughout the relevant topics and subtopics wherever applicable.

4. Integrity and anti-corruption.

Corruption remains a serious problem in SOEs and can influence the financial strength and valuation of a company, negatively affect investor perceptions, lead to the misallocation of scarce government resources, and constrain overall economic and financial growth. Better-governed companies with integrity and accountability mechanisms are likely to be less corrupt and more transparent.

The training modules incorporate integrity and anti-corruption mechanisms as appropriate, including the following:

- Incorporating integrity and anti-corruption mechanisms in company policies and procedures such as whistle-blower policy, code of conduct/code of ethics
- Putting a robust internal control environment in place to combat corruption and ethical challenges
- Enhancing disclosure and transparency in financial and nonfinancial reporting to minimize chances of corruption

These aspects are embedded throughout the relevant topics and subtopics wherever applicable, along with case studies to further enhance the adoption and retention of this knowledge.

A detailed mapping of the applicability of these crosscutting themes with various modules is included in **Annex B: Incorporating cross-cutting themes in the curriculum**.

Key learning objectives

The SOE Leadership Toolkit covers an extensive range of topics to meet the specific learning objectives of a variety of participants. It is designed to provide them with adequate knowledge on these topics and empower them to apply these learnings in their organizations. Key learning objectives, at a broad level, include the following:

- **Improved understanding of corporate governance.** The participants will gain an understanding of the entire corporate governance landscape and of emerging trends and key issues. Most importantly, they will learn how to apply good corporate governance principles and practices in all aspects of the SOE's operations.
- **Strong understanding of the role of the state as an owner.**[3] The principal-agent relationship between the state and the board is very different from conventional relationships between owners/majority shareholders and the board. Thus it is vitally important for both the state and the board members to understand the state's role as an owner as well as principles for effective state-board relationships.
- **Recognition of the need for balanced board composition and formal board procedures.** The politicization of SOE boards is one of the most common challenges facing SOEs. It is important for board members and the state (in its ownership capacity) to understand the need for balanced boards and to adopt structured and formal processes for board member nomination and selection, with due consideration for diversity and inclusion.
- **Strong understanding of conflicts of interest and related-party transactions.** This is an important topic for SOEs as well as private sector entities. To reduce the likelihood of corruption and malpractice, board members must be alert to conflicts of interests and questionable related-party transactions and know how to identify and handle them.
- **Improved capacity for balancing commercial and public service obligations.** This is a critical area for SOEs, which often face challenges related to their dual mandate of meeting commercial objectives while fulfilling public service obligations. The curriculum addresses this topic sufficiently to equip participants to understand the key considerations and decision factors involved in finding the right balance between these multiple objectives.
- **Increased knowledge of financing sources for funding SOE obligations.** It is critical for board members to look beyond the state as a source of funding. The training shows how to explore alternative sources of financing for an SOE's commercial and public service obligations.
- **Improved understanding of internal and external control environment.** SOE boards often find it challenging to define their internal and external control environments, which makes it equally challenging to ensure compliance with control requirements. An objective of the curriculum is to help participants gain an increased understanding of and appreciation for the internal and external control environments, and to equip them with the tools necessary for enforcing compliance with control requirements.
- **Strong understanding of the need for disclosure and transparency.** SOEs often do not place enough importance on disclosure and transparency, partly because in many instances they are not subject to the same standards as those applied to private sector enterprises. For improved corporate governance, it is critical for board members to be sensitized to the need for and benefits of proactive disclosure and transparency (beyond what is expected) and to understand their impact on the SOE's performance.

- **Improved understanding of public investment management, including incorporating climate-change adaption and resilience considerations.** SOEs are often vehicles of public investment, with emphasis on the need to invest in improving the efficiency of this public expenditure. An objective of the curriculum is for participants to understand the principles and the best practices of public investment management, including planning, procurement, and implementation. The training curriculum also covers climate-change adaption and resilience considerations with the aim of sensitizing the board members to the importance of this emerging theme and its impact on public investment.
- **Increased appreciation for anti-corruption measures and integrity.** Because SOEs are publicly owned, they are subject to high standards of public scrutiny, and in the past they have been plagued with issues such as corruption. Responding to this need, the curriculum covers the relevant topics sufficiently to empower board members to strengthen the integrity of their practices and implement anti-corruption measures to improve governance.

Snapshot of training delivery approach

Several critical steps are involved in formulating a structured training delivery plan. Effective implementation of these steps will help meet the training objectives, participant objectives, and learning objectives, and will improve participant commitment.

Figure 2 outlines the steps involved in formulating a training plan. A separate document in this SOE Leadership Toolkit, "Methodological Note for Trainers," discusses these steps in detail.

Using the prioritization matrix

In the prioritization matrix every topic in the curriculum is assigned a degree of relevance for each of the three trainee groups: policy makers (PM), board of directors (BOD), and senior management (SM). Based on the degree of relevance, the matrix provides a standard allocation of time for each topic. (See Table 3.) Where the time allotted for certain modules results in less than five minutes, that is considered to be below the materiality threshold and is equivalent to "no relevance."

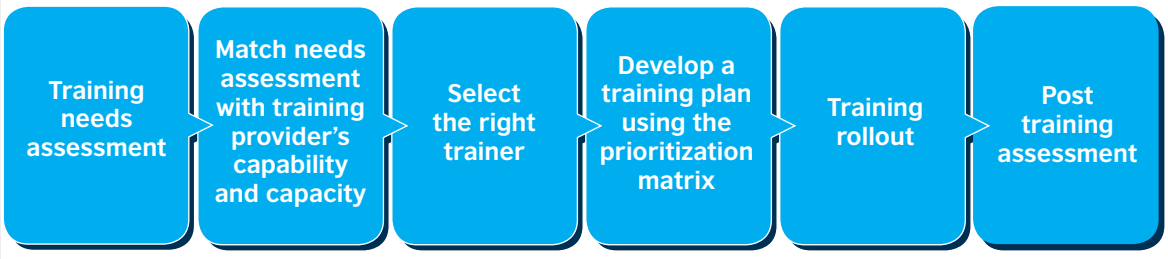
Table 3: Standard Time Allocation Based on the Degree of Relevance

Degree of relevance	Time allocation (%)
Highly relevant	100
Medium relevance	50
Low relevance	25
No relevance	0

Source: World Bank Group (2021)

The trainer institution should use the prioritization matrix to customize the agenda based on the composition of the trainee group. Customization is particularly important when the participants represent a mix of two or more of the trainee groups. The customized agenda will be a key determinant in the selection of a trainer and the follow-on training rollout.

Figure 2: Steps in Formulating a Training Plan



Source: Adapted from *Corporate Governance Board Leadership Training Resources Kit* (IFC, World Bank Group, 2008).

Importance of embedding experiential learning cycle (ELC) in training delivery

By embedding ELC[4] in the overall training delivery, the trainer can ensure that the training has practical benefits for the participants. The experiential learning cycle appeals to diverse learners and incorporates practical experiences from life. This four-step learning process relates directly to adult learning. It also forms the basis for program design and session planning.

People learn best when given an opportunity to acquire knowledge and skills relevant to specific experiences. Experiential learning occurs in a circular or spiral process that involves four interrelated phases, as illustrated in Figure 3. The four phases of experiential learning:

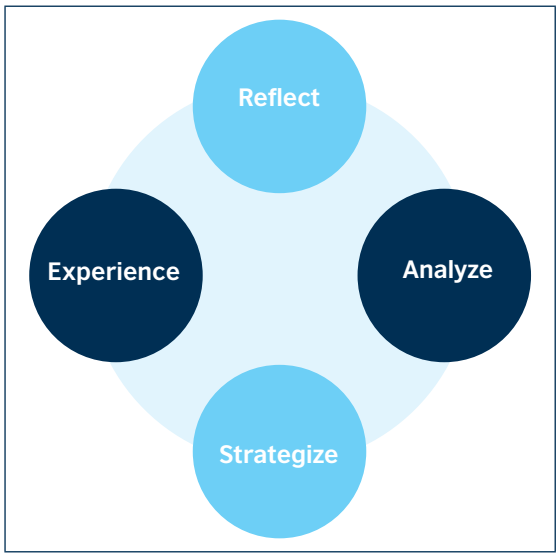
- Having an experience
- Reflecting on the experience
- Analyzing to form generalizations
- Strategizing to apply understandings to a relevant experience

Each phase in the learning cycle is related to and builds on what happened before. Learners can begin at any one of the four phases of the cycle, yet the learning process most often begins with a specific experience.

First comes the experience. Then learners reflect on the experience, considering what they observed, who was involved, and why it was significant. Next they analyze the experience to identify patterns, causes, results, and options. Using what they've learned, they strategize how to apply these lessons to relevant situations. Facing similar situations, learners will begin this process afresh. These phases are discussed in detail in the "Methodological Note for Trainers."

In the training sessions, the participants share in the experiential learning, working in pairs or groups.

Figure 3: Experiential Learning Cycle



Source: Adapted from Corporate Governance Board Leadership Training Resources Kit (IFC, World Bank Group, 2008)

Notes:

1 IFC. 2008. *Toolkit 3: Corporate Governance Board Leadership Training Resources Kit.* Washington, DC: World Bank Group. https://www.ifc.org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_site/ifc+cg/resources/toolkits+and+manuals/leadershiptoolkit.

2 World Economic Forum. 2019. *How to Set Up Effective Climate Governance on Corporate Boards: Guiding Principles and Questions*. Geneva, Switzerland: World Economic Forum. http://www3.weforum.org/docs/WEF_Creating_effective_climate_governance_on_corporate_boards.pdf.

3 For the purpose of this curriculum, the terms *state* and *ownership entity* are used interchangeably unless otherwise specified.

4 Kolb, David A. 1984. *Experiential Learning: Experience as the Source of Learning and Development*. Englewood Cliffs, NJ: Prentice-Hall.

Annex A: Detailed training curriculum

Table 4: Detailed Training Curriculum

Part/Module/Topic	Time allocation as per curriculum (in mins)				Prioritization (Degree of relevance)			Duration of each topic (in mins)		
Particulars	**Interac-tive pres-entation**	**Exercise / Activities**	**Case studies**	**Total**	**PM**	**BOD**	**SM**	**PM**	**BOD**	**SM**
PART I: FUNDAMENTALS OF CORPORATE GOVERNANCE										
MODULE 1: INTRODUCTION TO CORPORATE GOVERNANCE FOR SOES										
Introduction to overall program	20			20	●	●	●	20	20	20
Defining corporate governance for SOEs	20			20	●	●	●	20	20	20
Key principles of good corporate governance systems	30	30		60	●	●	●	60	60	60
Business case for corporate governance including corporate governance concerns and challenges	30		30	60	●	●	◑	60	60	30
Corporate governance policies and procedures – Country and company level with an emphasis on legal and regulatory framework for SOEs	30			30	●	◔	●	30	8	30
MODULE 2: ROLE OF THE STATE AS THE OWNER/MAIN SHAREHOLDER										
Defining state ownership role	20			20	●	●	◔	20	20	5
The core rights and functions of the State acting as owner: Overview of different ownership modules, legal framework and ownership policies	30	30		60	●	◔	◔	60	15	15
Setting the policy priorities (commercial vs public policy objectives, dividend policy)	30			30	●	◑	◔	30	15	8
Ensuring competitive neutrality	30			30	●	◑	○	30	15	-
State's ownership role over the Board (selection and removal of board members)	25		30	55	●	◑	◔	55	28	14
State's financial monitoring responsibilities	30			30	●	●	◔	30	30	8
Criteria for assessing fiscal risks of SOEs	30			30	●	◑	○	30	15	-
State-Board relations and communication -the Do and Don't	30		30	60	●	●	◔	60	60	15
Monitoring SOE performance via performance agreement	30			30	●	◔	◔	30	8	8
MODULE 3: PROTECTING MINORITY SHAREHOLDER AND STAKEHOLDER RIGHTS										
Importance of minority protection, international good practices and key elements	30			30	◑	◔	◑	15	8	15
Shareholder rights - minority and golden shares	30	30		60	◑	◔	◑	30	15	30
Key stakeholders in SOEs with a focus on stakeholder identification/mapping, stakeholder engagement and external communication mechanism.	40			40	◑	●	●	20	40	40

Part/Module/Topic	Time allocation as per curriculum (in min)				Prioritization (Degree of relevance)			Duration of each topic (in min)		
Particulars	Interactive presentation	Exercise / Activities	Case studies	Total	PM	BOD	SM	PM	BOD	SM
PART II: THE BOARD										
MODULE 1: BOARD COMPOSITION AND STRUCTURE										
Characteristics of a balanced board including gender aspects	30			30	●	●	◔	30	30	8
Optimizing Board size	15	30		45	●	●	◔	45	45	11
Types of directors and their leadership attributes	35			35	●	●	●	35	35	35
Establish specialized board committees (audit committee, sustainability committee, risk committee, HR committee)	45		30	75	◑	●	◑	38	75	38
MODULE 2: BOARD'S ROLES, DIRECTOR'S DUTIES AND LIABILITIES										
Board's roles and responsibilities including facing ethical challenges, anti-corruption and integrity, codes of ethics/conduct and whistleblowing	45			45	●	●	◔	45	45	11
Role of the state representative on SOE board	20			20	●	●	◔	20	20	5
Differentiate managing versus directing and identifying dilemmas	30			30	◔	●	◔	8	30	8
Director's legal duties and liabilities	45		30	75	◑	●	◔	38	75	19
MODULE 3: BOARD PRACTICES AND PROCEDURES										
Role of the Company Secretary	20			20	◔	●	◔	5	20	5
Meeting preparation	10	10		20	◔	●	◔	5	20	5
Conducting meetings	10	10		20	◔	●	◔	5	20	5
Follow up and in between meeting	10	10		20	◑	●	◔	10	20	5
Communicating with the State/ Shareholder	10	10		20	●	●	◔	20	20	5
MODULE 4: IMPROVING BOARD PROFESSIONALISM AND EFFECTIVENESS										
Chairman and CEO - role separation	30			30	◑	●	◔	15	30	8
Develop formal (written) policies and procedures for board operations	30			30	◔	●	◔	8	30	8
Board evaluation systems	20	30		50	●	●	◔	50	50	13
Characteristics of dysfunctional boards	20			20	●	●	◔	20	20	5
Remuneration policies for the Board of SOEs in line with Government policy	30			30	●	●	◔	30	30	8
Invest in board director training, including identification of general environmental and social risk issues	20			20	●	●	◔	20	20	5

Part/Module/Topic	Time allocation as per curriculum (in min)				Prioritization (Degree of relevance)			Duration of each topic (in min)		
Particulars	**Interac-tive pres-entation**	**Exercise / Activities**	**Case studies**	**Total**	**PM**	**BOD**	**SM**	**PM**	**BOD**	**SM**
PART III: STRATEGY, RISK, AND PERFORMANCE										
MODULE 1: DEVELOPING AN EFFECTIVE BUSINESS STRATEGY										
Elements of a good strategy	30			30	◔	●	●	8	30	30
Board's role in the governance of a company's strategy, including governance of risk	25			25	◑	●	◔	13	25	6
Stratergic planning process (role of the board vs management)	30			30	◑	●	●	15	30	30
Tools to formulate strategy linking Performance Management Agreement (PMA) and CG code	30			30	●	●	◔	30	30	8
Balancing SoE public service obligations with commercial obligations Role of state- setting broad mandates and objectives Role of the board -setting the strategy	30		30	60	●	●	◔	60	60	15
Monitoring implementation of strategy by management	30	30		60	◑	●	●	30	60	60
HR policy to support strategy delivery (planning and recruitment, training and development, management, board succession)	45			45	●	●	●	45	45	45
MODULE 2: FINANCIAL PLANNING AND BUDGETING FOR SOE SERVICE OBLIGATIONS										
Budgeting process and management in SOEs	30			30	◑	●	◔	15	30	8
Financing options for service obligations, advantages and disadvantages	30			30	●	●	◔	30	30	8
MODULE 3: FINANCIAL OVERSIGHT AND DECISION-MAKING										
Financial oversight arrangements in SOEs - Board level	30			30	◑	●	◔	15	30	8
Assessing financial performance and health of SOEs	45		30	75	●	●	●	75	75	75
Company's capital gearing, dividend policy and valuation	45			45	◑	●	◔	23	45	11
Subsidiary governance	20			20	◑	●	◔	10	20	5
MODULE 4: RISK GOVERNANCE										
Concepts and nature of risk management (risk identification/ mapping, role of the board, risk function and reporting of risk)	30			30	◑	●	◔	15	30	8
Risk appetite, strategy and management	30			30	◑	●	●	15	30	30
Risks arising from Environmental, Climate and Social factors	45			45	◑	●	●	23	45	45
Disaster recovery and business continuity planning	30			30	◑	●	●	15	30	30

Part/Module/Topic	Time allocation as per curriculum (in min)				Prioritization (Degree of relevance)			Duration of each topic (in min)		
Particulars	Interactive presentation	Exercise / Activities	Case studies	Total	PM	BOD	SM	PM	BOD	SM
PART IV: CONTROL ENVIRONMENT, TRANSPARENCY, AND DISCLOSURE										
MODULE 1: INTERNAL AND EXTERNAL CONTROLS & COMPLIANCE										
Understanding the control environment including internal and external controls	30		30	60	◑	●	●	30	60	60
Internal audit, risk assessment and decision-making frameworks	45	45		90	◑	●	●	45	90	90
Importance of a comprehensive compliance program	30			30	◑	●	●	15	30	30
HR procedures and control (HR compensation, HR performance management)	30			30	◑	●	●	15	30	30
Effective organizational structure	30			30	◑	●	●	15	30	30
External audit for SOEs/Role of the Supreme Audit Institution/Parliamentary Oversight)	30			30	◑	●	●	15	30	30
MODULE 2: FINANCIAL ACCOUNTING AND DISCLOSURE										
Transparency and disclosure of financial information	15			15	◑	●	●	8	15	15
International and local accounting environment for SOEs	45			45	◑	●	●	23	45	45
Financial reporting of SOEs, key users and their need for information	30	30		60	◑	●	●	30	60	60
Consequences of inadequate financial information	20		30	50	●	●	●	50	50	50
MODULE 3: NONFINANCIAL INFORMATION REPORTING AND DISCLOSURE										
Nonfinancial information disclosure	15			15	◑	◔	●	8	4	15
Disclosure provisions under procurement guidelines and right to information	30			30	◑	◔	●	15	8	30
Sustainability Reporting	30			30	◑	◔	●	15	8	30
Narrative reporting and methods of communication	30			30	◑	◔	●	15	8	30
MODULE 4: SOE PROCUREMENT										
Good procurement principles and standards for SOEs	30			30	●	◔	●	30	8	30
Developing a procurement strategy and plan based on market assessment	30			30	◑	●	●	15	30	30
Efficient procurement processes and competencies	30			30	◑	◔	●	15	8	30
Transparency and integrity of SOE procurement	30			30	◑	◑	●	15	15	30
Total (min)								**1,853**	**2,241**	**1,605**
Total (hours)								**31**	**37**	**27**
Total (days)								**6**	**7**	**5**

Legend	Harvey Ball Icon	Degree of relevance	Time allocation
	●	highly relevant	100%
	◑	medium relevance	50%
	◔	low relevance	25%
	○	no relevance	0%

Annex B: Incorporating cross-cutting themes in the curriculum

Table 5: Cross-cutting Themes in the Curriculum

Module No. and title	Mapping of cross-cutting themes to the respective parts/modules	MFD	Gender	Integrity and anti-corruption	Climate change and resilience
Part I					
2. Role of the state as an owner/main shareholder	Adoption of professional criteria for the selection and removal of board members		✓	✓	
	Fiscal risk assessment and oversight, vetting of the business case of SOE investments/MFD (when treasury guarantee or financing is sought), and performance monitoring	✓			✓
3. Protecting minority shareholder and stakeholder rights	Shareholder rights— minority and golden shares			✓	
	Key stakeholders in SOEs with a focus on environmental and social responsibility		✓	✓	✓
Part II					
1. Board composition and structure	Characteristics of a balanced board		✓		
2. Board's roles, director's duties, and liabilities	Board's roles and responsibilities, including facing ethical challenges, anti-corruption, and integrity			✓	✓
	Role of the state representative	✓		✓	
3. Board practices and procedures	Ensuring clear policies for addressing potential conflicts of interest, ethical challenges and responses, and strengthening anti-corruption and integrity measures			✓	
Part III					
1. Developing an effective business strategy	Strategic planning process				✓
	HR policy to support strategy delivery (planning and recruitment, training and development)		✓		
2. Financial planning for SOE service obligations	Financing options for service obligations, advantages, and disadvantages	✓			
3. Risk governance	Risks arising out of environmental and social factors				✓
Part IV					
1. Internal and external controls and compliance	Understanding the control environment, including internal controls and internal audit			✓	
	HR procedures and control (HR compensation, HR performance management)		✓		
	Whistle-blowing			✓	
2. Financial accounting and disclosure	Disclosures and transparency			✓	✓
	Consequences of inadequate financial information			✓	
3. Nonfinancial information reporting and disclosure	Sustainability reporting				✓
4. SOE procurement	Transparency and integrity of SOE procurement				✓

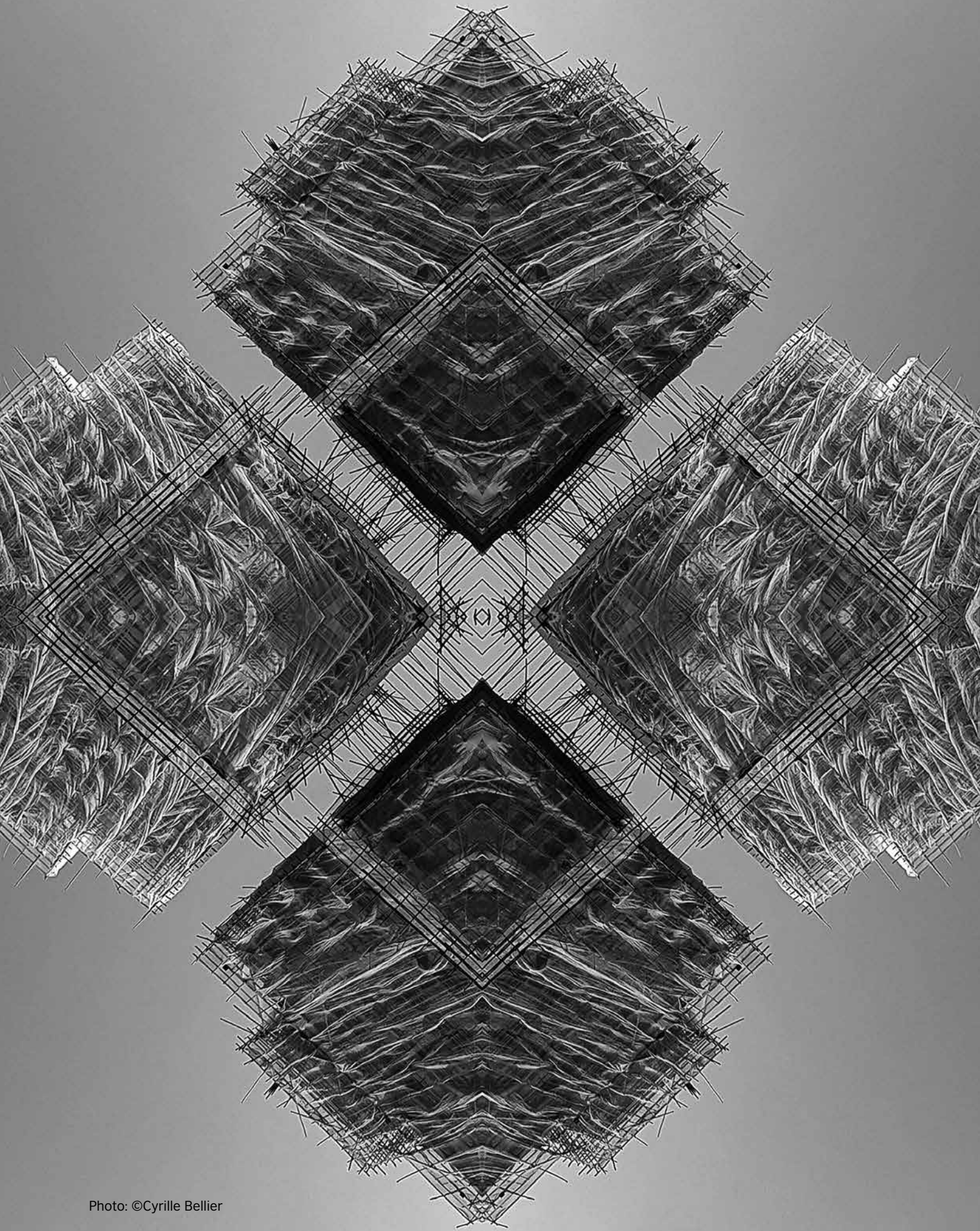


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Corporate Governance

Leadership Training Toolkit for SOEs

Part I Module 1
Fundamentals of Corporate Governance

Introduction to Part I: Fundamentals of Corporate Governance

> *"Corporate governance refers to structures and processes for the direction and control of companies. Corporate governance concerns the relationships among the management, board of directors, controlling shareholders, minority shareholders, and other stakeholders. Good corporate governance contributes to sustainable economic development by enhancing the performance of companies and increasing their access to outside capital."*
> – International Finance Corporation (IFC)

Part I explores the roles played by the shareowners, boards, directors, executive managers, and other stakeholders within the corporate governance system, and the principles underlying a sound corporate governance system.

Table 6: Coverage of OECD Guidelines on Corporate Governance of State-Owned Enterprises (SOEs) in Part I

OECD Guidelines	Coverage
Rationales for state ownership	☑
The state's role as an owner	☑
State-owned enterprises in the marketplace	☑
Equitable treatment of shareholders and other investors	☑
Stakeholder relations and responsible business	☑
Disclosure and transparency	☑
The responsibilities of the boards of state-owned enterprises	☑

Figure 4: Contents of Part I

Module 1	**Introduction to corporate governance**	• This module provides an overview of the corporate governance landscape in the SOE context, covering the key principles, elements, and guidelines for developing an effective corporate governance framework. It also discusses the business case for corporate governance.
Module 2	**Role of the state as an owner**	• This module describes the rights and responsibilities of the state as an owner. It covers various ownership models, responsibilities of the state with respect to board nominations, financial oversight, and performance monitoring. It also discusses state-board relationships.
Module 3	**Protecting minority shareholder and stakeholder rights**	• This module examines the importance of minority protection, shareholder rights for the minority and golden shares as well as the key stakeholder environment in SOEs.

Part I Module 1: Fundamentals of Corporate Governance

This session (module) covers the following topics:

1 Defining corporate governance for SOEs



2 Key principles of good corporate governance system



3 Business case for corporate governance



4 Corporate governance policies and procedures

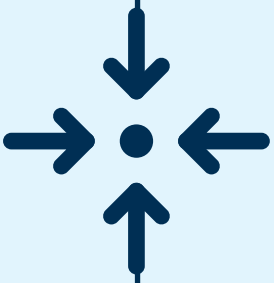




Photo: ©Sergio Souza/Unsplash.com

Learning objectives

By the end of this module, the participants will be able to



- **Appreciate the significance and unique challenges of SOE corporate governance within a larger universal corporate governance context and vision of success**
- **Describe the types of SOEs and define corporate governance in SOEs**
- **Identify the key elements and principles of corporate governance as prescribed in OECD Guidelines for SOEs**
- **Explain the importance of corporate governance in SOEs**
- **Identify and detail the concerns and challenges of corporate governance in SOEs**
- **Identify the constituents of the corporate governance framework, both at the country level and the company level**

Agenda

Total time: 3 hours 10 min

Time	Topic
20 min	Introduction to the overall program
20 min	Defining corporate governance for SOEs
30 min	Key principles of good corporate governance
30 min	Exercise on principles of good corporate governance
30 min	The business case for corporate governance including corporate governance concerns and challenges
30 min	Case study on a business case for corporate governance
30 min	Corporate governance policies and procedures – country and company level with an emphasis on the legal and regulatory framework for SOEs

Topic one: Defining corporate governance for SOEs

Definition of corporate governance in SOEs

The World Bank Group (WBG) defines corporate governance as a set of structures and processes for the direction and control of companies. It involves relationships between the company's shareholders, stakeholders, board, and executive bodies for creating sustainable and long-term value. It ties together the strategy and performance dimensions of the company.

Good corporate governance contributes to sustainable economic development by enhancing the performance of companies and increasing their access to outside capital. Improved governance structures and processes help ensure quality decision-making, encourage effective succession planning for senior management, and enhance the long-term prosperity of companies, independent of the type of company and its sources of finance.

Essentially, the definition of corporate governance does not distinguish between the private and public sector. The difference lies in the process of implementation and functioning of corporate governance. For example, while the functions and responsibilities of the board do not differ between the private sector and SOE, the establishment and composition structure of the board, board procedures and management will vary from the private sector to SOEs.

Owing to the prevalence of SOEs and their specific governance challenges, a need for developing tailored corporate governance principles and guidelines was identified, materializing as the OECD Principles and Guidelines on Corporate Governance for SOEs. They are the internationally agreed standard for how governments should exercise the state ownership function to avoid the pitfalls of both passive ownership and excessive state intervention.

The guidelines were first developed in 2005 as a complement to the OECD Principles of Corporate Governance. They have been updated in 2015 to reflect a decade of experience with their implementation and address new issues that have arisen concerning SOEs in the domestic and international context. The Guidelines provide advice on how governments can ensure that SOEs are at least as accountable to the general public as a listed company should be to its shareholders. Consequently, these principles and guidelines form a key part of the framework for this training curriculum.

Defining SOEs

SOEs are known by many names—public corporations, government corporations, government business enterprises, government-linked companies, parastatals, public enterprises, and public sector units or enterprises.

The OECD Guidelines for Corporate Governance in SOEs define "any corporate entity recognized by national law as an enterprise, and in which the state exercises ownership, should be considered as an SOE. This includes joint-stock companies, limited liability companies and partnerships limited by shares. Moreover, statutory corporations, with their legal personality established through specific legislation, should be considered as SOEs if their purpose and activities, or parts of their activities, are of a largely economic nature."

The rationale for state ownership of enterprises varies among countries and industries. It can typically be to comprise a mix of social, economic, and strategic interests. Often, in sectors that have less penetration of private sector enterprises, governments invest in the establishment of industries to maximize community welfare. Also, the government's entry into the production of goods and services renders control of natural monopolies, 'regulates' competition, and facilitates the pursuit of social objectives.

Types of SOEs

SOEs come in different legal forms and typically reside at the intersection of public and private law, with significant variation among countries and across sectors. SOE legal frameworks range from a full-fledged application of public law to a private law framework or a mixed approach that places some SOEs under public law, others under private corporate law, and the remaining under both. There is a wide range of legal forms for SOEs,[5] depending on the following factors:

- The level of government that owns the enterprise (central/federal, state/regional, or local)
- How the enterprise was founded
- The purpose of the SOE
- The status of the SOE if it is in the process of being privatized

Other variations include

- Full, majority, or minority ownership by the government
- Listing (or not) on a stock exchange
- Government shareholdings through vehicles such as government pension funds, asset management funds, restructuring corporations, and development lenders
- State-enabled (for example, enterprises that have been granted exclusive rights by the state) as opposed to state-owned.

In some cases, an individual SOE may be set up as a statutory corporation established by an act of parliament and governed by its special statute that gives it financial independence or certain special power (for example, authority to collect specific fees). Such SOEs are often legally assigned a specific policy goal or tasks other than profit maximization. Such SOEs are typically wholly state-owned and operate in sectors, where public authorities are the most directly involved, such as the supply of public services or utilities. More typically, SOEs are in the form of public enterprises that may or may not be corporatized.

In many countries, incorporated SOEs in the form of joint-stock companies or limited liability companies are regulated by normal company legislation as outlined in Box 1.

Box 1: Example of Countries with SOEs under Company Legislation

Corporatized SOEs operate under normal company legislation in many countries and sometimes under both company law and SOE law:

- *In Bhutan*, SOEs operate under the company law, they must also abide by the SOE ownership policy that is in place.
- *In Chile*, company law applies to all SOEs except for nine large SOEs that have their own separate laws.
- *In Ghana* and *Kenya*, SOEs are governed mainly by company law.
- *In India*, SOEs fall under company law but must also follow different guidelines established for SOEs as well as a corporate governance code for SOEs.
- *In Malaysia*, government-linked corporations (GLCs) are governed by company law with the GLC Transformation Program and the *GLC Transformation Manual* in place.
- *In Pakistan*, SOEs are regulated by the Companies' Ordinance and by recently issued Rules on Corporate Governance for SOEs.
- *In Peru*, SOEs fall under both company law and an SOE law that creates the state ownership entity FONAFE, with a corporate governance code in place for SOEs.
- *In Serbia*, corporatized SOEs fall under the new company law.
- *In South Africa*, SOEs operate under company law with the Protocol for Corporate Governance in place.
- *In Zambia*, most of the SOEs are legally founded under the Companies Act.

Source: IFC. 2008. *Toolkit 3: Corporate Governance Board Leadership Training Resources Kit*. World Bank Group.

Topic two: Key principles of good corporate governance systems

Four pillars of corporate governance

Primarily, corporate governance relies on the foundation of trust among shareowners, directors, and managers, which is built on the following:

- **Transparency.** Directors should clearly communicate any material decisions to relevant stakeholders to bring visibility into performance. Detailed and sincere financial statements are published on time.
- **Accountability.** Employees at all levels take responsibility for their actions and achievements.
- **Fairness.** All shareowners should receive equal, just, and unbiased consideration by the directors and management.
- **Responsibility.** Directors and other leaders should carry out their duties with honesty, probity, and integrity.

The mentioned principles intend to assist governments in their efforts to evaluate and improve the legal, institutional, and regulatory frameworks for corporate governance in their countries and to provide guidance and suggestions for stock exchanges, investors, corporations, and other parties that have a role in the process of developing good corporate governance. These principles also provide the bedrock for the establishment of a corporate governance framework discussed in the subsequent sections. (*See Topic 4 in this module.*)

The principles are also applicable to SOEs and compatible with the OECD Guidelines on Corporate Governance of State-Owned Enterprises. As an indication of their universal acceptance, these six OECD principles have been endorsed by the WBG, the United Nations (UN), the International Organization of Securities Commissions (IOSCO), the Basel Committee for Banking Supervision, the Islamic Financial Services Board and all 30 OECD member countries.

Fundamentals of corporate governance for SOEs

The OECD Guidelines on Corporate Governance of State-Owned Enterprises postulate specific guidance to countries on effectively managing their responsibilities as company owners and establishing a good corporate governance environment in the SOEs to make them more competitive, efficient, and transparent. (*See Handout on G-20/OECD Guidelines for SOEs, 2015.*)

The following constitute the elements of a good corporate governance system (elaborated in Table 7):

- Good board practices
- Effective controls
- Transparent disclosure
- Well-defined shareowner rights
- Board commitment
- Environment, Social, and Corporate Governance (ESG)
- Financial discipline

Table 7 illustrates the content of the seven fundamental elements of corporate governance and how they relate to the G-20/OECD Guidelines which are presented as an additional read in this material.

While Table 7 covers the fundamentals of good corporate governance, it has evolved significantly over the past decade, expanding to cover various new themes such as integrity and anti-corruption, climate change and resilience, and gender diversity and inclusion. This is further illustrated in Box 2 and incorporated in this SOE leadership toolkit as cross-cutting themes.

Box 2: Recent Trends in Corporate Governance

The existing debates on corporate governance have gained new intensity in the face of mega-forces such as climate change, income inequality, digitalization, and so on, sweeping the globe. The past few years have seen a proliferation of statements, proposals, and revised codes of corporate governance such as the 'New Paradigm', the 'Common Sense Principles', the 'King IV Report', and the '2018 UK Corporate Governance Code', and so on. While some of these statements reaffirm conventional doctrines and practices, others call for efforts to better align the activities of corporations with society's interest in building a more inclusive, equitable, and sustainable economy.

In recent years, the environment and social dimensions of ESG have become two such emerging global governance trends. Investors increasingly demand greater focus and disclosure about climate-related risks, conflict minerals in the supply chain, workplace safety measures, or various pay ratios, for example—calls with regard to comprehensive periodic reports on companies' social and environmental performance.

Asset managers and asset owners are integrating ESG into investment decisions, some under the framework of sustainability or integrated reporting. The priority for investors involves linking sustainability to long-term value creation and balancing ESG risks with opportunities. ESG oversight, improved disclosure, relative company performance against peers, and understanding how these issues are built into corporate strategy are the key focus areas. Climate change and sustainability are critical issues to many investors and are at the forefront of governance in many countries. Therefore, 'climate change and resilience' comprise a major cross-cutting theme of this Toolkit and is discussed under relevant topics as mentioned in Annex B.

Sources:

O'Kelley, Rusty, Anthony Goodman, and Melissa Martin. 2018, Russell Reynolds Associates, 2019 *Global & Regional Trends in Corporate Governance*. Harvard Law School Forum on Corporate Governance.

Sharma, Abha, and Howard Dicker. 2018. *Common Sense Principles: A Blueprint for U.S. Corporate Governance?* Harvard Law School Forum on Corporate Governance.

Integrated Reporting Committee of South Africa. 2017. *Disclosure of Governance Information in the Integrated Report*. Institute of Directors, South Africa.

Financial Reporting Council. 2018. *The UK Corporate Governance Code*. London.

Table 7: G-20/OECD Guidelines on Corporate Governance of SOEs

Fundamentals of Corporate Governance	G-20/OECD Guidelines for Corporate Governance in SOEs, 2015
Good Board Practices • Clearly defined roles and authorities • Duties and responsibilities of directors understood • Board is well-structured • Appropriate composition and mix of skills • Appropriate board procedures • Director remuneration in line with best practice • Board self-evaluation and training conducted	**The boards of SOEs should have the necessary authority, competencies, and objectivity to carry out their functions of strategic guidance and monitoring of management. They should act with integrity and be held accountable for their actions.**
Control Environment • An independent audit committee established • Risk-management framework present • Internal control procedures • Internal audit function • Independent external auditor conducts audits • Management information systems established • Compliance function established	A. SOEs' annual financial statements should be subject to an independent external audit based on high-quality standards. Specific state control procedures do not substitute for an independent external audit. B. SOEs should develop efficient internal audit procedures and establish an internal audit function that is monitored by and reports directly to the board and to the audit committee or the equivalent corporate organ.
Transparent Disclosure • Financial information disclosed • Nonfinancial information disclosed • Financials prepared according to International Financial Reporting Standards (IFRS) • High-quality annual report published • Web-based disclosure	**State-owned enterprises should observe high standards of transparency and be subject to the same high-quality accounting, disclosure, compliance, and auditing standards as listed companies.**

Well-defined Shareowner Rights • Minority shareholder rights are formalized • Well-organized general assembly conducted • Policy on related-party transactions • Policy on extraordinary transactions • Clearly defined and explicit dividend policy	• The state exercises the ownership of SOEs in the interest of the public. It should carefully evaluate and disclose the objectives that justify state ownership and subject these to a recurrent review. • The state should act as an informed and active owner, ensuring that the governance of SOEs is carried out in a transparent and accountable manner, with a high degree of professionalism and effectiveness. • Where SOEs are listed or otherwise include non-state investors among their owners, the state and the enterprises should recognize the rights of all shareholders and ensure equitable treatment to shareholders and equal access to corporate information. • The state ownership policy should fully recognize SOEs' responsibilities toward stakeholders and request that SOEs report on their relations with stakeholders. It should clarify any expectation the state has for responsible business conduct by SOEs.
Board Commitment • The board discusses corporate governance issues and has created a corporate governance committee • The company has a corporate governance champion • A corporate governance improvement plan has been created • Appropriate resources are committed • Policies and procedures have been formalized and distributed to relevant staff • A corporate governance code has been developed • The company is publicly recognized as a corporate governance leader	**The boards of SOEs should have the necessary authority, competencies and objectivity to carry out their functions of strategic guidance and monitoring of management. They should act with integrity and be held accountable for their actions.**
Environment, Social, and Governance (ESG) • Periodic disclosure to shareholders and the public on the SOE's CG framework and practices and their conformance to the country's national CG code of best practices are disseminated. • A compliance function ensures compliance with ESG policies and procedures, code of ethics and/or conduct. • The company is publicly recognized, at least among SOEs, as a global leader in ESG practices.	**The state ownership policy should fully recognize the SOEs' responsibilities toward stakeholders and request that SOEs publish a report on their relationships with stakeholders. It should clarify any expectation the state has regarding responsible business conduct by SOEs.**
Financial Discipline • The SOE has clearly identified and differentiated between its commercial and policy objectives • The SOE's commercial and policy objectives are explicit and disclosed to the public • Funding costs and sources, including any form of financial assistance from the state are transparent and disclosed to the public • If any public procurement rule applies to the SOE, it does not unduly restrict the ability of the SOE to procure goods and services.	**SOEs should report material financial and nonfinancial information to the enterprise in line with high-quality internationally recognized standards of corporate disclosure, including areas of significant concern for the state as an owner and the public. This includes SOE activities that are carried out in the public interest. With due regard to enterprise capacity and size, examples of such information include:** a. A clear statement to the public of enterprise objectives and their fulfilment (for fully owned SOEs, this would include any mandate elaborated by the state ownership entity) b. Enterprise financial and operating results, including the costs and funding arrangements on public policy objectives, wherever relevant c. Any financial assistance, including guarantees, received from the state and commitments made on behalf of the SOE, including contractual commitments and liabilities arising from public-private partnerships (PPPs)

Source: Adapted from OECD 2015.

Topic three: Business case for corporate governance including corporate governance concerns and challenges

Why is corporate governance important?

Numerous studies conclude that well-governed companies worldwide perform better in commercial terms (refer to Box 3). Adopting corporate governance best practices:

- Improves the operational performance of SOEs;
- Increases access to alternative sources of financing through domestic and international capital markets, while helping develop markets;
- Contributes to financing for infrastructure development;
- Reduces the fiscal burden of SOEs and increases net contribution to the budget through higher dividend payments;
- Reduces corruption and improves transparency.

As mentioned in Box 3, the prevalence of SOEs begets the need for good corporate governance, which positively affects their performance over the long term in the following ways:

1. **Improved operational performance of SOEs** – Sustainable wealth creation in SOEs can only be achieved through good professional management, entrepreneurship, innovation, and better allocation of resources. Effective corporate governance adds value by improving the SOEs' performance through efficient management and better asset allocation (refer Box 4).
2. **Increased access to alternative sources of financing through domestic and international capital markets, while helping develop markets** – As governments face continued budget constraints, better-governed SOEs are more easily able to raise financing for infrastructure and other critical services through the capital markets. In turn, SOE issuances can help develop capital markets. Malaysia's government-linked companies, for example, account for about 36 percent of the market capitalization of Bursa Malaysia and about 54 percent for the benchmark Kuala Lumpur Composite Index. In India, 41 centrally owned SOEs account for 20 percent of the market capitalization of the Mumbai Stock Exchange.[6]
3. **Financing for infrastructure development** – Most public spending on infrastructure passes through SOEs. The value of SOEs lies in their potential to provide efficient, reliable, and affordable critical products and services in key sectors, such as power generation and water supply, transport, oil and gas, and hospitals. They enable expensive and

Box 3: SOEs – A Global Snapshot

- Accounts for 20–30 percent of gross domestic product (GDP) in transition economies and 15 percent of GDP in OECD countries
- Account globally for 20 percent of investment and 5 percent employment
- SOE global revenues is estimated to be US$8 trillion
- 30 percent of Chinese GDP, 38 percent of Vietnamese GDP, and 25 percent of Indian GDP
- Comprise more than 10 percent of worlds' 2,000 largest companies and a similar share in sales value
- Share in Fortune Global 500 is estimated at 23 percent
- 13 of top 15 biggest oil companies are SOEs
- Account for 11 percent of global FDI inflows

Source: Independent Evaluation Group. 2018. *World Bank Group Support for the Reform of State-Owned Enterprises, 2007-2018: An IEG Evaluation*. Approach Paper, World Bank, IFC. MIGA.

Box 4: Improving the Operational Performance of SOEs

A study of 44 SOEs in the water and electricity sectors of countries in Latin America and the Caribbean finds a positive correlation between six dimensions of corporate governance reform and the operational performance of the utilities. The dimensions include the legal and ownership framework, the composition of the board, the performance management system of the enterprise, the degree of transparency and disclosure of financial and nonfinancial information, and the characteristics of staff (for example, education, salary, and benefits). The study shows that the composite index of these dimensions is strongly correlated with labor productivity, tariffs, and service coverage.

Another recent study conducted in Indonesia reveals that the corporate governance index variables affecting the financial performance (measured in terms of net profit margin) of SOEs are Board of Commissioners, Nomination and Remuneration Committee, and the Risk Management Committee. The SOEs chosen in this study pertain to government's economic priorities, namely, food, fishery and marine, energy, industry, tourism sector.

Sources:

Andrés, Luis, José L. Guasch, and Sebastián L. Azumendi.. 2011. "Governance in State-Owned Enterprises Revisited – The Cases of Water and Electricity in Latin America and the Caribbean." Policy Research Working Paper 5747, World Bank, Latin American and the Caribbean Region.

Fatmawati, Rini, and Suhardjanto Djoko. 2018. "Corporate Governance and Its Influence on Financial Performance of State-Owned Enterprises (SOEs) In Indonesia." *International Journal of Business and Management Invention (IJBMI)* 7 (2).

expansive investments that are often beyond the private sector's capacity. Thus, well-run SOEs can contribute to health, welfare, education and infrastructure improvements, poverty reduction, and inclusive economic growth. By reducing internal inefficiencies, SOEs can make that spending go farther.

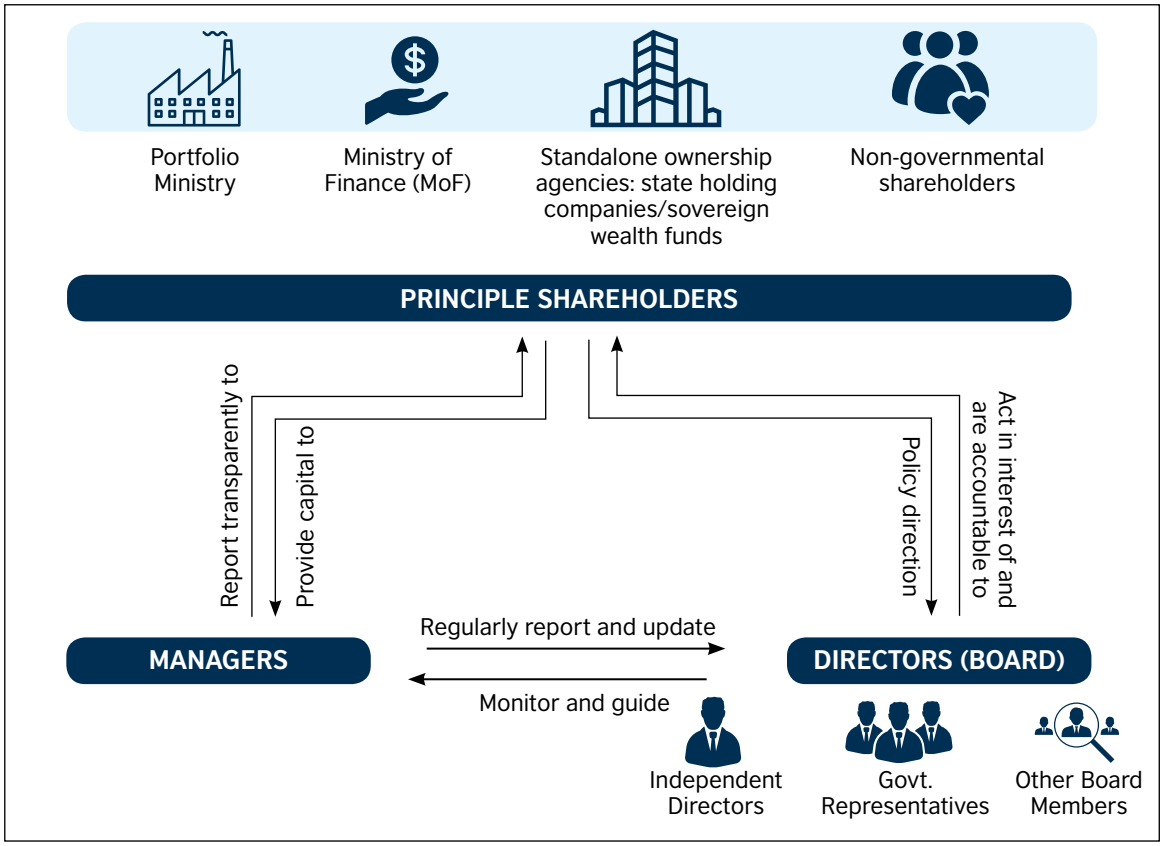
4. **The reduced fiscal burden of SOEs and increased net contribution to the budget through higher dividend payments** – SOEs are generally associated with persistent losses and burgeoning debt commitments, thereby creating a huge burden on the country's budget. Improved corporate governance mechanisms have the potential to augment the operating performance of SOEs, and in turn, reduce fiscal burden. Improved governance also increases the transparency of the contingent liabilities associated with SOEs, thereby reducing fiscal risk (refer to Box 5).
5. **Reduced corruption and improved transparency** – Corruption remains a serious problem in SOEs and can influence the financial strength and valuations of the companies, negatively affects investor perceptions, leads to the misallocation of scarce government resources, and constrains the overall economic and financial growth. Better-governed companies with integrity and accountability mechanisms are likely to be less corrupt and more transparent. Appendix A1.1C lists down the principles governing anti-corruption and integrity at SOEs by various international institutions.

Corporate governance challenges

Traditional corporate governance challenges stem from the misalignment of the principal's objectives with the agent's mandate. While the basic premise stands in the SOE context, by nature of their ownership, objectives and operations, SOEs face additional governance challenges arising out of other internal and external sources. This topic discusses various corporate governance challenges faced by SOEs and explores solutions to address these risks.

Figure 5 illustrates various principal-agent relationships in an SOE and interactions between the shareholders, directors, and managers. The multiple and sometimes ill aligned principal-agent relationships may hinder the effective functioning of an SOE as described in the figure; the SOE's inability to effectively manage these multiple principals, may lead to excessive transaction costs

Figure 5: Multiple Principal-Agent Relationships in an SOE



Source: Adapted from World Bank Group 2014.

Box 5: Reduced Fiscal Risks of SOEs

The Lithuanian government, which is working to improve the governance of its major SOEs, has estimated that annual dividends from better governance could be increased by 1 percent of GDP, helping reduce its budget deficit as part of efforts to join the Euro Area in 2014. In 2010, the Chinese government announced that it would start extracting more dividends from its SOEs with the aim of forcing them to compete more fairly with the private sector and allocating resources to social expenditures.

An article by Dag Detter and Stefan Fölster estimates that better-governed SOEs around the world would enable central governments to generate an astonishing US$3 trillion in annual returns—"more than the world's yearly investment in infrastructure including transportation, power, water and telecommunication."

Sources:

IFC. 2008. *Toolkit 3: Corporate Governance Board Leadership Training Resources Kit*. World Bank Group.

Detter, Dag, and Stefan Fölster. 2014. "Hidden Assets, How Countries Can Capitalize on Public Wealth". *Foreign Affairs*. November 24.

and interference, to policy inconsistency and duplicate reporting. This may in turn undermine both the state shareholder and oversight function as well as the SOE performance.

The multiple principal-agent relationships that exist in an SOE cause concern over the effective functioning of the corporate governance system in the SOE. A direct consequence of multiple principals is multiple goals, which provides scope for conflict, thus negatively affecting the performance of the SOEs. With multiple principals pursuing multiple (and often conflicting) objectives and targets, SOE board and management representation are often utilized as an effective tool to exercise influence and drive vested interests. Consequently, politically motivated representatives of various principals may often dominate the SOE boards. This leads to greater political interference and micromanagement by the principals.

While SOEs are subject to several checks and balances to ensure transparency and accountability at the state level (such as

external audit mechanisms, public scrutiny, parliamentary oversight, and so on), the enforcement of such measures is often quite weak. These challenges stem from the absence or lack of proper financial reporting and of a robust performance monitoring system to ensure accountability and responsibility for the performance of the agents, particularly the board of directors and senior management. Another major issue of multiple and dominant principals is the weak protection of minority shareholders and other stakeholders.

Owing to the aforementioned challenges of multiple principals and goals, limited transparency, and accountability, most minority shareholders face challenges in exercising their rights as shareholders to the extent that controlling state shareholders may encourage SOEs to conduct transactions that benefit them at the expense of other minority shareholders. Furthermore, weak protection of minority shareholders can damage the potential of the SOEs to raise finances from the private sector, increasing its reliance on the state.

Figure 6 further elaborates on these challenges and their potential impact on the SOE's performance across various dimensions.

Developing solutions to address these challenges

To address the corporate governance challenges discussed above, reforms across multiple elements of corporate governance can be explored, which included those shown in Figure 7 on the next page.

Figure 8 describes a list of potential reform steps/solutions across each of the aforementioned areas to address various corporate governance challenges faced by SOEs.

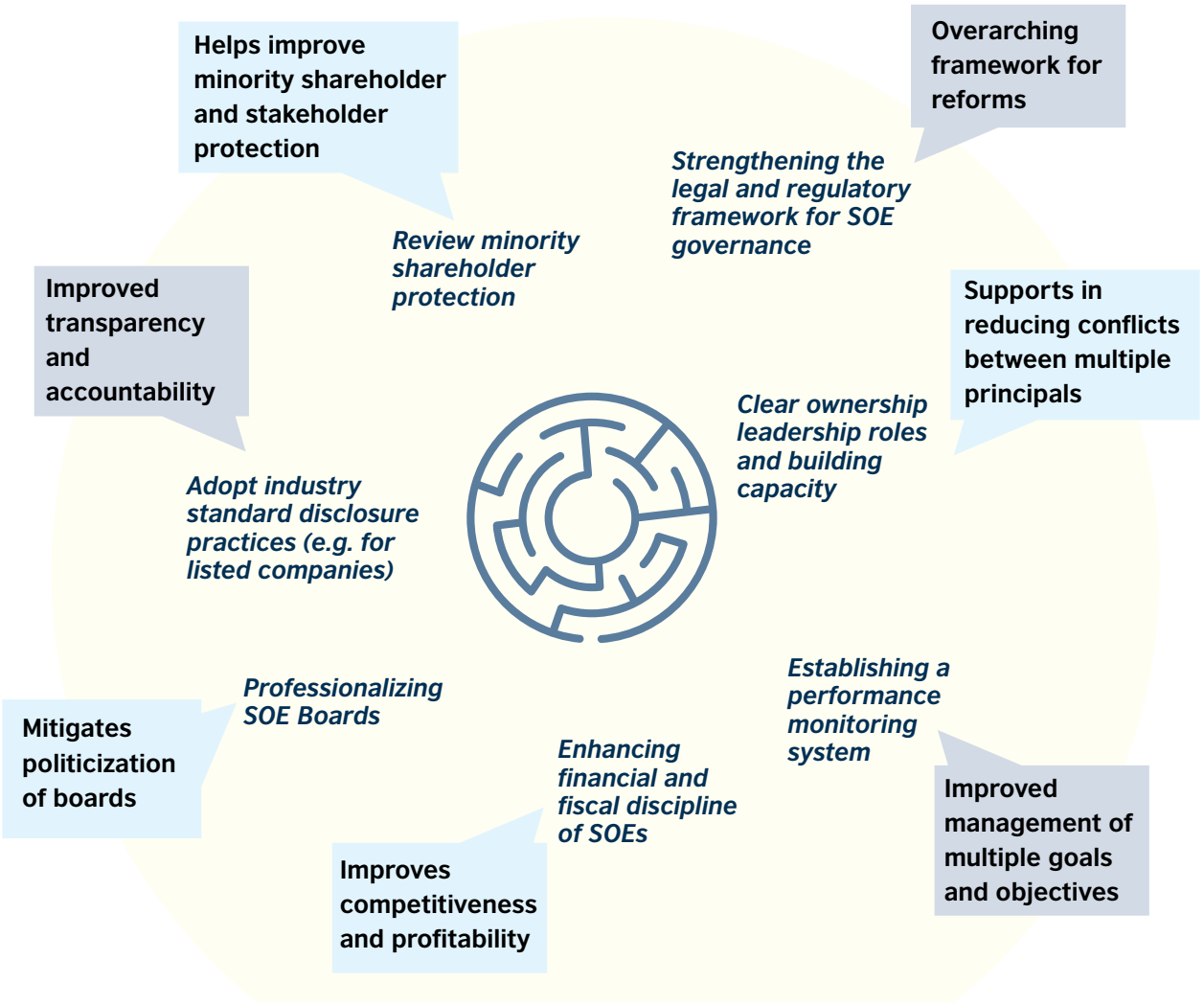
It is important to note that exploring these solutions requires a thorough understanding and analysis of challenges faced, as well as weighing their implicit and explicit costs against the benefits of implementation. These are further elaborated in subsequent modules across the training curriculum.

Figure 6: Consequences of Corporate Governance Challenges

Poorly defined ownership structures and responsibilities between multiple principals	• Possibility of conflicting objectives • Challenges in providing sufficient capital • Interference to board operations from shareholders
Pressure to balance multiple commercial and social goals and objectives	• Challenges in pricing of services/commodities • Challenges in achieving increased operational targets with reduced budgets • Challenges managing transparency and accountability due to unclear reporting relationships with multiple principals
Politicized boards and management	• Difficulties prioritizing corporate strategy initiatives based on influence levels of multiple principals • Capacity constraints (experience/expertise) for efficient decision-making
Low levels of transparency and accountability	• Limited information sharing to support decision-making • Possible misrepresentation to shareholders • Concealment of SOE debt portfolio
Weak shareholder and stakeholder protection	• Loss of confidence in SOE management • Affects potential of SOEs to raise finances
Protection from competition through preferential treatment	• Affects commercial viability and profitability of other private sector competition • Long-term negative impact on overall economic growth

Source: Adapted from World Bank Group 2014.

Figure 7: Solutions to Address Corporate Governance Challenges



Source: Adapted from World Bank Group 2014.

Figure 8: Potential Solutions/Reforms Steps to Address Corporate Governance Challenges

Strengthening legal and regulatory framework	• Higher clarity and certainty like uniform application of company laws and regulations to SOEs and private sector • Listing SOEs on stock markets to create capital market discipline
Ownership arrangements	• Creating safeguards against government intervention • Centralizing the state's ownership functions to bring focus, consistency, and good practices to the SOE sector
Performance monitoring	• Establishing performance agreements between owners and boards • Measuring and evaluating performance and ensuring accountability
Financial discipline and oversight	• Reducing fiscal costs and risks • Reducing preferential access to direct and indirect public financing • Identifying, computing, and financing the true cost of public service obligations • Prudent debt and guarantee management for SOEs
Professional SOE boards	• Standard Operating Procedures (SOPs) for board composition, nomination, roles and responsibilities, remuneration, evaluation, and other aspects • Empowerment of board sub-committees
Transparency and disclosure	• Applying private sector principles and international standards to SOEs for audit, reporting, and disclosures
Minority shareholder protection and rights	• Encouraging representation and participation from minority shareholders • Protecting against abusive related-party transactions

Source: Adapted from World Bank Group 2014.

Topic four: The corporate governance framework

The key elements of the corporate governance framework at the national level are given below.

Laws, regulations, rules

The underlying aim of a well-defined legal and regulatory framework is to make the broad policy directions of the state and the 'rules of the game' clear for everyone. While no one-size-fits-all approach applies to all countries and contexts, the framework should achieve the following:

- Set clear boundaries and define the relationship between the government as shareholder and SOE boards and management
- Separate legitimate government control and oversight for ensuring SOE accountability

Typically, the requirements for a company's formation and its operations are specified in company legislation. However, often a body of additional laws may affect the board's behavior and decisions. These laws, regulations, and rules may involve

- Company
- Insolvency
- Director disqualification
- Safety
- Employment
- Environment
- Intellectual property
- Consumer protection
- Competition
- Financial
- Stock exchange listing rules

The directors and managers must always act within the laws, regulations, and rules.

National corporate governance codes

Many countries now have a national code of corporate governance that recommends good practices for companies to follow. SOE codes are of three main types:

- **Voluntary codes.** Some SOE codes are voluntary, encouraging but not forcing SOEs to comply with their provisions. Voluntary SOE codes are found in Bhutan and Egypt, for example.
- **Comply-or-explain codes.** Some codes are applied on a comply-or-explain basis. All European Union (EU) countries have corporate governance codes that operate on the 'comply or explain' basis as well as requirements set out in law. In Sweden, the code goes beyond the standard 'comply or explain'. It requires companies that do not comply to explain what they did instead. The regulatory bodies in Japan including the financial services agency continue to lead reforms, with several new comply-or-explain guidelines added to the Amended Corporate Governance Code that came into effect in 2018. Like voluntary codes, comply-or-explain codes provide greater flexibility and scope for the application of a more customized approach by a company.
- **Mandatory codes.** Given the wide range of SOEs and the need to align commercial, political, and public policy goals, a mandatory or rules-based code is less common, as it may not allow the flexibility needed by different types of companies (listed SOEs, however, are required to follow the listing rules and codes of the stock exchange.) For example, in India, the Guidelines on Corporate Governance for Central Public Sector Enterprises were issued in 2007 as voluntary guidelines but based on the experimental phase, and after due inter-ministerial consultations, they were made mandatory in 2010.

Corporate governance codes can be found across various countries and companies with varying forms and substances (outlined in Box 6).

Developing an SOE code can be a way of increasing awareness regarding governance issues not only within SOEs but also within the government and the ownership entity (where one exists) and among the public. Consequently, any country seeking to develop an SOE code can consider the following steps:

Reach agreement within the government on the need for and purpose of the code and the desired outcomes. High-level support for developing and implementing a code is useful.

- Take time early on to consider the purpose of the code and develop an implementation plan, for example:
  - Consider whether the code should be used as a benchmarking tool as a model for individual SOE codes, or as a formal requirement
  - Identify an appropriate backer or champion for the preparation of the code
  - Nominate a leader or champion to be the public face of the code
  - Garner commitment from leaders (administration officials, board members, SOE executives)
  - Design complementary training and awareness-raising activities
- Identify key contributors to the code:
  - Line ministry and finance ministry officials
  - Ownership entity where one exists
  - SOE executives and board members
  - Academics
  - Private sector board members, executives, and other experts
  - High-level political supporters
- Form a working group and define its terms of reference
- Analyze and discuss existing codes
- Develop a first draft
- Disseminate the draft among relevant stakeholders, including the public, for comments
- Collect and publish the comments
- Formally adopt the code
- Roll out the code according to the implementation plan
- Periodically examine the impact of the code and adjust it and its implementation as needed

While voluntary codes and guidelines are meant to encourage SOEs to improve their governance practices, ensuring compliance can be a challenge, as companies get fewer incentives or come across no significant pressure—especially when codes are developed by third parties. In some cases, SOEs simply lack awareness of the code. Alternatively, they may lack the knowledge and practical guidance to implement the code, especially when it contains many aspirations but no clear priority. In other cases, once the code is in place, the ownership entity itself may take only modest steps to disseminate,

Box 6: Examples of the Legal Framework Governing SOEs in Various Countries

Some countries have general SOE framework laws. While some laws cover all the SOEs, others exclude large strategic SOEs such as utilities, natural resources, and defense, which may have their own separate laws.

- *In the Arab Republic of Egypt*, commercial SOEs fall under the Public Business Sector Law, and under the law, SOEs are also subject to the company law. Utilities and defense SOEs, however, have their own separate laws.
- *In case of the Republic of Korea*, the government-owned companies and government-invested companies are all subject to the Act on the Management of Public Institutions.

Corporatized SOEs operate under normal company legislation in many countries and sometimes under both company law and SOE law.

- *In Chile*, company law applies to all the SOEs except for nine large SOEs that have their own separate laws.
- *In Ghana* and *Kenya*, SOEs are governed mainly by company law.
- *In India*, SOEs fall under company law but must also follow many different guidelines established for SOEs as well as a corporate governance code for SOEs.
- *In Malaysia*, the government-linked corporations (GLCs) are governed by company law with the GLC Transformation Program and the GLC Transformation Manual in place.

Source: IFC. 2008. *Toolkit 3: Corporate Governance Board Leadership Training Resources Kit*. World Bank Group.

promote, and monitor compliance with the guidelines, even though promotion of good corporate governance practices should be a key function of such agencies.

It is also important to set out the state's implementation strategy in the national corporate governance code. It is relatively straightforward to develop corporate governance codes. The challenge lies in ensuring their effective implementation and enforcement, as evidenced by the anecdotes from some countries that their governance codes have not lived up to their promise to spur enduring improvements in corporate practices.[7] Therefore, it is pertinent to consider the following while rolling out the code:

- **Designing a suitable country tailored code.** Each country, whether developed or emerging, must devise its approach to developing and successfully implementing corporate governance codes. While all governance codes should be benchmarked against international best practices to aid comparability, they must also be customized to work in the local environment. Careful consideration during the design phase of the principal objectives to be achieved, the broader societal and regulatory context, and the optimal allocation of monitoring and enforcement responsibilities, combined with periodic refinements after their introduction to remedy shortcomings and respond to new developments, will increase the likelihood that corporate governance codes will have the desired impact.
- **Timeline for implementation.** The code must specify the timeline of implementation across different classes of SOEs. When the sophisticated requirements are rolled out to all SOEs at one go, it creates an unnecessary burden for smaller size SOEs and distracts governments from the quality application in the largest entities. With time, such push turns into a box-ticking exercise. Therefore, governments may consider a cascaded approach, that is, a phased implementation plan, which confirms whether it should be applied to the listed SOEs first or the largest SOEs in terms of market size or public utility relevance.

Governments can take several steps to promote and monitor compliance. They are:

- Disseminating the code to build awareness
- Developing tools and manuals to help SOEs adopt good governance practices from the code
- Providing training on the code to companies, owners, and regulators to build an understanding of the provisions and their application. In Egypt, for example, the Egyptian Institute of Directors played a vital part, not only in preparing and disseminating the SOE code but also in training SOE directors on the code's implementation and developing a manual for implementation
- Focusing on selected companies that understand the importance of good governance and using them to demonstrate an active commitment to applying the code, which can be a powerful inducement
- Developing the capacity of SOE owners and regulators to monitor and evaluate compliance and elevating their role and profile in promoting compliance
- Including compliance with the code as a critical part of the performance monitoring and disclosure systems. In India, for example, the corporate governance guidelines mandate that the annual reports of companies contain a separate section on corporate governance with details of compliance, with a certificate on compliance from auditors or the company secretary. Companies are also required to submit quarterly compliance or grading reports in a prescribed format to their line ministries, which in turn submit a consolidated annual report to the Department of Public Enterprises (DPE). Initially, only a few companies submitted reports, but the department's reminders and follow-up meetings with line ministries led to higher compliance rates over time.

Appendix A1.1A: For reference

See Section 1: Definition of corporate governance

There are several definitions of corporate governance, including the following:

The **corporate governance team within the Financial Markets Integrity Group of the World Bank**[8] describes corporate governance as follows:

Corporate governance concerns the system, by which companies are directed and controlled. It is about making companies, owners, and regulators more accountable, efficient, and transparent, which in turn builds trust and confidence. Well-governed companies carry lower financial and nonfinancial risks and generate higher shareholder returns. They also have better access to external finance and reduced systemic risks due to corporate crises and financial scandals. Reliable financial reporting, timely disclosures, better boards, and accountable management also facilitate the development of stronger capital markets. They improve a country's ability to mobilize, allocate, and monitor investments and help foster jobs and economic growth. Better supervision and monitoring can detect corporate inefficiencies and minimize vulnerability to financial crises.

According to the **IFC**[9], corporate governance refers to structures and processes for the direction and control of companies. It concerns the relationships among the management, board of directors, controlling shareholders, minority shareholders, and other stakeholders. Good corporate governance contributes to sustainable economic development by enhancing the performance of companies and increasing their access to outside capital.

Appendix A1.1B: G-20/ OECD Principles of Corporate Governance

The attributes of a good corporate governance framework are drawn from the *Principles of Corporate Governance* (2015) laid down by OECD. These are:

- Ensuring the basis for an effective corporate governance framework. "The corporate governance framework should promote transparent and fair markets and the efficient allocation of resources. It should be consistent with the rule of law and support effective supervision and enforcement."
- The rights and equitable treatment of shareholders and key ownership functions. "The corporate governance framework should protect and facilitate the exercise of shareholders' rights and ensure the equitable treatment of all shareholders, including minority and foreign shareholders. All shareholders should have the opportunity to obtain effective redress for violation of their rights."
- Institutional investors, stock markets, and other intermediaries. "The corporate governance framework should provide sound incentives throughout the investment chain and provide for stock markets to function in a way that contributes to good corporate governance."
- The role of stakeholders in corporate governance. "The corporate governance framework should recognize the rights of stakeholders established by law or through mutual agreements and encourage active cooperation between corporations and stakeholders in creating wealth, jobs, and the sustainability of financially sound enterprises."
- Disclosure and transparency. "The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company."
- The responsibilities of the board. "The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the board, and the board's accountability to the company and the shareholders."

Appendix A1.1C: Principles for preventing corruption and ensuring integrity in SOEs by the G-20 and Transparency International

The G-20 high-level principles for preventing corruption and ensuring integrity in SOEs.[10]

The high-level principles are guidance for G-20 and other governments and for those state representatives that are charged with exercising ownership rights in SOEs on behalf of the government. These principles draw on general corporate governance standards, according to which the state should act as an active and informed owner of enterprises but should abstain from intervening in their daily management. Company-internal methods for preventing corruption in individual SOEs can be mandated by the state but should normally be implemented by the corporate management under the supervision of the board of directors, subject to oversight by the relevant auditing bodies. The high-level principles are as follows:

A. Integrity of the state

- Principle 1. Applying high standards of conduct to those exercising ownership of SOEs on behalf of the general public
- Principle 2. Establishing ownership arrangements that are conducive to integrity

B. Ownership and governance

- Principle 3. Ensuring clarity in the legal and regulatory framework and the state's expectations
- Principle 4. Acts as an informed and active owner with regards to integrity in SOEs

C. Corruption prevention

- Principle 5. Requires adequate mechanisms for addressing the risks of corruption
- Principle 6. Necessitates the adoption of high-quality integrity mechanisms within SOEs
- Principle 7. Safeguarding the autonomy of SOEs and their decision-making bodies

D. Corruption detection and response

- Principle 8. Establishing appropriate accountability and review mechanisms for SOEs
- Principle 9. Taking action and respecting the due process for investigations and prosecutions
- Principle 10. Inviting the inputs of civil society, the public, media and the business community

Transparency International's 10 Anti-Corruption Principles for SOEs:[11]

Transparency International has developed 10 anti-corruption principles for SOEs to help and guide them, supported by their state owners, to reach high standards of integrity and transparency. They are as follows:

1. Operate to the highest standards of ethics and integrity by the following means:

- Embed an organizational culture of ethics and integrity
- Commit to advancing integrity in societies
- Commit to an anti-corruption policy and program
- Provide tone from the top

2. Ensure the best practice governance and oversight of the anti-corruption program with the following measures:

- Implement governance that conforms to the accepted global best practice
- Ensure that board directors act in the best interests of the SOE
- Apply a rigorous and transparent procedure for the appointment of directors to the board
- Structure the SOE's board to have a balance of skills, experience, knowledge, diversity, and independent directors

- Set a clear division of responsibilities between the board and the chief executive
- Carry out vigilant oversight of the anti-corruption program and ensure accountability

3. Be accountable to stakeholders through transparency and public reporting by the given means:
- Set and observe the best practice in accountability to stakeholders
- Report publicly on the anti-corruption program
- Apply organizational transparency and country-by-country reporting
- Engage with stakeholders
- Be transparent on the relationship with the ownership entity

4. Ensure that human resources policies and procedures support the anti-corruption program in the following ways:
- Design personnel policies and procedures to support the anti-corruption program
- Incentivize ethical behavior and integrity
- Assign responsibilities for the anti-corruption program
- Integrate the anti-corruption program into the organizational structure
- Apply disciplinary procedures

5. Design the anti-corruption program based on the thorough risk assessment by keeping the following things in mind:
- Risk assessment should be the basis for the design of the program
- Identify risk factors
- Understand the forms of corruption and related risks

6. Implement detailed policies and procedures to counter the key corruption risks and follow the given measures:
- Implement controls to counter risks related to vulnerable functions and transactions
- Commit to fair trading practices
- Provide transparency of contracting and procurement processes
- Counter the highest corruption risks
- Establish and maintain internal accounting controls
- Maintain accurate books and records
- Subject the anti-corruption program to regular internal audits
- Develop an incident management plan

7. Manage relationships with third parties to ensure that they perform as per an anti-corruption standard equivalent to that of the SOE and also
- Apply general standards in all dealings with third parties
- Implement controls for specific forms of third parties: controlled entities, investments and mergers and acquisitions of joint ventures and consortia of agents and other intermediaries

8. Use communication and training to embed the anti-corruption program by the following means:
- Establish effective internal and external communications
- Provide general and tailored training

9. Offer secure and accessible advice and whistle-blowing channels and comply with the following things:
- Position advise and whistle-blowing channels within an organizational culture of openness and trust

- Provide accessible and secure advice channels, including hotlines
- Adopt a policy and procedure that offers secure and accessible channels for whistle-blowing

10. Monitor, assess and continuously improve the implementation of the anti-corruption program and follow the given measures:

- Implement systematic, continuous monitoring and improvement
- Undergo regular independent review
- Provide regular leadership reviews and make improvements as appropriate

Notes:

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Corporate Governance

Leadership Training Toolkit for SOEs

Part I Module 2
Role of the state as an owner

Introduction to the module

The OECD's Guidelines on Corporate Governance of State-Owned Enterprises describe the rationale for state ownership as being exercised in the public interest. Consequently, the state needs to be cognizant of its roles and responsibilities as an owner, for which certain guidelines have been specified by the OECD. In this regard, the World Bank's Toolkit on Corporate Governance of State-Owned Enterprises specifies that the state's role as the owner should be clarified, fragmentation of ownership responsibilities across multiple institutions should be reduced, and accountability for results should be enhanced.

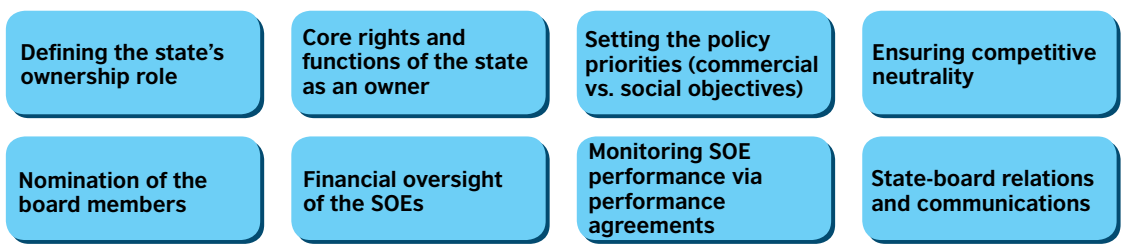
The implementation of the guideline requires an understanding of various roles and responsibilities and the structures through which the state exercises its ownership role over SOEs.

Specific guidelines have been enumerated by the OECD to provide further guidance on the state's role as an owner. These include the following:

- Governments should simplify and standardize the legal forms under which SOEs operate. Their operational practices should follow commonly accepted corporate norms.
- The government should allow SOEs full operational autonomy to achieve their defined objectives and refrain from intervening in SOE management. The government as a shareholder should avoid redefining SOE objectives in a non-transparent manner.
- The state should let SOE boards exercise their responsibilities and should respect their independence.
- The exercise of ownership rights should be clearly identified within the state administration. The exercise of ownership rights should be centralized in a single ownership entity, or, if this is not possible, carried out by a coordinating body. This 'ownership entity' should have the capacity and competencies to effectively carry out its duties.
- The ownership entity should be held accountable to the relevant representative bodies and have clearly defined relationships with relevant public bodies, including the state supreme audit institutions.
- The state should act as an informed and active owner and should exercise its ownership rights according to the legal structure of each enterprise.

This module examines these guidelines in further detail, elaborating on various ownership models, roles and responsibilities of the state, and other guidelines on managing the relationship between the state and the SOE boards as illustrated in Figure 9.

Figure 9: Exploring the Role of the State as an Owner



Source: Adapted from World Bank Group 2014.

Part I Module 2: Role of the state as an owner

This session (module) covers the following topics:

1 Role and rights of the state as an owner (and ownership structures)



2 State's role in setting policy priorities for SOEs



3 State's role and rights over board nomination, financial oversight



4 Negotiating and monitoring performance agreements

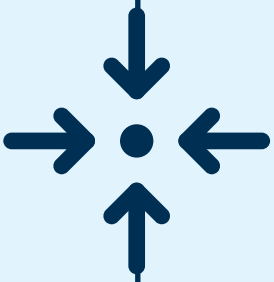




Photo: ©Geogif/123rf.com

Learning objectives

By the end of this module, the participants will be able to



- **Understand the role and rights of the state as an owner**
- **Understand the different ownership models and structures**
- **Understand the state's role and rights over board nominations, financial oversight, and performance monitoring of SOEs**
- **Understand the importance of state-board relations and steps to ensure healthy relationship and communication**

Agenda

Total time: 5 hours 15 min

Time	Topic
20 min	Defining the state's ownership role
30 min	Core rights and functions of the state as an owner
30 min	Exercise
30 min	Setting the policy priorities
25 min	State's ownership role over the board (nomination and dismissal of board members)
30 min	Case study
30 min	State's financial oversight and monitoring responsibilities
30 min	Criteria for assessing the fiscal risk of SOEs
30 min	State-board relations and communication – the Dos and Don'ts
30 min	Case study
30 min	Monitoring SOE performance via performance agreement

Topic one: Defining state's ownership role

The ownership function of the state concerning SOEs refers to the fundamental rights and normal functions exercised by shareholders when they own share in a company or when they own a company outright. It includes, for instance, the right to nominate (or appoint) members to the board and the right to vote shares at the general meeting of shareholders. Normal shareholder functions also include monitoring the performance of the company and approving or investing additional capital when necessary.

The G-20/OECD Guidelines on Corporate Governance of State-Owned Enterprises, 2015, details the prime responsibilities of the state as an owner to fulfil its ownership function. These include the following:

- Being represented at the general shareholders meetings (GSMs) and effectively exercising voting rights.
- Establishing well-structured, merit-based, and transparent board nomination processes in fully or majority-owned SOEs, actively participating in the nomination of all SOEs' boards and contributing to board diversity.
- Setting and monitoring the implementation of broad mandates and objectives for SOEs, including financial targets, capital structure objectives, and risk tolerance levels.
- Setting up reporting systems that allow the ownership entity to regularly monitor, audit, and assess SOE performance, and oversee and monitor their compliance with applicable corporate governance standards.
- Developing a disclosure policy for SOEs that identifies what information should be publicly disclosed, the appropriate channels for disclosure, and mechanisms for ensuring the quality of information.
- When appropriate and permitted by the legal system and the state's level of ownership, maintaining continuous dialogue with external auditors and specific state control organs.
- Establishing a clear remuneration policy for SOE boards that fosters the long- and medium-term interest of the enterprise and can attract and motivate qualified professionals.

Cross-cutting theme: integrity and anti-corruption

The state should establish ownership arrangements that are conducive to integrity. Appropriate steps should be taken by the state to prevent the abuse of SOEs for personal or political gain by

- Stating that applicable laws criminalizing bribery of public officials apply equally to the representatives of SOE governance bodies
- Prohibiting the use of SOEs as vehicles to engage in bribery of foreign and domestic public officials
- Prohibiting the use of SOEs as vehicles for financing political activities and for making political campaign contributions

Topic two: Core rights and functions of the state as an owner

This topic covers the core rights and functions of the state as an owner detailed out in the following sub-topics:

- Overview of different ownership models
- Legal and regulatory framework for SOEs
- Ownership policies

Overview of different ownership models

The ownership arrangement of the state refers to the way in which the state organizes itself to exercise its ownership rights over SOEs. In some cases, the body or entity that exercises the ownership rights is the legal owner of the assets. In other cases, the entity that legally owns the assets may have delegated the ownership rights to another entity, such as a ministry or a specialized ownership body. For example, a finance ministry may legally own SOE shares while delegating to line ministries the rights typically associated with the ownership of a corporation, such as nominating board members or making major decisions.

Thus, the term ownership arrangement, as used here, refers not just to the legally recognized owner of the assets but also to the body or entity that has the authority to exercise the state's ownership rights.

Some of the typical functions of a finance ministry concerning the state's role as an owner of SOEs are outlined in Box 7.

Ownership arrangements have evolved over time, as SOEs have changed in form and as governments have sought to improve their productive capacity. While countries vary substantially, ownership models fall broadly into the following categories:

Decentralized model – No one single institution or state actor acts on the responsibilities of the ownership function. Public perception often perceives line ministries to be de facto running the SOE as an extension of their ministerial powers. For each of the three ownership function responsibilities, a unique state unit or a mix of state units subsumes the role. The central body conducts all financial targets, technical and operational issues, and the process of monitoring SOE performance. Board members

Box 7: Typical Functions of a Finance Ministry

Governments are responsible for performing a wide range of fiscal and financial functions, which may be carried out by the finance ministry or other governmental agencies. These functions can be classified as below:

Policy functions – involve setting fiscal policy rules or targets, managing fiscal risks, developing a debt strategy, formulating the annual budget and the medium-term budget framework, and providing advice on alternative tax policy option. With respect to SOEs, this function would involve laying down the state policy for SOEs defining financial and nonfinancial (say, climate-related) performance metrics, risk appetite, and so on.

Regulatory function – can be further classified into three types (a) ensuring that the legal framework for budgeting and public finance is respected and enforced by the line ministries and agencies; (b) supervision of banks and other financial institutions; and (c) supervision of specific economic sectors (for example, electricity, telecommunications, water). With respect to SOEs, this function would involve monitoring implementation of the policy framework through a performance agreement.

Transactional (or operational) functions – involve processing of budgetary payments, the exercise of internal control, the issuing of government securities, and the collection of taxes and other government revenues. With respect to SOEs, this function would involve provision of data and periodic reports by line ministries and SOEs.

Source: Allen, Richard, Hurcan Yasemin, Murphy Peter, Queyranne Maximilien, and Yläoutinen Sami. 2015. "The Evolving Functions and Organization of Finance Ministries." IMF Working Paper, WP/15/232, Fiscal Affairs Department, IMF.

are appointed in different ways, but the instrumental input comes from the central unit. This model is used in countries such as Argentina, Colombia, Mexico.

While this model still exists in several countries, it has evolved to other models on account of various shortcomings, which include the following:

- Scope for political interference
- Conflicts between ownership and policy-making functions
- Fragmentation of ownership responsibilities and diffused accountability
- Insufficient ownership capacity
- Inadequate oversight of the SOE sector as a whole

Dual-ownership model – To introduce checks and balances and promote both technical and financial oversight, some countries have adopted a dual ownership model in which the Ministry of Finance has responsibilities in addition to those of the line ministries. These typically include approving annual SOE budgets, subsidies, or major financial transactions and monitoring the financial performance of SOEs. Belgium and Turkey use this model.

The potential advantage of the dual ministry model over the decentralized model is that it provides for overall financial oversight of individual SOEs and the SOE sector as a whole. However, it also has its weaknesses. Finance ministries typically focus on budgetary and financial issues but may lack the authority and power that line ministries have over SOEs as well as the capacity to act as an owner and strong advocate for SOE reforms. Moreover, the dual model, like the decentralized model, allows for the continued dispersion of other key ownership functions, such as board nominations, planning and investment decisions, and monitoring of performance.

The decentralized and dual models are the more traditional ones for organizing the state's ownership arrangements. Countries are moving away from these models toward the advisory and centralized models to bring focus and professionalism to the state's ownership role.

Advisory model – The advisory model involves creating advisory or coordinating bodies to help professionalize the state's ownership role, promote good governance practices in individual enterprises, and bring consistency to SOEs as a whole. Specialized government units act in an advisory capacity to other shareholding ministries on technical and operational issues, and their most important mandate often is to monitor SOE performance. The more limited role of these central agencies, coupled with the autonomy that line ministries thus maintain, leads to considerable overlap with the decentralized model. India, Israel, Kazakhstan, Latvia, and Lithuania use this model.

The advisory model provides an option for strengthening the state's ownership arrangements, especially in countries with a strong public sector administrative culture and a large and diverse SOE portfolio that may make full centralization difficult. It can also be an option in countries with weak capacity and weak governance environments. In such circumstances, creating an advisory or coordinating body may also avoid the concentration of power in a single entity. However, the advisory model only partially addresses the drawbacks of the decentralized or dual models, as illustrated here:

- Line ministries remain both owners and policy makers, and sometimes regulators, allowing continued scope for conflicts of interest.
- Continued dispersion of SOEs among many ministries may allow an expanded scope for day-to-day political interference.
- Without sufficient authority or power, advisory or coordinating bodies may be ignored by ministries and SOEs.
- In the absence of skills, resources, and political backing, advisory bodies themselves may lack both the capacity to deal with ministries, companies, and other institutions, and the ability to influence and drive change.
- Absence of comprehensive and proactive fiscal risk monitoring and mitigation.

Centralized model – In recent years, the models discussed above have been

supplanted by more centralized approaches that concentrate SOE ownership authority in a single specialized entity. Under a centralized ownership model, the specialized entity serves as the shareholder representative with oversight responsibility for SOEs. It owns the SOE shares or is responsible for exercising all ownership functions on behalf of the state as owner, while the line ministry is responsible for policy making and the regulatory environment in which SOEs operate. Two broad types of centralized entities are widely used: (a) government ownership agencies that are under the direct authority of the government; and (b) company-type structures, such as, holding companies or investment companies that have separate legal identities and greater independence from the government. Example: While China, Finland, France, Hungary, Republic of Korea, Slovenia, Spain, Sweden, and so on, follow the centralized model, Chile, the Netherlands, Norway, Poland, the Russian Federation, South Africa, and so on, follow the centralized model with exceptions.

(a) **Government ownership agencies** – Different approaches have been used to create ownership agencies under the authority of the government. These include the following:

- Stand-alone ministry
- Ownership department or unit (within a central ministry, usually the Ministry of Finance)
- Stand-alone ownership agency or company

Some examples of the same are outlined in Table 8.

(b) **Company-type structures** – These entities have a separate legal identity and their own governance bodies, including a board of directors and a chief executive officer responsible for investment, divestment, and business decisions. Broadly, company-type structures fall into two broad categories, although they have similar characteristics: (i) a holding company structure responsible mainly for managing the assets in the portfolio and (ii) an investment company structure that also acts as the government's strategic investor.

The centralized model faces one major risk of concentration of power. In several countries in Europe and Central Asia, company-type structures have been seriously considered but subsequently shelved because of this risk. Essentially, if the top management of such a holding company is captured and colludes with the government representatives at the board, such a holding company becomes a shadow government/or a center of vested interest for one particular group controlling the most lucrative and cash generating SOEs. Unfortunately, due to weak corporate governance systems and a high level of corruption, this risk is extremely high in developing countries.

Some examples of countries with centralized ownership under a company-type structure are outlined in Table 9 on the next page.

While useful for comparison and classification, the models are not rigid archetypes. Specific country arrangements often combine

Table 8: Centralized Ownership Under Government

Country	Name of entity	Location of entity
Ownership ministries		
Indonesia	Ministry of State Enterprises	Ministry of State Enterprises
Ownership departments in a ministry		
Finland	Ownership Steering Department	Prime Minister's Office
France	Agence des Participations de l'Etat	Ministry of Economy and Finance
Norway	Ownership Department	Ministry of Trade and Industry
Poland	Department of Ownership Supervision	Ministry of Treasury
Ownership agencies		
Chile	Sistema de Empresas	Ministry of Economy
China	State-Owned Assets Supervision and Administration Commission	State Council

Source: Adapted from World Bank Group 2014.

Table 9: Centralized Ownership Under Company-Type Structure

Country	Name of entity	Location of entity
Ownership under government		
Bhutan	Druk Holding and Investments	Ministry of Finance
Hungary	State Holding Company	Directed by the National State Holding Board
Malaysia	Khazanah Nasional	Ministry of Finance
Mozambique	Institute for the Management of State Holdings	Ministry of Finance
Peru	Fondo Nacional de Financiamiento de la Actividad Empresarial del Estado Holding company	Ministry of Finance
Singapore	Temasek Holdings	Wholly owned by Ministry of Finance

Source: Adapted from World Bank Group 2014.

elements of more than one model: for example, the split-authority characteristic of the dual model may be integrated with an advisory board. Additionally, governments may assign their SOEs to separate clusters (for example, commercial versus non-commercial enterprises) and apply a different ownership model to each group. For example, public sector banks in most countries are regulated by the central bank of the respective country.

While these structures have been successfully used across several countries, there are still **several risks that can arise, which include the following:**

- **Continued interference from the government in the absence of a strong accountability framework and culture**. Establishing an arm's-length relationship between the ownership entity and its SOEs—and between the government and the entity—can be a significant challenge. Governments may still interfere in operational decisions or impose social obligations that are not clearly defined. The central ownership entity unit may not be shielded from short-sighted political pressures.
- **Risk of capture and corruption.** High levels of politicization such as politically appointed individuals in ownership entity and the associated corruption can generate institutional instability. The resources of SOEs may often be diverted to fund political parties or electoral campaigns. This tends to weaken the overall accountability system. This issue is exacerbated in countries with political turmoil and they remain as vulnerable as ever to state capture and weakening accountability mechanisms.
- **Lack of power and authority of ownership agencies**. In other cases, ownership entities themselves may be no more than a passive adviser and owner, with little power over SOE managers, especially those directing strategic or high-profile and profitable SOEs, which are often among the biggest companies in a country. Backed by higher-level political principals, SOE managers of such companies can have their own political clout, and together with their political allies, can treat ownership entities as adversaries rather than allies.[12] In such cases, without political backing, an ownership entity may make slow progress, as it confronts opposition from vested interests
- **Lack of capacity**. Faced with difficulties in recruiting people with the necessary skills and obtaining budgetary resources, ownership entities often lack the strategic, financial, and technical capabilities needed to carry out their mandate and responsibilities effectively.

Consequently, the following **steps can be taken to minimize the risks of various ownership models and making ownership entities more effective:**

- Ensuring high-level political support and public attention
- Providing a clear and focused mandate with a high degree of autonomy

- Appointing highly qualified professionals
- Developing clear ownership policies and guidelines
- Monitoring performance of ownership entity itself

Cross-cutting theme: integrity and anti-corruption

Ownership arrangements should be conducive to integrity, which implies:

- Clearly identifying the exercise of ownership rights within state administration as centralized in a single ownership entity or, if impossible, by a coordinating body that has the capacities and competencies to effectively carry out its duties
- Separating ownership from other government functions to minimize conflict of interest and opportunities for political intervention (non-strategic or operational) and other undue influence by the state, serving politicians, or politically connected third parties in SOEs; where ownership functions are vested in ministries with other functions related to SOEs, adequate measures should be taken to separate the two
- Clarifying and making publicly available information about the ownership structure, including linking the SOEs to the ownership entity responsible for said SOEs; this could include, for instance, recording SOEs in beneficial ownership registers
- Clarifying and disclosing the roles of other (non-ownership) state functions that may interact, whether infrequently or frequently, with the SOEs in the execution of their functions—including, among others, regulatory agencies and audit or control institutions
- Encouraging professional dialogue between the ownership entity and state authorities responsible for the prevention of corruption or other irregular practices, when appropriate and permitted by the legal system
- Setting an appropriate framework for communication that includes maintaining accurate records of communication between the ownership entity and SOEs
- Maintaining high standards of transparency and disclosure when SOEs combine economic activities and public policy objectives regarding their cost and revenue structures, allowing for attribution to main activity areas
- Ensuring that the ownership entity is equipped to regularly monitor, review, and assess SOE performance and oversee and monitor SOE compliance with applicable corporate governance standards—including those related to anti-corruption and integrity

Legal and regulatory framework for SOE ownership

A clearly defined legal and regulatory framework for SOEs is essential for communicating key expectations to SOE shareholders, boards, management, and all other stakeholders, including the public.

While no one-size-fits-all approach applies to all countries and contexts, the framework should set clear boundaries and define the relationship between the government as shareholder and SOE boards and management, separating legitimate government control and oversight for ensuring SOE accountability from the managerial autonomy necessary in commercial decision-making.

Several countries have revised their existing SOE laws or have developed new, more modern laws and regulations to provide strength and legitimacy to the government shareholder; to codify relations among the shareholder, board, and management; and to outline reporting functions. Such laws generally aim to recast the state's role as an owner rather than as a policy maker and manager of state assets and are typically based on several key principles:

- Clear definition of SOEs versus other non-commercial parastatals
- Operation of SOEs on a commercial basis
- Separation of the state's ownership functions from its policy-making and regulatory functions to avoid conflicts of interest, real or perceived
- Professionalization of corporate governance bodies

- Greater transparency and accountability of the SOE sector

The details of more modern SOE laws differ from one country to the next, but in general, they contain several common elements:

- Designation of the state's shareholder representative or ownership entity, including its structure, composition, functions, and accountability framework
- Broad outlines of a performance-monitoring system to hold SOEs accountable for results
- Clarification of SOE objectives, and in some cases, the identification and separation of the costs and financing of specific public service obligations or non-commercial goals
- Establishment of criteria and processes for the appointment of qualified and competent SOE boards as well as processes for dismissal of board members and for identification of the rights and responsibilities of the board of directors and the management in guiding and managing SOE operations
- Financial reporting and disclosure requirements for SOEs, which are often in line with the private sector practices

These topics are further discussed in subsequent topics of this module. Appendix A1.2A discusses the accountability provisions for the state, SOE, and the SOE board that should be built in the legal and regulatory framework governing SOEs in the country.

Cross-cutting theme: climate change and resilience

In 2015, the world agreed upon a new vision that would guide their actions in the future adopting the 2030 Agenda for Sustainable Development (2030 ASD) and signing the Paris Agreement. In line with these international agreements, countries have made specific commitments called nationally determined contributions (NDCs) and are developing long term strategies towards a carbon neutral economy. These commitments and policies are especially relevant to SOEs given their significant presence in priority sectors for this transition, including energy, transport, agriculture, industry, and infrastructure / urbanization. It is therefore essential that the State as an owner reflects these priorities in its shareholder policy beyond the normal ESG principles and that SOEs fully integrate those in their corporate plans. A brief overview of these agreements is given below:

- **2030 Agenda for Sustainable Development** – In September 2015, the heads of state and government at the UN headquarters in New York City adopted the 2030 Agenda for Sustainable Development. The international community committed to promoting the sustainable development agenda in its three dimensions—economic, social, and environmental—in a balanced and integrated manner, for which it is essential to guarantee lasting protection of the planet and its natural resources and where there is universal access to a supply of affordable, reliable, and sustainable energy. One of the key elements in the 2030 ASD includes a commitment to enhancing international cooperation to facilitate access to advanced and cleaner fossil-fuel technology.
- **Paris Agreement** – On December 12, 2015, in Paris during the 21st Conference of the Parties (COP21) to the United Nations Convention Framework on Climate Change, the international community signed the Paris Agreement, an international treaty in which for the first time all nations came together into a common cause to undertake joint efforts to combat climate change and adapt to its effects. The Paris Agreement has two fundamental pieces to fight climate change. First, foster low greenhouse gas (GHG) emissions development by incorporating carbon planning in government policy, and the second, finance flows consistent with a pathway toward a low-carbon economy.

Beyond these international commitments that guide the development trajectories, it is in the best self-interests of countries to mitigate the high and growing socioeconomic and fiscal risks stemming from climate change: (a) the risks from climate-related extreme weather events that affect their infrastructures and SOEs and represent mounting fiscal costs

and risks in times of extremely stressed public finances due to COVID and (b) the risk stemming from the global transition to a low-carbon economy which will affect the business model of SOEs and sustainability of important assets.

Climate policies have often focused on the role of the state as a regulator. Meanwhile, their role as leading economic actors, especially as shareholders and investors, has been neglected. This is changing with more active shareholding policies, given the rising fiscal costs and liabilities coming from SOEs and exacerbated by climate risks and disasters. SOEs control significant shares of economic sectors, which are central to a carbon-intensive economy (for example, fossil fuels, power generation, and so on), particularly in emerging economies, and will thus be particularly affected by the transition toward a low-carbon economy.

An example of the State Climate Policy Framework in Sweden is outlined in Box 8.

For governments to respond to the climate change crisis, SOEs are one of their best instruments at their disposal. SOEs have a competitive advantage in their readiness to proactively address these risks and to seize the opportunities from this transition toward a low-carbon economy, for three reasons: corporate governance, mandate, and scale.

- **Corporate governance**: Most SOEs have an institutional structure in which there are representatives of the government. Therefore, board members representing the state would be mindful to voice and reflect the views of the government as a shareholder to safeguard and grow the SOE assets and manage the liabilities and fiscal risks stemming from climate change.
- **Mandate**: SOEs typically are seen as a means to support a country's medium-term socioeconomic development and to spur innovation and growth in their respective sectors, including through strategic partnerships and technology transfers. Thus, embedding sustainability into the corporate strategy of the SOE

Box 8: State Climate Policy Framework

In 2017, **Sweden** decided to introduce a climate policy framework with a climate act. It sets out implementation of the Paris Agreement in Sweden – by 2045, Sweden is to have zero net emissions of GHGs into the atmosphere. The framework contains new ambitious climate goals, a climate act and plans for a climate policy council.

- **Climate Act.** The act states the following:
  - The government's climate policy must be based on the climate goals and how work is to be carried out.
  - The government is required to present a climate report every year in its Budget Bill.
  - Every fourth year, the government is required to draw up a climate policy action plan to describe how the climate goals are to be achieved.
  - Climate policy goals and budget policy goals must work together.
- **Climate Goals.** The framework contains several new climate goals for Sweden:
  - By 2045, Sweden is to have zero net emissions of GHGs into the atmosphere and should thereafter achieve negative emissions.
  - By 2030, emissions from domestic transport, excluding domestic aviation, will be reduced by at least 70 percent compared with 2010.
  - By 2030, emissions in Sweden in the sectors that will be covered by the EU Effort Sharing Regulation should be at least 63 percent lower than in 1990, and at least 95 percent lower by 2040.
- **Climate Policy Council.** The council will be tasked with supporting the government by providing an independent assessment of how the overall policy presented by the government is compatible with the climate goals. The council will evaluate whether the direction of various policy areas will increase or reduce the likelihood of achieving the climate goals.

Source: Government Offices of Sweden. 2017. *The Swedish Climate Policy Framework*. Ministry of the Environment and Energy, Sweden.

is directly linked to the rationale of their existence and their mission.

- **Scale**: SOEs in the energy sector represent 70 percent of all the assets of oil and gas production, and around 60 percent of the coal power plants globally. To accelerate the recovery and the pace toward low-carbon development, size matters, and in this case, given that SOEs dominate the energy sector, a policy focused on low-carbon growth has to be led by SOEs. Conversely, if these SOEs do not adapt to the transition, they will become irrelevant and their assets will lose their value.

Based on a government's ownership status and the degree of shareholder power therein, the following array of tools may be leveraged to prompt its SOEs to reduce their emissions, protect their investments and assets, and catalyze the transformation in the sector/economy:

- **Shareholder directives and directions:** Governments can issue shareholder resolutions and other directives to the board in favor of reducing emissions and increasing its resilience to climate risks, which are then transmitted to company senior management. The state can also employ informal measures to guide low-carbon action that takes advantage of its position as the dominant shareholder, for example, by organizing periodic discussions between high-ranking government officials and company executives.

  Government directives and direction can address a wide variety of company actions that will impact emissions by influencing the choice of technology (for example, favoring the construction of low-carbon power plants rather than traditional thermal ones) or economic diversification through the adoption of low-carbon solutions (such as carbon capture and storage). Mandating greater energy efficiency in the SOE's operations is another way to lower emission, including for heavy industry and oil and gas producers.

  The government shareholders can also encourage SOEs to innovate their business practices, direct them to increase spending on research and development (R&D), encourage them to become active traders in a newly established Emission Trading System (ETS) or instruct them to join specific international collaborative efforts.

  Some examples of country policies on energy efficiency are outlined in Box 9 for reference.

- **Climate risk screening and mitigation of SOE investments:** SOEs represent a substantial share of public investments and infrastructure in many countries. Their investments and assets are directly exposed to the physical risks from climate change and climate transition risks. It is therefore essential that both the SOE investment committee and the state consider these climate risks when appraising and approving an investment, financing, or guarantee provided to its SOEs as it has a direct impact on the corresponding return on investment and contingent liabilities. Fiscal risks arising out of climate change are discussed in Part I, Module 2 under 'State's financial oversight and monitoring responsibilities'.

- **Aligning SOE corporate mandates with the government's climate change efforts, policies and international commitments:** An important way in which a government can support the engagement of its SOEs in the low-carbon transition is by ensuring that the enterprise's corporate mandate is aligned with climate goals. A study by the OECD found that policy misalignment can weaken the low-carbon transition effort, while alignment can provide important synergies.[13]

- **Senior management controls – Power of appointment and replacement:** For a government looking to shift its SOEs to a low-carbon pathway, installing/appointing senior executives, who have the commitment, vision, and managerial capacity to carry out the low-carbon transition can be useful, just as removing those who resist this path can also create the right incentives for prompting effective management action. The government can also install the executive

compensation system to influence SOE senior management, including through promotions and financial benefits. SOEs may be encouraged to include climate-related targets and indicators, such as carbon emission indicators or external ESG ratings, in their management incentive schemes.

- **'Climate-friendly' middle management and other human resources policies:** While leadership at the top of a public sector company is critical to effecting change within the company, change also requires action by middle management and other staff. As a result, it is important to ensure that the company's internal recruitment and organizational and evaluation systems are aligned with low-carbon action. For example, establishing human resources policies that reward employees for innovations or other actions that lower emissions can be effective in changing business practices.
- **SOE procurement:** Governments can shape the asset base of SOEs to reduce emissions through the issuance of procurement directives (including public procurement regulations) that favor low-carbon solutions. They can direct an SOE to coordinate with other public sector purchasers to favor low-carbon technologies that in turn can help create a larger market that encourages manufacturers to build out their low-carbon product line.[14] Additionally, as SOEs are often big enterprises that purchase a large amount of goods and services themselves, governments can influence

Box 9: Country Case Studies on Energy Efficiency

Germany: Germany has established a variety of coordinated policies to implement energy savings measures for industry. The federal government has entered into voluntary agreements with the German industry to reduce CO_2 emissions and sets targets for annual reductions in energy intensity until 2022. To encourage large companies to reach savings targets, they become eligible for a large-scale tax exemption when their savings goals are met. The German government has also established a target of obtaining 25 percent of electricity generation from combined heat and power (CHP) by 2020. The CHP Act also provides investment support in the form of a feed-in tariff, which offers an incentive payment for electricity generated by CHP. The German government has also encouraged the implementation of energy management systems for large companies, which helps energy-intensive industries achieve emissions and energy savings targets.

Japan: Japan has employed a mix of regulatory measures, voluntary actions, and financial incentives to encourage energy efficiency in its industrial sector. The Act Concerning the Rational Use of Energy introduced a benchmarking system for obligating businesses to achieve specific medium- (2015) and long-term (2020) energy-efficiency targets. A tax incentive scheme supports these requirements by providing a special depreciation rate for all businesses investing in specified energy conservation and efficient equipment. The government offers support to help encourage greater contribution of CHP electricity resources. Japan also dedicates a significant amount of its investment in R&D toward the industrial sector.

United Kingdom: The Environment Agency administers Climate Change Agreements (CCA), which establish voluntary commitments with energy-intensive companies to reduce energy use. In exchange for reaching their targets, companies receive a discount on the Climate Change Levy (CLL), a tax added on electricity and fuel bills. The government also provides tax relief to help businesses invest in specific energy-saving technologies or machinery that might otherwise be too expensive, including boiler equipment, CHP, compressed air equipment, motors and drives, and other products. A range of other measures provide additional support for CHP, including access to financial incentives, exemptions from certain fees and taxes, and the development of a strategic framework for reducing emissions with CHP in the United Kingdom.

Sweden: The Swedish industrial efficiency program successfully introduced energy management schemes. Those undertaking a set of measures get a modest rebate on the energy tax. The comparatively small financial signal has unleashed investments that would have been profitable but were not taken so far.

Sources:

United Nations. 2015. *Best Policy Practices for Promoting Energy Efficiency*. UN, New York and Geneva.

Meegan, Kelly. 2016. *International approaches to industrial energy efficiency: a comparison of countries.* American Council for an Energy-Efficient Economy (ACEEE).

the broader supply chain by mandating that their SOEs require low-carbon products and solutions from their private sector and other suppliers.

- **Reporting requirements**: The state should encourage SOEs to enhance transparency and disclosure around climate-change-related practices. These disclosures may form part of the Annual Report of SOEs or in the form of separate stand-alone statements such as Annual Sustainability Reports. Sustainability or triple-bottom-line reporting is aimed at a wide, multi-stakeholder audience. This tool reports performance on issues that stakeholders care about as well as monitors internal performance improvements. A sustainability report should form part of a broader strategy for communicating with and reporting to stakeholders on the outcome of consultations or dialogues.

  The Task Force on Climate-related Financial Disclosures (TCFD) has structured its recommendations around four thematic areas that represent core elements of how organizations operate—governance, strategy, risk management, and metrics and targets. This is discussed in detail under Part IV, Module 2. SOEs should also report on nonfinancial information around the environment and social (E&S) metrics as discussed in Part IV, Module 3.

- **Monitoring and enforcement:** It is important for a government to follow up on its guidance with monitoring plans and to put in place both rewards to support success and sanctions to address failure. This can be particularly important in contexts where SOE independence means that government shareholder directions do not necessarily translate into conforming company action. Climate change objectives and risks, therefore, need to be included in SOE statements of corporate interests or other performance contracts between the state and the SOE. Some examples of good practices in monitoring and enforcement are outlined in Box 10.

Cross-cutting theme: integrity and anti-corruption

There should be clarity in the legal and regulatory framework regarding the operation and accountability of SOEs, whereby private sector best practices in areas such as corporate liability, accounting, and audit apply to SOEs. The legal and regulatory framework should facilitate a level playing field in the marketplace where SOEs undertake economic activities.

The state should clearly specify SOE objectives and avoid redefining these objectives in a non-transparent manner. The state's broad mandates and objectives for SOEs should be revised only in cases where there has been a fundamental

Box 10: Good Practices on Monitoring SOE Objectives and Performance

Saudi Arabia: State-owned oil giant Saudi Aramco joined the 'Zero Routine Flaring by 2030' initiative by the World Bank, a flagship global effort to eliminate flaring. For over 40 years, Aramco has been investing in advanced technologies to enable greater efficiency and lower emissions in transport, carbon-free hydrogen fuels, and carbon capture, utilization and storage (CCUS). This is part of a broader effort to enable the circular carbon economy and deliver clean, reliable, and affordable energy to the world while minimizing GHG emissions.

China: Since the 11th Five Year Plan (2006–10), a shift in priorities has elevated environmental reform as key to growth and social stability. This has taken the form of consolidating the market share of large SOEs in energy and heavy industry, while increasing state support of SOE investment in clean energy technologies for less-polluting industries and other industries like oil and gas (Sinopec, PetroChina). These objectives have been implemented through ordered shutdowns of small, inefficient power and steel plants, as well as through selective investment approvals, credit controls, and cadre evaluation systems.

Sources: World Bank. 2020. *Zero Routine Flaring by 2030*. World Bank, IBRD, IDA.

Baeumler, Axel, Ijjasz-Vasquez Ede, Mehndiratta, Shomik. 2012. *Sustainable Low-Carbon City Development in China. Directions in development; countries and regions*. Washington, DC: World Bank.

International Energy Agency. 2015. *Complementary measures for decarbonization: Looking beyond pricing and regulation to motivate private businesses and state-owned enterprises*. Paris: IEA.

change of mission. The ownership entity should be assigned a role for executing ownership. When representatives of government, including those of the ownership entity, give instructions that appear to be irregular, SOEs should be able to seek advice or to report it through established reporting channels.

The state should clearly set and consistently communicate high expectations regarding anti-corruption and integrity through, among others, the processes of

- Identifying and expressing their expectations related to high-risk areas that could include investment and divestment by the state; human resource management; procurement of goods and services; board and senior/top management remuneration; conflict of interest; political contributions; facilitation payments, solicitation, and extortion; favoritism, nepotism or cronyism; offering and accepting gifts; hospitality and entertainment; and charitable donations and sponsorships
- Periodically reviewing state expectations regarding anti-corruption and integrity, based on a comprehensive analysis of existing and emerging corruption-related risks

Ownership policies

To bring greater clarity and consistency to ownership issues, some countries have developed comprehensive ownership policies as a tool for communicating expectations and good practices to shareholders, boards, and management. Ownership policies were earlier conceived as a portfolio level policy. However, currently, such policies are recommended for specific sectors or homogeneous groups such as banking, insurance, power, and so on, or even for specific SOEs depending on the level of centralization of ownership. For example, in Norway, the ownership policy contains one section on the 'scope of the state's direct ownership'. It includes the list of companies covered by the ownership policy, the state's shareholding in the companies, and the ministry with which companies are affiliated. The ownership policy covers companies for which the state has mainly commercial objectives and important companies with sectoral policy objectives. While drawing up the ownership policy, an important consideration for governments is to ensure competitive neutrality, that is, SOEs should not enjoy net competitive advantages over their private sector counterparts, simply under government ownership.

As per the Commonwealth Competitive Neutrality Policy Statement of the Government of Australia, governments should not use their legislative or fiscal powers to advantage their businesses over the private sector. The implementation of competitive neutrality policy arrangements is intended to remove resource allocation distortions arising out of public ownership of significant business activities and to improve competitive processes. Where competitive neutrality arrangements are not in place, resource allocation distortions occur because prices charged by significant government businesses do not fully reflect resource costs. Consequently, this can distort decisions on production and consumption, for example, where to purchase goods and services, and the mix of goods and services provided by the government sector. It can also distort investment and other decisions of private sector competitors.[15] Therefore, if the governments ensure a level playing field between SOEs and private sector competitors, it can help prevent competitive distortion and encourage private sector investment.

Ownership policies usually cover several relevant subjects:

- **Purpose of state ownership.** This section may describe the justification for state ownership and both short-term and longer-term goals.
- **Types of enterprises covered by the ownership policy.** Enterprises are usually categorized into two broad groups—commercial enterprises providing a product or service, that is, enterprises that could be subject to competition and could operate under private ownership and enterprises with sectoral policy objectives that operate in a regulated environment (such as water and electricity). These categories are often revisited periodically to determine whether the ownership criteria continue to be met and to adjust portfolio practices accordingly.

- **Criteria under which SOEs operate.** These criteria might address the commercial sustainability of SOEs; the importance of shareholder value or equity value, relative to social objectives; associated performance measures; and the calculation of (and compensation for) costs of non-commercial objectives/public service obligations.
- **Roles and responsibilities of specific institutions.** The respective roles of the state, the ownership entity, the SOE board, SOE management, and independent regulators as well as the separation of financial and policy oversight should be specified.
- **Requirements for transparency and public disclosure.** Both the state and SOEs are held accountable for their financial and social performance. Financial reporting requirements are established. Public disclosure covers both financial and nonfinancial information and describes the means of dissemination.

The process of setting formal ownership policies is easier when there is a centralized ownership entity in place that can drive and manage the process of developing the policy. Where ownership responsibilities are fragmented among different line ministries, building support and managing the process can be more difficult and time-consuming, especially when parliamentary approval is required. Developing a coherent policy can also be more difficult when there is a large and diverse portfolio of SOEs, with many different legal forms.

Topic three: Setting the policy priorities

Throughout the world, governments have created SOEs as commercial entities and often imposed non-commercial public service obligations (PSOs) on their operations. Also referred to as community service obligations, or public service agreements, PSOs enable governments to pursue public policy objectives through SOEs in addition to regular budget channels, often with little transparency, particularly concerning the financing of PSOs.

This is also recognized in the OECD's Guidelines on Corporate Governance of State-Owned Enterprises (2015), and corresponding recommendations have been proposed to help create transparency around SOE public service/social objectives and to lend credibility to the processes involved in putting these public service/social objectives into practice. These guidelines include the following:

> "Where SOEs combine economic activities and public policy objectives, high standards of transparency and disclosure regarding their cost and revenue structures must be maintained, allowing for an attribution to main activity areas. Costs related to public policy objectives should be funded by the state and disclosed." – OECD Guidelines on Corporate Governance of State-Owned Enterprises (2015).

Besides, the World Bank's Toolkit on Corporate Governance for State-Owned Enterprises (2014) also elaborates on the recommendations outlined in the OECD Guidelines specifically with regard to

- Formalizing PSO mandates
- Implementation of PSOs
  - Defining and calculating the cost of PSOs
  - Practices for financing PSOs
  - Monitoring the performance of PSOs

These are detailed further in this topic.

Formalizing PSO mandates

The state, with the primary ownership and oversight function over the SOEs, defines the mandate for the respective SOE and sets out its objectives. The mandate and objectives laid out by the state can be formalized through the legal framework (based on which the

SOE was constituted) and the SOE's charter, among others. The overall mandate of the SOE indicates whether the SOE's operations are commercially oriented or are constituted for achieving specific socioeconomic public policy objectives. While an SOE can be expected to fulfil both commercial and public service obligations, the formal mandate set out by the state defines the SOE's primary objectives.

Box 11 outlines certain country case studies on defining PSOs for SOEs.

In addition to the overall mandate, the state also plays an important role in defining short- and medium-term objectives for the SOEs, wherein SOEs can often be instructed to prioritize PSOs over commercial considerations. Examples of these instances can include utilizing SOEs for correcting market distortions and failures and achieving specific public policy objectives. These priorities are communicated periodically, and are usually aligned to the budget cycle, wherein specific policy priorities are also communicated by the ownership entity, in addition to the financial information regarding resource availability and support, debt ceilings, and so on. These are formally incorporated into the SOE's budget and annual/medium-term strategy for implementation.

Step-by-step implementation of PSOs

In addition to formalizing these PSO mandates in legislation or regulations disclosed to the public at large, the OECD Guidelines suggest three steps for implementing PSOs without compromising SOE efficiency relative to other market players:

- Define and calculate the costs of PSOs
- Finance these costs through a specified budget transfer to the SOE so that the cost is explicit both in the budget and in the SOE's financial statements
- Monitor the performance of PSOs to enhance transparency and ensure their relevance and effectiveness

Step 1: Define and calculate the costs of PSOs – A PSO must be defined clearly and separated from the regular commercial activities of the SOE. Calculating the cost of a mandated PSO can be a complex exercise, as these obligations involve offering public goods for which the price, by definition, is difficult to determine. Nonetheless, estimating costs is an important process, for it allows governments

Box 11: Country Case Studies on PSOs for SOEs

In Netherlands, specific non-commercial objectives may be imposed on SOEs in one of the following fashions:

1. **Performance contracts**. This is the preferred form of imposing specific objectives for individual SOEs. The advantage is that, if the SOEs operate in a competitive environment, a level playing field can be maintained by offering the contracts in tender.

2. **Regulation/legislation**. The sectoral legislation and attendant regulation by the line ministries apply to all enterprises regardless of ownership. However, in the (relatively few) sectors, where an SOE has a monopoly, the exercise of regulatory powers is effectively equivalent to establishing company objectives.

3. **Shareholder action**. The shareholder (Ministry of Finance, pursuant to cabinet decision) retains the right of approval for the corporate strategy, major (dis-) investments and remuneration and dividend policy. There is no 'instruction right' for any shareholder under Dutch law, but the state can thus effectively block major decisions that are not aligned with the intention of its investment.

Non-commercial priorities for New Zealand Post: New Zealand Post is the designated postal administrator for New Zealand and is the operator of the only nationwide postal network. The government has a deed of understanding (administered by the Ministry of Business, Innovation and Employment (MBIE), and periodically reviewed) with NZ Post to set social, price and service undertakings that must be met within the postal services market. Essentially, this ensures that NZ Post's rural and urban postal services are provided at universal pricing (despite the likely higher costs of provision of rural services), whilst enabling other postal operators to offer competing services, including services, which access NZ Post's national network at fair and transparent cost.

Source: Christiansen, Hans. 2013. "Balancing Commercial and Non-Commercial Priorities of State-Owned Enterprises." Working Papers No. 6, OECD Corporate Governance, OECD Publishing.

to assess whether the services being provided are worth the cost. SOEs typically have an incentive to overestimate the true costs of PSOs. If information asymmetries between the SOE and the government are significant, the SOE may be overpaid for fulfilling those obligations. However, the government tends to underestimate the cost of PSOs.

Various methods of calculating PSO costs are discussed in the OECD's Accountability and Transparency Guide for State Ownership (OECD 2010). Following are the four main methods and their associated pros and cons:

- Marginal costs. While reflecting the real opportunity cost of supplying the service, the estimation of marginal costs can be daunting due to practical difficulties such as treatment of common and joint costs, depreciation, and variations in demand.
- Fully distributed costs (or average variable cost plus a mark-up to cover fixed costs). These calculations tend to overestimate costs.
- Avoidable costs (or costs associated with an additional block of output, including variable and capital costs whenever additional capacity is required). This is a commonly used method.
- Stand-alone costs (or costs for producing an output in isolation). This method ignores economies of scale and scope and usually results in significant overestimation of the real cost.

In some settings, SOEs are required to maintain separate accounts for commercial and non-commercial activities. SOEs tend to benefit from privileges that are not available to the private sector. These benefits include state aid in a variety of forms such as the following:

- Outright subsidization. Includes monetary or in-kind subsidies received directly from the government to sustain commercial operations.
- Concessionary financing and guarantees. Include a line of credit received directly from the government or a state-owned financial institution at below-market interest rates; explicit or implicit state guarantees, which help the SOE to borrow competitively compared to the private sector.
- Other forms of preferential treatment that may lead to financial distortions in the market include exemption from costly regulatory regimes applicable to private firms that aid in the reduction of operating costs of SOEs.

The European Commission (EC) uses a tool known as the 'transparency directive'[16] to achieve competitive neutrality between public and private firms, which requires public companies to have separate accounts for commercial and non-commercial activities to demonstrate how their budget is divided. This tool has been used in many sectors, including postal services, energy, and transport.

A more radical approach requires the structural separation of the business and nonbusiness parts of an SOE, which is the easiest way to prevent cross-subsidization. However, efficiency gains may be lost if economies of scale cannot be realized through a joint provision of commercial and non-commercial activities. Similarly, separation of activities may not be advisable if the provision of commercial (or non-commercial) activities is very limited compared to the rest of the SOE's activities.

A basic principle holds that governments should not mandate PSOs, whose cost exceeds their value to the public. Yet, it is more difficult to determine whether a PSO could be replaced by another mechanism that could achieve the same objectives at a lower cost more effectively or with fewer market distortions. Potential alternative mechanisms include direct subsidies or (conditional) cash transfers to targeted populations, vouchers, contracting out services to private providers (where they exist), and regulatory provisions. To this effect, distributional impact analyses form an important tool to decide on the optimal mode of fulfilling a government's public service obligations.

This is briefly outlined in Box 12 on the next page.

Step 2: Financing PSOs directly from the budget – In line with good practice, once PSOs are defined and costed, they can be funded directly from the budget, and the size of the government transfer can be divulged. The government can then purchase PSO services from SOEs under arm's-length commercial contracts and signal the price to non-SOE suppliers, against which to compete as a future provider of those services. Where PSOs are met through restrictions on competition or other regulatory distortions, a similar costing and value-for-money exercise should be conducted. The economic costs of preferential regulatory treatment should be assessed against the value of the objectives achieved.

The procurement process should be transparent and competitive, in line with the national procurement rules which often apply to SOEs. Procurement policies and procedures should ensure clear selection criteria in advance; and there should be fair and equitable treatment in the selection of suppliers. Unfair barriers, if any, must be removed to ensure fair and non-discriminatory selection processes or when such barriers cannot be removed, they should be appropriately disclosed to all potential bidders. Principles of competitive neutrality must be adhered to while undertaking any procurement (refer to Part IV, Module 4). High standards of integrity and ethics must be ensured during the entire procurement process.

Step 3: Monitoring and disclosing PSOs – This is critical to ensuring their relevance and effectiveness. Monitoring is usually conducted through the overall performance-monitoring system for SOEs. A specific review can also be carried out separately with the involvement of concerned departments and stakeholders. Progress in meeting PSOs and their attendant costs should be disclosed to the public to enhance transparency.

Box 12: Distributional Impact Analysis (DIA)

Distributional impacts relate to the extent to which there are differences in the way impacts affect different groups in society. DIA concerns the study of the distributional consequences of interventions due to the participants' heterogeneous responses or participation decisions. In particular, DIA investigates features beyond the gross total gain of a program by studying where the gains/losses of a program—if any—were produced, and who wins or loses as a result of program participation.

Mean impacts constitute a natural first summary statistic to describe the effect of a policy. Thereby, it provides the central piece in any cost-benefit analysis. However, a decision-maker usually requires information on the effects of a policy beyond its mean impact. For example, mean impacts allow to calculate the total gain from a program or policy, but do not allow to say anything about the distribution of the gain or how the outcome distribution is affected by the program beyond changes in its mean. Even a purely welfare-maximizing social planner with no normative concerns for particular demographic groups, inequality or not harming anyone will often need information on program impacts beyond their average.

Many outcomes, such as educational attainment and health status, cannot feasibly be redistributed themselves. To redistribute the welfare gains derived from such outcomes, one needs to know the relation between the outcomes and individual utility, which can usually at best be approximated. In practice, transfers may be costly and implementing the optimal transfer scheme requires some knowledge of the distribution of gains and losses, that is, an evaluation that goes beyond the mean impact. Finally, some interventions may work well for particular subgroups of the target population, such as those living in urban areas, while there may be better options for rural populations. Knowing which groups benefit more or less can help improve the way policies and programs target and thereby allocate limited resources more effectively.

Finding answers requires thinking about the impact of a program or policy as a collection of distributional parameters rather than a single scalar parameter such as the mean. This is where distributional impact assessments are useful. An equity assessment can complement the cost-benefit analysis of an initiative undertaken by an SOE. This can help in efficient allocation of scarce public resources by the SOE.

Source: Guadalupe, Bedoya, Bittarello Luca, Davis Jonathan, Mittag Nikolas. 2017. "Distributional Impact Analysis, Toolkit and Illustrations of Impacts Beyond the Average Treatment Effect." Policy Research Working Paper 8139. World Bank Group, Washington, DC.

Examples of monitoring and disclosing PSOs are outlined in Box 13.

In addition to PSOs, the state also has an important role in defining the dividend policy of the SOE. Dividends paid to the government usually reflect the profitability of the enterprise and the need to retain profits for investment in capital assets. Higher dividends may not always be desirable as they may reflect monopoly profits or deprive SOEs of funds they may require for investment in new capital assets. As an alternative to dividends, governments may establish a policy of retaining funds in the enterprise to increase shareholder value.

A dividend policy for SOEs would divide its after-tax profit into two parts: retained earnings to finance investment and dividends to finance public spending by the government. As such, the rationale for a sound dividend policy is twofold: first, it has the potential to enhance the efficiency of investments financed by the retained earnings of SOEs and second, it may improve the overall allocation of financial and fiscal resources.

In most countries, the general practice is for SOE dividends to be paid to the finance ministry for general public uses, regardless of which government department acts as the state shareholder, as dividends are considered public financial revenues and should be managed as such. Countries with separate ownership agencies or holding companies may receive SOE dividends and retain a portion for reinvestments in SOEs; however, a share of dividend payments is usually made to the finance ministry. In some cases, dividend payments from the ownership entity to the finance ministry may be based on a fixed percentage that the entity itself receives from SOEs in its portfolio, or on a percentage of the capital employed by the SOEs in the ownership entity's portfolio, or some combination of the two.

A challenge for policy makers arises in the case of SOEs delivering public service objectives through the pricing of their services below cost (for example, postal services, sale of fuel, electricity). This would translate into lower profitability of such enterprises compared to their private sector competitors, and as such a commercial rate of return may not be guaranteed for these SOEs. As discussed in step 1 above, such services need to be accounted for and compensated transparently while ascertaining a suitable dividend policy.

Strengthening corporate governance and dividend policy should lead to greater scrutiny of capital allocation, thus making it more difficult for managers to invest in bad projects and enhancing shareholder wealth while minimizing the financial and fiscal risks of SOEs. Profitable SOEs should provide funds for public spending to improve the equity of key public services, such as education and health.

Cross-cutting theme: climate change and resilience

Climate-induced risks significantly affect strategic planning processes and operational capacities of enterprises. PSOs enable governments to pursue public policy objectives through SOEs rather than through regular budget channels. While assessing PSOs, manifestations of climate change and its associated impact including higher temperatures, altered rainfall patterns, and more frequent or intense extreme events

Box 13: Country Case Study on Disclosing PSOs

In a study, it was found out that only 4 countries of over 30 countries surveyed produce aggregate reports (Lithuania, Norway, Sweden, and Turkey) in an attempt to produce distinct reporting on the costs related to SOEs' public policy objectives and (where applicable) the related funding provided from the state budget. In Lithuania, a section of the aggregate report is dedicated to the estimated costs taken on by SOEs for the implementation of 'special obligations', and the amount of compensatory funding provided by the state. In Norway, the aggregate report provides an index of all SOEs and the value of state subsidies provided to each over the course of the year.

Source: OECD. 2018. *Ownership and Governance of State-Owned Enterprises: A Compendium of National Practices.*

such as heatwaves, drought, and storms, and so on, should inform the formalization of PSO mandates. This would result in climate-informed project appraisal and selection, improved risk management, a more climate-consistent policy framework and targeted investments thereof.

The World Bank Climate and Disaster Risk Screening Tools[17] provide a systematic and transparent way of considering climate and disaster risks at the early concept stage of national policy planning processes. Developing an understanding of the vulnerabilities of SOEs to climate risks is the first step in the development of exhaustive policy frameworks and strategic processes required to operationalize them in providing services tailored toward stated public policy objectives. The simple, self-paced tools provide step-by-step guidance to help users connect climate and disaster information to their planning components. The tools provide relevant climate and disaster information through the web-based World Bank Climate Change Knowledge Portal and its Country Adaptation Profiles.

The development of the **National/Policy level Climate and Disaster Risk Screening tool** integrates an **Exposure–Sensitivity–Adaptive-Capacity framework** that incorporates elements of the risk analysis framework **adapted from the work of the Intergovernmental Panel on Climate Change (IPCC)** and the framework for vulnerability assessment used by the U.S. Agency for International Development (USAID), with some modifications. Hence, to effectively leverage the tool and derive insights required to inform policy making, the state officials and SOE managers need to first understand the following key aspects:

- **Exposure.** It refers to the degree of climate stress upon a particular unit of analysis and may be characterized by a long-term change in climate conditions, or changes in climatic variability including the magnitude and frequency of extreme events in the urban context (IPCC 2007). Depending on the type of hazard the SOEs are exposed to, which in turn depend on the magnitude of climate stress and the SOEs' respective geographical areas of jurisdiction and the sectors served therein, and to better understand how they are vulnerable, it becomes imperative to assess where, what, and how these hazards might affect the concerned locations and sectors.
- **Sensitivity.** This means "the degree to which different systems and sectors of the population are affected by climate-related hazards" (IPCC 2007). Understanding sensitivity to climate change requires the state to think not only about the geography of a place but also to consider its socioeconomic context—the level of poverty, the prevalent unemployment rates, or the access to basic services, and so on, within the ambit of which the SOEs operate. Such non-climate-related factors can influence an SOE's vulnerability. They make it more difficult to recover from a disaster, avoid it, or respond to it effectively, and this results in them being more vulnerable to its damaging effects. These characteristics vary widely across different districts, different administrative divisions and local economies and must be carefully thought of to suit the ulterior objectives of the SOEs' policy implications.
- **Adaptive Capacity.** It refers to "the ability of a system to adjust to climate change to moderate potential damage, take advantage of opportunities, or help cope with consequences" (IPCC 2007). This is integrally dependent on the institutional strength of SOEs, the potential and integrity of which must always be realized through appropriate staffing and regular training of personnel, climate-resilient infrastructure, and so on.

The quantified rates of vulnerability to risks based on the stated components (exposure, sensitivity and adaptive capacity) will generate insights, which can be leveraged to inform not only the policy framework for the SOEs but also the identification of appropriate sectors and project sites, wherein they ought to provide services as part of their public service agreements (PSAs). This, in turn, can help in fine-tuning effective and targeted financial management mechanisms toward the provision of the said services.

Topic four: Ensuring competitive neutrality

Given the importance of SOEs in many economies and sectors, from natural monopolies to sectors with important private sector presence, it is essential for governments to assess the role and market effects of SOEs in their countries with the goal to increase SOE efficiency, mitigate negative market effects, and encourage private sector growth to improve overall welfare. Departing from fair competition and fair conduct norms could harm consumers or distort the market, thereby reducing overall welfare. This calls for the assessment and safeguarding of 'competitive neutrality' of SOEs and reflecting this in the shareholder's policies and public service obligations as well as subjecting SOEs fully to competition law and agencies/ regulators.

A definition of competitive neutrality adopted in Australia is outlined in Box 14 on the next page.

Competitive neutrality policy initiatives directly address the market advantage of SOEs. Competitive neutrality policy recognizes that SOE activities should not have a competitive advantage vis-à-vis the private sector merely by virtue of government ownership and control. Market advantages in this context may manifest in several ways. Distortions by advantaged SOEs may be direct in their statute, mandates or through state aid or it may unintended and more subtle, through insufficiently costed and compensated public service obligations assigned to SOEs. Such distortions result in crowding out of private investments, which in turn inhibits the SOE's efforts of maximizing finance for development.

Competition distortions can take different forms as summarized in Table 10.

Given the numerous potential distortions and their detrimental impact on consumers and the economy, the state needs to maintain a level playing field. The main building blocks in ensuring competitive neutrality are as follows:

- **Streamline government businesses either in terms of corporate form or the organization of value chains.** Two things need to be addressed: the degree of corporatization of government business activity and the extent to which commercial and non-commercial activities need to be structurally separated. Separation makes it easier for commercial activities to function in a more market-consistent way. Incorporating public entities with an emphasis on commercial activities and operating in competitive, open markets, as separate legal entities aids in enhancing transparency.
- **Ensure transparency and disclosure around cost allocation.** Identifying the cost of any given function of commercial government activity is essential if competitive neutrality is to be credibly ensured. For incorporated SOEs, the major issue is accounting for costs associated with fulfilling PSOs. For unincorporated entities, problems arise when they provide services in the public interest as well as perform commercial activities from a joint institutional platform.
- **Devise methods to calculate a market consistent rate of return on business activities.** Achieving a commercial rate of return is an important aspect of ensuring that SOE's activities are operating like comparable businesses. If SOEs operating in a competitive environment are not required to earn a market consistent rate of return, an inefficient producer may seem cheaper to consumers than an efficient one.
- **Ensure transparent and adequate compensation in the discharge of public service obligations.** Competitive neutrality concerns arise when PSOs are imposed on SOEs which also operate in the marketplace. Therefore, such entities need to be adequately compensated for any non-commercial requirements based on the additional cost incurred for such PSOs.

Table 10: Types of Preferential Treatment for SOEs

Type	Description
Preferential financing from state banks or other (state-backed) financial institutions	Preferential financing can include the following: (a) favorable requirements concerning the rate of return on capital of SOEs; (b) favorable requirements for dividends of SOEs; (c) direct financial support from the state; (d) recapitalization of SOEs at lower than market rates; (e) provision of finance at below-market interest rate; (f) provision of state-backed guarantees.
Privileged access to information	If SOEs are privy to privileged information from the state, including classified intelligence, confidential cabinet decisions, and so on, this amounts to unfair advantage that can, in turn, have an impact on market confidence. SOEs may also have access to data and information, which may not be available to their private sector counterparts such as planned regulation, procurement, environmental laws, sanitary rules, technical specifications, and so on.
Outright subsidies/ tax concessions	Some SOEs receive direct subsidies from their government or benefit through other forms of financial assistance to sustain their commercial operations.
In-kind subsidies	These benefits include land usage, rights of way at prices lower than market rates or what private competitors would have to pay under similar circumstances, and so on. These relaxations artificially lower the SOE's costs and enhance their ability to price more efficiently than their competitors.
Grants and other direct payments	This includes (a) policies that support R&D, environmental and green programs; (b) general economic development policies (for example industrial policies); (c) sector- or product-specific policies; and (d) support for the provision of public services; all of which if not provided equally to competitors on the same market could create a non-neutral situation.
Privileged position on the domestic market	SOEs are at the time, entrusted with exclusive or monopoly rights over some activities that they are mandated to pursue such as postal services, railways, and so on, in some countries. Where SOEs continue to benefit from a legal or natural monopoly, this may be of little practical consequence for the competitive landscape, but several SOEs in the network industries operate as vertically integrated structures with incipient monopolies in parts of their value chains. This can have a direct effect on relative competitiveness, and it may also allow them to influence the entry conditions of would-be competitors.
Explicit or implicit guarantees	State guarantees for SOEs result in reduced cost of borrowing and enhance their competitiveness in relation to private firms.
Exemptions	For example, exemptions from bankruptcy rules for SOEs in some sectors. State equity is like lock-in capital and SOEs can generate losses for a long period without fear of going bankrupt. Other examples include exemptions from antitrust enforcement may lead to anti-competitive behavior that may in turn lead to predatory pricing.
Preferential regulatory environment	This includes (a) simplified procedures to obtain license or permits, (b) granting of special rights to extract resources, (c) exemptions from regulatory compliance under environmental laws, (d) relaxation in disclosure requirements, (e) exemptions from building permits, (f) unjustified denial of approvals to potential competitors, and so on.
Preferential treatment in public procurement	Preferential access to information about upcoming public procurement tenders (that is, technical or other specifications essential for contract award) or outright favoritism of SOEs in awarding contracts can give a relative upper hand to SOEs.
Price support	Refers to policy measures that can create a gap between domestic market prices and reference prices of a specific commodity.
Support in the form of commercial diplomacy	Reliance on the government's backing and diplomatic relations to pursue business opportunities, otherwise not commercially possible without such support or not available to competitors, can give a comparative advantage to SOEs.

Source: Adapted from World Bank Group 2014.

Box 14: An Australian Definition of Competitive Neutrality

Competitive neutrality requires that government business activities should not enjoy net competitive advantages over their private sector competitors, simply by virtue of public sector ownership.

The implementation of competitive neutrality policy arrangements is intended to remove resource allocation distortions arising out of public ownership of significant business activities and to improve competitive processes. Where competitive neutrality arrangements are not in place, resource allocation distortions occur because prices charged by significant government businesses need not fully reflect resource costs. Consequently, this can distort decisions on production and consumption, for example, where to purchase goods and services, and the mix of goods and services provided by the government sector. It can also distort investment and other decisions of private sector competitors.

Competitive neutrality requires that governments should not use their legislative or fiscal power to advantage their own businesses over the private sector. If governments do advantage their businesses in this way, it will distort the competitive process and reduce efficiency, more so if the government businesses are technically less efficient than their private sector competitors.

Source: Australian Government. 1996. *Competitive Neutrality Policy Statement*.

- **Ensure that SOEs operate in the same or similar tax and regulatory environment.** SOEs must operate in the same or similar tax and regulatory environment as private companies to ensure competitive neutrality. Where SOEs are incorporated according to company laws, tax and regulatory treatment, it is generally similar or equal to private businesses.
- **Ensure debt neutrality.** This involves avoidance of concessionary financing to SOEs and subjecting them to similar financial market discipline. However, many SOEs continue to benefit from preferential access to finance in the market due to their explicit or perceived government backing.
- **Promote competitive and non-discriminatory public procurement.** Ensuring competitive neutrality in public procurement includes (a) competitive and non-discriminatory practices in procurement and (b) allowing all public entities to participate in the bidding contest.

Country case studies of competitive neutrality frameworks and oversight are outlined in Box 15.

Box 15: Country Case Studies on Competitive Neutrality Frameworks and Oversight

Many governments express commitment to address aspects related to competitive neutrality in the context of SOEs. This commitment is often not manifested explicitly in the form of policy frameworks or laws. It may be expressed implicitly through competition policy and a myriad other laws or guidelines that apply to the operations of SOEs. It may take the following form:

Explicit policy statements – Countries like Denmark, Australia, Finland, the Netherlands, Spain, the United Kingdom, and so on, have explicitly addressed and built-in the enforcement of competitive neutrality to their national policies, these are either comprehensive competitive neutrality frameworks or competition law.

Competition laws and policies – In most countries, aspects of competitive neutrality are dealt through competition laws and policies.

Constitutional commitments – In countries like Brazil, Chile, China, Hungary, Mexico, Peru, Russia, and so on, the overall commitment to a level playing field is enshrined in the Constitution.

Rules on state aid and transparency – The EU and European Economic Area (EEA) countries are subject to EU rules which explicitly address the issue of competitive neutrality through the EU Rules on State Aid and the Transparency Directive.

Source: OECD. 2012. *Competitive Neutrality – National Practices.*

Topic five: State's ownership role over the board of SOE (selection and removal of board members)

In most countries, the nomination or appointment of SOE directors is a government responsibility. While in some countries there is at least formal self-nomination by boards first (for example, through nomination committees), it is usually exercised by the relevant ministers or through some form of inter-ministerial process. In exercising this power, ministers should safeguard overall public interests rather than acting as private owners of companies. According to the degree to which the state has centralized its enterprise ownership function and the size of the state's ownership stake in an SOE, this authority may rest with individual ministers or the entire cabinet and/or executive power.

In countries, where the state enterprise ownership function is centralized, for example, through a dedicated state enterprise ownership unit—such as in China, Korea, Sweden, and Thailand—this ownership unit has the direct responsibility for nominating or approving members to wholly owned SOE boards, whereby the decision often benefits from advisory functions. In countries, where ownership is more decentralized like Egypt, India, Malaysia, Morocco, and Vietnam, the agency exercising a central state function and sectoral ministries often shares responsibility for board nominations. Line ministries exercise most of the power but finance ministries sometimes oversee the process through some degree of coordination. In the case of partially owned SOEs, such nominations must in principle be further vetted by shareholders in a general meeting for appointment to the board.

In some countries, there is a continuum of dependency on the ownership function regarding board composition with varying degrees as follows:

- Appointment of direct representatives from the ownership function
- Other directors for the state, who by law or statutes, are tasked with representing the government interest. In some countries, individuals can be selected from the private sector or academia and tasked to act in the interest of the state, but in most cases they are, civil servants
- Directors that are picked at the discretion of the nominating minister or the ownership function
- Independent directors picked according to national or SOE-specific definitions of 'independent'

The board should include people with a mix and balance of skills and understanding to match and complement the SOE's business and its strategic aims. Therefore, the appointment of directors to SOE boards should be based on well-defined eligibility criteria and not merely on account of holding office in the government. In Korea, for example, since 1999, public officials or civil servants cannot become members of SOE boards as stipulated in the 'Act on the Management of Public Institutions'. If it is less than three years since the person was removed from her/his office as a public official, she/he should not be qualified for a director of an SOE or quasi-governmental institution.

The OECD Guidelines on Corporate Governance for SOEs recommend that the recruitment process should be based on eligibility rules and appropriate vetting mechanisms (that is, nomination committees) before the ultimate decision of ministers and shareholders. Where SOEs have minority non-state investors, their adequate board representation should also be ensured. The board nomination decision should be facilitated by the consistent policy framework that enables boards to play a role in identifying potential members with appropriate expertise and knowledge. The policy framework entails setting clear minimum qualification criteria for board appointments, vetting mechanisms for ministerial board nominations, establishing nomination committees or taking a tailored nomination approach, and ensuring shareholders' right to elect board members.

Accordingly, the mentioned topic explores the adoption of professional criteria for the selection and removal of board members as well as the development of a structured nomination and appointment process.

Adoption of professional criteria for selection and dismissal

As more and more countries move toward including independent directors and are moving away from the practice of filling board positions with political figures and government representatives, professional criteria for the selection of directors become all the more important. While the specific skills required will vary from board to board, governments are identifying the competencies, skills, and experience needed to exercise independent judgment and lead the SOE successfully—including industry-specific knowledge and financial, legal, corporate governance, and other skills—and striving to appoint directors, who match those profiles. The aim is to create professional boards with independent judgment and a wider range of talent and perspectives.

Selection criteria – More rigorous qualifications have accompanied efforts to bring greater professionalism to the makeup of boards. In addition to minimum requirements for education and experience, industrial, financial, business, legal, and corporate governance skills, as well as private sector backgrounds and experience, are carrying more weight. Other skills such as integrity, ability to add value, and critical faculty are also important. While specialized expertise has been targeted for inclusion, certain backgrounds are also being identified to disqualify candidates.

Table 11 provides an overview of qualification requirements for board directors.

Given the state's role over SOE board nominations, it also has an important role to play in ensuring gender diversity of the boards. The state should actively ensure that adequate gender representation on SOE boards is implemented and can also develop and implement policies to help enforce the same. Besides, the state should also ensure that integrity and ethical standards are incorporated as part of the selection criteria to help improve the board's effectiveness and professionalism.

Profile of board skills – The sharper focus on the competency of boards is attracting greater

Table 11: Qualification Requirements for Board Directors

Priority	Example of Qualification Requirements
Reduce participation by ministers and other high-level public officials	**Estonia:** Ministers and ministerial secretaries-general can serve on the boards of foundations but not companies. **Israel:** Ministers, deputy ministers, and parliamentarians cannot serve as SOE directors; additional rules are established to prevent possible conflicts of interest. **Slovenia:** High-level public officials cannot serve on SOE boards, and no more than two civil servants can serve on a supervisory or management board at any one time.
Specific expertise required: Criteria may be the same for all SOEs or special criteria may apply only to certain SOEs or positions	**Czech Republic:** Requirements include experience in corporate governance and knowledge of economics, financial statements, and the commercial code. Hungary: A degree in finance, economics, or law is required. Romania: Most of the board members must have experience with profitable private sector companies.
Skillset differentiation for particular positions or the board as a whole	**Chile, Israel, and Lithuania:** Additional proficiency and suitability requirements apply for candidate board members of large SOEs; the required expertise of each director position is specified to ensure that the board has an appropriate skills mix. **Switzerland:** Qualifications are divided into three categories: (a) for the board as a whole (team functions, strategic skills, relevant market and professional knowledge); (b) for single board members (integrity, independence, professional skills); and (c) for the chair (specific leadership skills).

Source: Adapted from World Bank Group 2014.

attention to developing profiles of board skills as an important tool for better management of board appointments. These profiles detail the skills needed for a board as a whole or for particular positions. Such efforts have grown out of the need for the government and its boards to bring greater professionalism to the makeup of boards, especially as they take on a bigger role in strategic business planning and board evaluations. Since directors have finite terms, SOE owners need to be aware of the duration of all appointments and include succession planning in medium-term skills profiles. Developing a profile of board skills is especially important for the board chair and specialist industry skills.

Dismissal criteria – Board members should be appointed for a fixed term, usually for the span of one to three years. In many cases, even though board members have finite terms, they may be rotated or removed for no substantiated reasons or, conversely, may be subject to unlimited renewals. In both cases, clear criteria should guide the process of removing directors. Company legislation generally provides that shareholders may seek to remove a director. However, dismissal standards may need to be stricter for SOEs than for private sector companies to avoid the risk of arbitrary dismissals for political or other reasons unrelated to performance. A non-performing director (for example, one who fails to attend board meetings) can jeopardize the health of the company, but a board member should not be subject to removal simply because of an election result.

Developing a structured nomination and approval process

Especially under the decentralized model of SOE ownership, line ministries typically lead the nomination process for board directors. This approach can allow for considerable political influence and result in varied nomination procedures from one SOE to the next and a lack of transparency. To reduce the ministerial influence, many countries, therefore, have adopted governance reforms that delegate part or all of the nomination processes to an advisory body, expert panel, centralized ownership entity, or the SOEs themselves.

Delegation to an advisory body or expert panel – An SOE advisory body may play an informal role, providing advice, as requested, to line ministries. However, without a systematic structure or process in place, their role and inputs may be minimal. Giving them a more formal role in the process usually yields better results and helps improve the prospects of identifying more qualified and merit-based boards.

Advisory or coordinating bodies are assigned a formal role in countries such as India, New Zealand, Sweden, and the United Kingdom. In these cases, they usually prepare shortlists of candidates, evaluate and propose candidates, maintain a database of potential candidates with different terms of reference, and keep records of board memberships and directors' terms.

A special panel or expert committee may also be created to provide supplementary advice for board nominations. Suitable panel members are usually experienced directors from the public or private sector.

Control by centralized ownership units – While advisory bodies typically support and advise line ministries on the nomination process, centralized ownership entities may have direct responsibility toward board nominations.

Responsibility of SOE nominating committees – The majority of the countries rely on a top-down nomination process led by ministries, an advisory body, or an ownership entity. However, some use a bottom-up process led by the SOEs themselves. SOE-led nominations are more common in developed countries for mixed-ownership companies, and for SOEs listed on an exchange with regulations that call for a board nomination committee.

An SOE-led process is potentially vulnerable to interference and manipulation of the nomination process. The government can influence shortlisting, while a type of self-censorship may occur since the nomination committees may be reluctant to propose candidates that they know stand with little chance of approval. However, integrating the

SOE into the nomination process may help identify the backgrounds most needed in board directors.

Below are some **practical guidelines for SOEs to follow in leading the process for board nominations:**

- Set up a nomination committee as a specialized committee of directors (refer to topic on establishing specialized board committees in Part II, Module 1 on recommended role and composition of a nomination committee).
- Nomination committee must reach out to institute of directors or equivalent bodies to access a pool of qualified candidates trained on corporate governance issues.
- Staff the committee with a majority of independent directors and employ independent external search consultants, as needed.
- Ensure that the nomination committee supports the objective of a formal, merit-based, and transparent process for the nomination of board members with specific skills.
- Ensure adequate succession planning to avoid board positions becoming and remaining vacant.
- Ensure that these committee objectives and procedures are documented with full information on the process and that board nominees be made available to shareholders and the public.
- Audit the process.

Creation of a directors' pool – Ownership units in countries such as India and Thailand have generated databases of qualified candidates to assist in future nominations. Created by the advisory body or ownership entity, the databases are developed through open advertisement, specialized screening, search committees, the use of professional recruiters, and consultations with other ministries and government agencies. Candidates are pre-screened and interviewed to ensure their competence and credibility. Such databases are one of the ownership unit's most valuable tools for professionalizing SOE boards.

Barriers to women in boards and senior management, and business case for gender diversity in boards[18]

The private sector has made significant strides in ensuring board gender diversity compared to the public sector including SOEs. Therefore, at multiple places, this section talks about the best practices from the private sector that can act as a guide for the SOEs to advance their efforts toward ensuring greater board diversity.

The business case for board gender diversity

It is important for the state as an owner to recognize that gender-diverse boards are not only essential for gender parity and inclusion considerations but that they also have a positive impact on SOE performance. An IFC study emphasizes that firm performance is not the only reason why governments and business leaders should embrace diversity. First, the social case for diversity is strong enough in itself: for example, businesses in the South East Asia Region have increasingly diverse workforces, where women play crucial roles in almost all the operational aspects, from the shop floor to senior management. There is no reason that company boards should not reflect this diversity. Second, senior female leaders have similar academic qualifications to their male counterparts, which suggests that there is no shortage of talent.

Increasing women's presence on company boards widens the talent pool from which they can draw driving operational excellence and bring unique insights and fresh perspectives, which enable stronger decision-making. For example, women may bring different leadership traits, introducing a more varied and comprehensive set of competencies to the boardroom. It has also been suggested that women can (in general) be more flexible in their views, more open to different ways of thinking, and less command-oriented than men, facilitating more open discussion among the board members, thus reducing groupthink and improving relations between the board members and employees. Evidence also shows that women are interested in engaging in environmental, social and governance (ESG) issues, which are vital for enhancing a firm's reputation and impact.

Country case studies of initiatives toward promoting gender diversity are outlined in Box 16.

However, there are several **challenges faced by women to be appointed and function effectively in boards** and senior management, which include the following:

- Board appointments are typically based on the old-boy networks
- Risk of tokenism—appointing women solely to fulfil a quota, appease investors, or make the firm appear more progressive and diverse
- Women in senior executive posts can be 'invisible'
- Boards lack an understanding of the benefits of a diverse board
- Lack of minimum access to mentoring, networking, and training
- Weak regulatory enforcement of current guidelines on gender diversity
- Lack of family-friendly policies, including childcare
- More male champions for gender diversity are needed
- Lack of gender-disaggregated data or minimum reporting on gender metrics
- No supportive tone at the top to change company culture

Drivers of board gender diversity

Advancing gender diversity requires a combination of country- and company-level initiatives. Over the past two decades, efforts to encourage board gender diversity have relied on both direct measures, such as introducing gender quotas and developing or revising corporate governance standards and indirect measures, such as promoting greater female labor force participation or gender equality in general.

Country-level factors that drive board gender diversity: Quotas and corporate governance standards are the most common top-down policy tools for increasing board gender diversity. Other policy tools that aim to develop more gender diverse societies can also indirectly influence board gender diversity—for example, increasing female labor force participation and introducing gender equality policies. Western European countries have generally taken the lead in imposing top-down direct measures, the most visible of which are mandatory quotas. Norway first established mandatory quotas in 2003, and several EU countries have since followed suit. While useful in theory, some studies conclude that quotas may be too narrow a policy tool to address some of the more systemic issues of female under-representation.[19] For instance, a 2011 study by IFC suggested that quotas encouraged tokenism and a lack of commitment from the existing board members.[20] However, a 2017 study by Solimene et al. found that the introduction of quotas supported a significant rise in the share of women on the boards of some of Europe's largest companies.[21]

Beyond quotas, other direct measures include revising corporate governance codes. This is seen as a less burdensome top-down method of achieving board gender diversity. These codes can require companies to publicly disclose the number of women on

Box 16: Country Case Studies on Gender Diversity Promotion in Company Boards

Western Europe remains the world leader in board gender diversity, with women holding more than 20 percent of board seats in many countries, and significantly more in countries such as Norway (42 percent), France (40 percent), and Sweden (31.7 percent). Since France and Italy established quotas in 2011, the share of board seats held by women in these countries has skyrocketed, from 12 percent in 2010 to 37 percent by 2016 in France, and from 5 percent to 30 percent in Italy. Over the same period, the share of board seats held by women in Germany increased from 13 percent to 27 percent. However, despite being an early champion of gender equality in the boardroom, in the United States, women hold only 14.2 percent of board seats. A lack of proactive policies has resulted in the country falling behind its European peers in recent years.

Source: International Finance Corporation. 2019. *Board Gender Diversity in ASEAN*. Washington, DC: World Bank Group.

their boards, consider gender diversity for boardroom appointments, and publicize their policies on gender diversity and their progress toward achieving it. This 'comply or explain' approach—adopted in countries such as Canada and the United Kingdom—provides a middle ground between implementing quotas and taking a laissez-faire approach.

Other macroeconomic factors such as greater female labor force participation and policies promote gender equality function as external drivers of board diversity. A 2016 study by the International Monetary Fund (IMF) found a stronger correlation between gender diversity in senior positions and the financial performance of companies in sectors where women accounted for a larger share of the labor force.[22] Similarly, a 2016 study by the Asian Development Bank (ADB) found that government policies promoting gender diversity in business leadership improved the social conditions required for gender equality, which can have a trickle-down effect on board diversity.[23]

Company-level factors that drive board gender diversity: No two firms are the same, but research has shown that factors such as the industry in which a firm operates, ownership structure, and diversity in leadership, can determine the likelihood of a company having a higher or lower proportion of female board members. The following company-level drivers that can potentially influence board gender diversity, ranging from company image to the desire to attract more investors are:

- SOE's recognition of the benefits of board gender diversity. Recognizing such benefits provides a much-needed push for companies to diversify their boards.
- Companies may be able to attract a variety of investors by increasing female board membership. Indeed, a 2017 Deloitte study[24] found that investors were among the most influential advocates for change and that some had even been pushing back on companies that were not doing enough to promote boardroom gender diversity.
- The third driver is the company's desire for a better reputation or business image. As a 2012 Credit Suisse study[25] explained, when a company appointed more women to its board, it sent a positive signal to the market about its focus on corporate governance. It could also indicate that the company was doing well.
- Finally, shareholder activism provides an impetus to appoint more women on boards. A 2011 Global Economic Symposium study[26] found that institutional shareholders were pushing to nominate and create their databases of diverse directors.

Impact of board gender diversity on company performance

The global literature on the impact of board gender diversity on company performance is mixed. Many studies comprehensively show improvement across at least one of the indicators of performance in firms that have more women on their board.

However, many studies have found either a negative or neutral association between gender diversity and performance, as outlined in Box 17 on the next page.

The benefits of increased gender diversity in boards on company performance is summarized in Figure 10 on the next page.

Opportunities for advancing board gender diversity

There are numerous opportunities to make progress toward achieving greater board gender diversity. Certain policies are critical to this effort, such as, expanding parental leave to include men and changing codes of corporate governance to include gender diversity disclosures. Companies and business leaders must also commit to improving diversity (for example, through mentoring and sponsorship programs), and must be proactive in promoting its benefits to their peers. Lastly, women can establish intra- and cross-company networks to facilitate peer-to-peer support and promote their skills and experience. This section talks about the key opportunities to enhance board gender diversity in the region, at both the country and company levels.

Country-level opportunities for advancing board gender diversity:

Box 17: Empirical Studies on the Relationship between Board Gender Diversity and Financial Performance Globally

A 2012 Credit Suisse report found that companies with at least one woman on the board outperformed—in terms of share price performance—those with no women on the board over the course of six years. Adams and Ferreira (2009) studied a sample of US firms and found that female directors performed better in terms of committee attendance and participation, allocating more effort to monitoring responsibilities. However, their results suggested that the average effect of gender diversity on company performance was negative. In contrast, the latest research from Morgan Stanley Capital International Environmental, Social and Governance (MSCI ESG) shows that companies with strong female leadership generated an ROE of 10.1 percent per year, compared to 7.4 percent for those without such leadership. Similarly, a 2015 study on women on the boards of Australian companies found a positive association between board diversity and company financial performance (Return on Equity, Return on Assets, and Tobin's q) after controlling for several firm-specific and governance variables.

Source: IFC. 2019. *Board Gender Diversity in ASEAN*. Washington, DC, World Bank Group.

- **Corporate governance codes are the most cost-effective public intervention.** Changing corporate governance codes to promote board gender diversity is almost universally seen as the key mechanism for increased female representation in boardrooms. To a large extent, this is because relying on corporate governance was seen as imposing less of a burden on companies than measures such as quotas.
- **Power of networks.** The 30 Percent Club is a global initiative that aims to achieve at least 30 percent female board membership on Financial Times Stock Exchange 100 boards, the critical mass of female representation needed to perpetuate further diversity. The club supports sustainable, business-led voluntary change designed to improve the current gender imbalance on boards. In July 2017, the 30 Percent Club launched a mentorship program with PwC Malaysia, where women identified as 'board-ready' are paired with experienced directors or existing board members. The program aims to mentor 100 women by 2020.
- **Family-friendly policies are needed, as are changes to social and cultural norms.** It is widely recognized that there is a need for policies that will help women to manage responsibilities as both business leaders and parents. This combination of family responsibilities takes a toll on the amount of time and effort women in the region can dedicate to work, which in the long term affects their likelihood of reaching top positions in the C-suite or the boardroom. Among the **various**

Figure 10: Business Case for Increased Gender Diversity on Boards

Enhanced firm performance	Increased board effectiveness	Influence nature, extent, and monitoring of reporting
• Better results on assets and sales • Stronger earnings quality • Enhanced firm value • Tighter internal controls • Increased ethical and social compliance • Reduced incidence of fraud, insider trader, and other unethical practices	• Stronger control over companies' strategic direction • More active board meetings • Reduced levels of conflict • Greater emphasis on board development • Increased willingness to replace underperforming CEOs	• Reduced risk of financial restatement • More conservative approach to earnings statements • Increased transparency and disclosure

Source: Adapted from IFC. 2018.

strategies that can be implemented at the country level to tackle this problem, policies that support men to play a larger role in childcare are crucial.

- **Stock exchanges can do what governments have yet to** (for listed companies only). Through their financial regulators, governments can play a key role in establishing the groundwork for board gender diversity by making changes to corporate governance codes. The directors of national stock exchanges can take the lead in promoting disclosure of gender diversity targets, pay parity, parental leave, and flexible work policies, and can help to foster networking and training for female leaders.
- **Make them known: the importance of directories and data.** Publicizing the efforts of women who already sit on boards can be a simple yet effective way of expanding the female talent pool for companies seeking to fill vacant board seats. IFC recently published Sri Lanka's first directory of this kind: Women on Boards of Companies Listed in the Colombo Stock Exchange[27]. Beyond directories, greater availability of gender-disaggregated data could help advocacy groups, researchers, and the media to understand the current levels of gender diversity, and to track progress over time.

Company-level opportunities for advancing board gender diversity:

- **Change must begin from within the company, and senior leaders need to play a bigger role.** At the company level, it is vital that the leadership supports board gender diversity and proactively adopts strategies in pursuit of this goal. According to a 2016 study by McKinsey & Company, CEO commitment was one of three 'game changers' that helped certain firms rank in the top tier for gender diversity. The study found that a committed CEO—male or female—ensured that gender diversity became a strategic priority for the firm and that senior managers were on board with this priority (although the trickle-down effect weakened at the middle manager level). An unequivocal statement of intent, supported by a clear and transparent action plan and communicated from the top of the organization, was identified as the first and most important step toward achieving organizational change. Boards and their nominating committees must consciously broaden their search criteria and present a more diverse pool of female and male candidates for consideration. Encouraging mentorship programs within companies is also an important mechanism for increasing the number of women in senior management.
- **Pipelines and networks for women are crucial game changers.** Companies can actively develop a long-term pipeline of female talent, focusing on both internal and external candidates with the right expertise, rather than those with previous board experience. After identifying these candidates, companies can provide dedicated board training and take steps to avoid 'leakage'—for example, by starting a dedicated return-to-work program for women, who have taken time off. The importance of introducing policies that would help to retain female employees and hopefully provide the company with a larger candidate pool to choose from when appointing board members in the future cannot be underscored. Possible policies include providing flexible work hours, promoting gender equality throughout the business, and running diversity events. Most countries already have some type of national directors' network in place, where female directors can play a role in promoting diversity.
- **Advocacy groups can also promote board gender diversity.** Dedicated diversity groups and councils also help to promote board gender diversity in various countries. This includes specialist advocacy organizations such as the 30 Percent Coalition and 2020 Women on Boards in the United States, and the 30 Percent Club in the United Kingdom, all of which have implemented various initiatives dedicated to increasing board gender diversity. For example, the Thirty Percent Coalition's 'Adopt a Company' letter campaign[28] targeted more than 150 major listed companies with no women on their

boards and managed to get 22 of them to recruit women into board positions. In response to apathy at the federal level regarding board gender diversity, 2020 Women on Boards decided to lobby state governments in the United States and succeeded in passing a resolution in Illinois that urged companies to have a minimum number of women on their boards.

- **Make work flexible and help women return to work.** This should include providing child-friendly working hours, or work hours that can fit in with other family commitments: working from home, teleworking, or arrangements to work part-time temporarily. Furthermore, companies should publicize their willingness to accept flexible work and highlight the business case for this (that is to retain talented female employees) to avoid any impression that women are getting an 'unfair advantage' from these arrangements.

Demonstrating a visible commitment to board gender diversity is critical. There is evidence that diversity tends to promote further diversity, prompting more widespread and inclusive searches for talent among a company's own ranks. Once a critical mass of diversity has been achieved, the push for even greater diversity tends to become automatic. Therefore, in the context of an SOE, the state has a key role to play to set the right tone at the top and facilitate the trickle-down effect of maximizing board gender diversity.

Topic six: State's financial oversight and monitoring responsibilities[29]

Many studies have highlighted how the failure of SOEs can result in huge economic and fiscal costs. A survey[30] analyzed a series of episodes, in which contingent liabilities materialized over the period 1990–2014. The study concluded that the maximum cost of those episodes involving SOEs was 15.1 percent of GDP, and the average cost was 3 percent of GDP which is significant.

SOEs were the second-largest category of fiscal risk after the financial sector (which includes many state-owned financial institutions). Moreover, the number of episodes involving SOEs and their average fiscal cost doubled between the 1990s and the 2000s. To contain such risks, an effective regime for the financial supervision and oversight of SOEs should be put in place.

In this topic, the essential building blocks of an effective framework for the financial oversight of SOEs are discussed. These elements include the policy, legal, and institutional frameworks for the oversight of SOEs, a robust system of financial controls and approvals, and arrangements for measuring and monitoring SOEs financial performance and their quasi-fiscal activities.

Financial oversight mechanisms

An effective framework for the financial oversight of public corporations requires a clearly defined ownership policy backed by strong legal and institutional arrangements. In some countries, the laws and regulations governing business enterprises will provide much of the required legal framework for public corporations. Such laws include those related to the structure and powers of the management board, requirements on financial reporting, and independent audit arrangements. However, for public corporations, these laws need to be supplemented by a public-sector-specific

oversight framework that defines the respective goals, power, and responsibilities of the corporation, the Ministry of Finance, and any line ministries involved. Three main components of this framework are described below:

Ownership policy – An effective framework for the financial oversight of SOEs requires a clearly defined ownership policy backed by strong legal and institutional arrangements. The ownership policy should explicitly address the following elements: planning or budgeting requirements, reporting requirements, pricing and tariffs, dividend policy, financial assistance from the government including guarantees, and contractual commitments. The policy should also ensure that all these elements are included in the government's financial monitoring and reporting framework.

Legal framework – To establish the respective roles of the government and its SOEs clearly in financial management, many countries have found it helpful to prepare a framework law on SOEs. **The legal framework should include the following elements:**

- A clear definition of the financial oversight function, whether the Ministry of Finance would carry out this role, a sector ministry in consultation with the Ministry of Finance, or possibly an independent agency.
- A statement of the powers of the government to receive, comment on, and approve the financial plans, financial targets, and annual financial statements of SOEs; set financial performance targets; and respond to requests by SOEs for compensation of public sector obligations, capital injections, borrowing, or government guarantees.
- A statement of the public reporting requirements for all corporations, including a full annual financial statement (containing a statement of operations, a cash flow statement, and a balance sheet) prepared following national or international accounting standards.
- A requirement for the government to publish an annual report on whether SOEs are achieving their policy and financial objectives and complying with their obligations to prepare regular and timely financial reports.
- A requirement for the annual accounts of the public corporation to be audited by a reputable, independent auditing body that is recognized internationally, and to publish the audit report.

Institutional framework – Because shareholders have the right to approve SOEs' corporate and financial plans and dividend policies and to receive financial reports, the ownership and financial oversight functions overlap with each other. For this reason, some countries have chosen to locate both the ownership and financial oversight functions in a central agency, often the Ministry of Finance, the Treasury, or the Presidency (examples are Brazil and Sweden). Other countries apply a more decentralized ownership model or a mixture of the centralized and decentralized models.

Financial controls over SOEs

In exercising their ownership functions, governments need to strike a balance between maximizing the operational autonomy of SOEs and minimizing fiscal risks. Countries have begun to delegate major decisions to SOE boards, particularly those of larger SOEs or listed SOEs, but may still fall short of full delegation (refer to Part II, Module 2 for an example on 'Delegating decision-making powers to SOE Boards in India'). **Although financial control mechanisms vary from country to country, they typically include some or all of the following elements:**

- **Financial and policy objectives.** Good financial management depends critically on a clear and operational statement of the government's financial and policy objectives related to each SOE. The former may be expressed in terms of the SOEs dividend, profit, return on equity, or other indicators discussed below. The latter may include the maintenance of universal access to infrastructure services, provision of certain strategic outputs, or provision of services at below-market prices, all of which should be compensated through transfers from the government's budget.
- **Financial plans**. The ownership of a majority of the voting interest gives the

government a veto power on all major decisions regarding corporate policy and financial plans. **When assessing an SOE's financial plan, governments should ensure the following:**

- Financial targets, prices and tariffs, capital levels, and targets for dividends are appropriate;
- The balance between commercial objectives and any public service obligations is adequate;
- Investment plans take government priorities and related activities into account;
- Financial and operational risks are actively managed;
- SOEs do not create subsidiaries as a means of transferring the control of public assets to private interests.

- **Borrowing**. The government in some countries with the formal approval of the legislature may establish ceilings on the borrowing of SOEs as a whole and/or individually to limit the contingent liability to the government itself and the impact on the wider economy.
- **Guarantees.** Governments in some cases either prohibit entirely or strictly control the issuance of guarantees by SOEs to third parties, as this impairs the government's equity in the corporation and is typically more expensive than extending the guarantee directly from the government.
- **Sale/pledging of assets.** SOEs' nonfinancial assets, such as land or buildings, are often provided to them by the government free of charge (in some cases, the legal ownership of the assets remains with the government rather than with the SOE itself). Therefore, to protect its equity in the SOE, the government may restrict the sale of these assets or their use as collateral in financial transactions. It may similarly restrict the pledging or securitization of future revenue streams.
- **Mergers/acquisitions.** Given the impact that mergers and acquisitions may have in terms of the SOEs operations and finances, as well as the environment for competition, governments typically require their approval before an SOE can merge with or acquire another enterprise.
- **Raising private finances.** SOEs are being increasingly encouraged to explore alternate sources of financing to reduce their reliance on the state. However, given that this avenue would have an impact on the capital structure of the SOE, the state must be consulted on all such decisions, especially where equity divestment is involved.

Vetting business case of large SOE investments

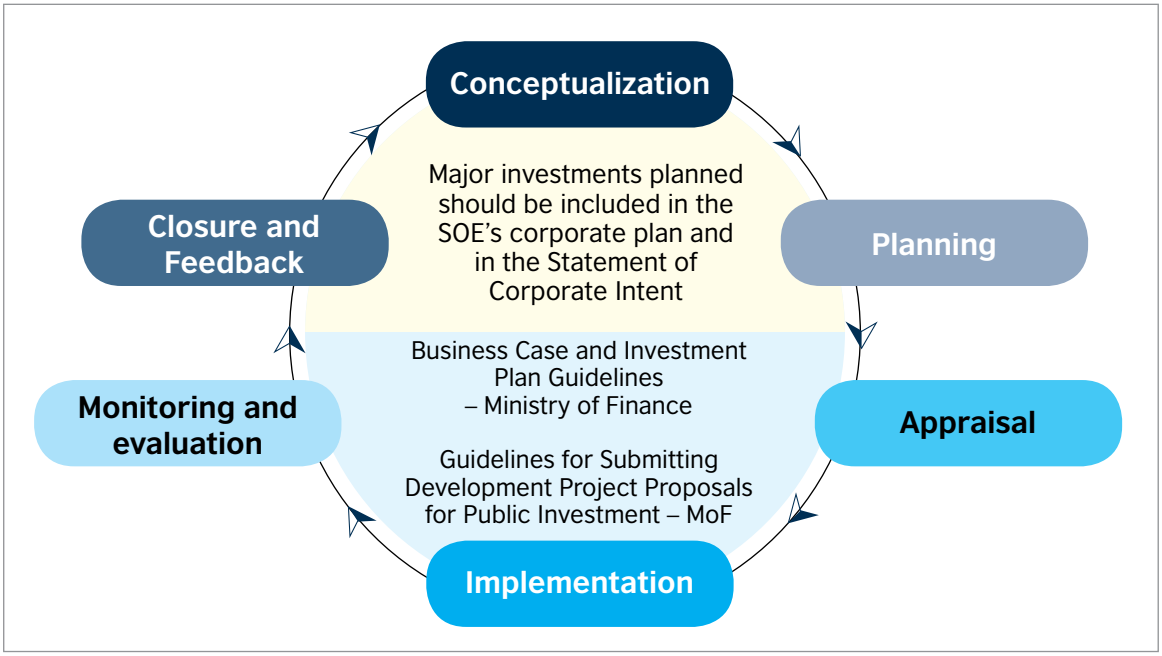
When SOEs initiate large capital investment project proposals that are submitted to the Ministry of Finance for review, notably when such projects require co-funding from the budget; or it imposes recurrent expenditures on the budget; or seek government guarantees, it requires a standardized framework to systematically appraise and vet the business case of such large SOE investments.

The framework is ideally applied in two steps during critical decision points in the project and budget cycle, at the planning and appraisal stage as given below. This framework entails a more rigorous project preparation and appraisal, which can be onerous and should, therefore, be applied in priority to large or risky projects (from a social or environmental point of view), as outlined in Figures 11 and 12 on the next page.

Completed project proposals should be submitted to the state/ownership entity/ portfolio and finance ministries for assessment and approval through the board of directors. Upon receiving the proposal, MOF will conduct the appraisal in two stages:

- ***Preliminary assessment/concept stage.*** The preliminary assessment, which will check the project rationale and sustainability issues, will examine the strategic importance of the project, an assessment of costs and benefits, a pre-feasibility study of the project and will verify whether a sufficiently wide range of alternatives has been considered. If the proposal lacks essential information/data, additional information will be requested

Figure 11: Project Cycle



Source: Authors.

Figure 12: Workflow of Investment Appraisals

Classical PIM review process	Ministries and Agencies	Planning	External Financing when applicable	Budget	Cabinet	
SOE investment review process	SOE/ Ministry	MOF SOE depart.	Planning	External Financing when applicable	Budget	Cabinet

Source: Author.

from the SOE in a given time frame (to specify in the policy/regulation).

The principal criteria to be used for appraisal of a project at the initial appraisal stage are (a) whether the project has been formulated in line with national and sectoral policy priorities and objectives of the government, (b) what specific development challenges it aims to address and how this can be measured, (c) the result of the socioeconomic benefit analysis, (d) affordability and financing capacity of the SOE, (d) potential fiscal risks and contingent liabilities, and (e) the proposed project team. It will further assess SOE specific dimensions such as the impact on the market and competitive neutrality, the corporate governance of the SOE and more recently the climate risks (physical and transition risks).

- ***Comprehensive assessment/appraisal stage.*** A detailed appraisal is carried out once the detailed project has been submitted along with a feasibility study in the second stage. This is accepted as the final step before a project is approved by the state after the merits and acceptability of projects are determined under established criteria. The feasibility of the project is set out at this stage to scientifically assess whether the objectives remain appropriate; the costs are reasonable; the project is technically, economically, socially and environmentally feasible; and the mitigatory measures are identified for risks.

The Ministry of Strategy and Finance of the Republic of Korea applies such a differentiated project appraisal process for large investments from public institutions (which includes SOEs): https://www.kdi.re.kr/kdi_eng/kdicenter/pimac_cp-law.jsp

Cross-cutting theme: maximizing finance for development (MFD)

With a future view on the limitations of foreign aid and unsustainable levels of public debt in several emerging economies, there is a renewed focus on domestic revenue mobilization and other innovative mechanisms to finance development outcomes. According to the new MFD approach of the World Bank, the focus of many governments regarding catalyzing private financing to advance development goals has shifted. This also includes the transformation of sectors that provide essential services or are critical to economic growth. Many businesses offer valuable skills, resources, and access to markets, and therefore, represent a unique opportunity to catalyze private investments instead of displacing them.

While the private sector has the necessary resources to invest in advancing development goals and efforts are being made to tap these resources, which will add to the scarce public resources, there is another line of resource available for the governments to maximize finance for development, that is, SOEs. With SOEs as some of the largest commercial entities in several countries, it is imperative to recognize their potential as financing sources for development projects to drive sustainable economic growth. As representatives of the state, the Treasury officials acting as directors on the SOE board must advocate for leveraging financing from various private sector sources to promote a sustainable growth trajectory of the SOE and prevent unduly reliance on government funding, while being mindful of the fiscal risks and contingent liabilities generated. This requires a careful analysis and sharing of risks and appropriate risk mitigation measures.

Financing of the project could be done via different forms not limited to funding from the national budget. SOEs must consider the least expensive and most feasible solution when planning an intervention, and in line with the MFD strategy, they are encouraged to identify ways to integrate private sector financing.

SOEs must systematically appraise and vet the business case of large SOE investments to avoid duplication of activities with other projects and agencies to minimize fiscal costs and risks for the state. The state representative should support the SOE to ensure relevance, efficiency, and effectiveness in resource allocation and maximizing finance for development by which the state is the fund provider of last resort, not first.

Box 18: Principles for Crowding-in Private Sector Finance for Growth and Sustainable Development at a Country Level

The Principles on Crowding-in Private Sector Finance is an initiative of G-20 member countries and the multilateral development banks (MDBs) such as the World Bank, to foster effective approaches to maximize the mobilization and catalyzation of private sector resources to support countries with the implementation of the 2030 Development Agenda—including through financial and management resources and innovation. It is a set of seven principles:

- Recognizing the primacy of country ownership
- Creating an investment-friendly environment; enhancing market liquidity and strengthening project management capabilities and governance
- Expanding and standardizing credit enhancement instruments in the form of guarantees, insurance products, blended finance, equity investment, and liquidity backup facilities
- Prioritizing commercial financing – pursue cost-effective, non-government-guaranteed commercial financing, contributing to the optimal use of scarce public resources
- Blending concessional resources and private capital in an optimal way
- Reviewing incentives for crowding-in and catalyzing private sector resources

Source: G20-Internaltional Financial Architecture Working Group. 2017. *Principles of MDBs' Strategy for Crowding-in Private Sector Finance for Growth and Sustainable Development.*

Certain principles outlined by the G-20 member countries and multilateral development banks to support decision-making concerning leveraging private sector financing are outlined in Box 18.

Monitoring SOE's financial performance

Financial reporting and auditing standards. Monitoring the financial performance of public corporations is greatly facilitated if public corporations follow International Financial Reporting Standards (IFRS) for financial reporting and auditing. Compliance with IFRS ensures a high-quality source of primary data on public corporations, including their financial oversight. By providing a true and fair view on the accounting for assets and liabilities, IFRS enhances the reliability of financial information, which is also more readily understood and comparable, both domestically and worldwide. Compliance with IFRS also facilitates the consolidation of financial data on public corporations with data on the general government sector in countries that follow International Public Sector Accounting Standards (IPSAS), Government Finance Statistics Manual (GFSM) 2014, or related standards.

SOE monitoring reports. These reports present the overall summary of the financial performance of the sector as a whole as well as provide information on individual SOEs. Its broad contents include

- An overview of the sector and highlights of public corporation activities during the year
- A full list of the companies owned by the government
- An overview of how the government has exercised its ownership policy
- Special topics
- Information on individual companies

The above contents have been further elaborated in Part III, Module 3. Handout 3.3A is a case study on the contents of Sweden's 2017 Annual Report of State-Owned Companies.

Assessing fiscal risks of SOEs

Public sector balance sheets provide the most comprehensive picture of public wealth. They bring together all the accumulated assets and liabilities that the government controls, including SOEs, natural resources, and pension liabilities. IMF's Fiscal Monitor of October 2018[31] presents a comprehensive estimate of public sector assets and liabilities for a broad sample of 31 countries, covering 61 percent of the global economy. Estimates of public wealth reveal that the assets are worth US$101 trillion or 219 percent of GDP in the sample, which includes 120 percent of GDP in SOE assets.

Although SOEs hold a significant share in global assets and market capitalization, there are also several vulnerabilities associated with them. For example, in China, general government net financial worth has deteriorated to about 8 percent of GDP, largely because of subnational borrowing and underperforming SOEs. Off-budget debt and the weak performance of SOEs both entail risks for the future.

Governments provide significant support to financial SOEs (mainly capital injections) and nonfinancial SOEs (predominantly recapitalizations and debt assumptions), with the maximum annual support to financial and nonfinancial SOEs reaching 18 and 16 percent of GDP, respectively (an updated version of the database by Bova and others 2016). SOEs that operate in the airline, banking, mining, railway, and utility sectors are among those that required costly support.

For example, Italy's national airline is under bankruptcy protection and has received large loans or transfers from the government in the past few years. Similarly, South Africa's government-owned power company, Eskom, is receiving a rolling government bailout of 2.33 percent of GDP over three years, although the cost may turn out larger (IMF 2019b). In Belarus, over the past years, the government on average provided 1.5 percent of GDP in subsidies and about 2 percent of GDP in additional off-budget support (Richmond and others 2019).

In some countries, the debt of SOEs exceeds 20 percent of GDP and in several cases

constitutes half or more of the public sector debt stock. In other countries, SOE external debt exceeds 25 percent of the countries' exports of goods and services (see also IMF 2020). Even if the debt was incurred to develop a natural resource, as in oil-exporting countries, the debt may increase the vulnerability of the government to shocks (for example, a fall in oil prices). In addition to debt, SOEs may have significant obligations to private parties through joint ventures, PPPs, and power purchase agreements.

A recent update on the fiscal risks posed by SOEs and the optimal means for governments to utilize SOEs in times of financial or economic crises are outlined in Box 19.

If an SOE does not perform well, the government faces a financial risk. Implicit payments to SOEs may lead to a systematic underestimation of the risk. For example, many SOEs enjoy implicit government guarantees, and therefore, have cheaper borrowing cost. The government's goal in managing SOE-associated fiscal risks should be to determine the actual amount of risk, manage that risk through appropriate debt management rules, and encourage better SOE performance.

Estimation of fiscal risks associated with PSOs and SOE contingent liabilities is challenging. It is, therefore, sensible to focus on those SOEs that pose large fiscal risks. IMF (2005) outlines a set of criteria for identifying SOEs that expose the government to large risks.

Some of the key terminologies associated with fiscal risk monitoring are outlined in Box 20 on the next page.

These criteria focus on the government's involvement with the SOE, its financial and operational track record, the quality of the SOE governance, and its strategic importance to the government (see Table 12 on next page).

Box 19: SOEs in the Time of Covid-19

The COVID-19 pandemic has highlighted the role of the public sector in saving lives and livelihoods. SOEs are part of that effort—in the form of public utilities that provide essential services of public banks that provide loans to small business. But some are also struggling and adding to the burden on government finances. These range from national oil companies that are dealing with a large fall in oil prices, to national airlines without enough passengers traveling.

At their best, they can help countries achieve economic and social goals. At their worst, they need large bailouts from taxpayers and hinder economic growth. Which version taxpayers get boils down to good governance and accountability.

At a time when governments are facing increasing demands and struggling with high debt, the IMF in its April 2020, Fiscal Monitor says – a core principle for state-owned enterprises is not to waste public resources. IMF has laid down four main recommendations for how countries can improve the performance of SOEs:

- Governments should regularly review if an enterprise is still necessary and whether it delivers value for taxpayers' money.
- Countries need to create the right incentives for managers to perform and government agencies to properly oversee each enterprise. Full transparency in the activities of the enterprises is paramount to improve accountability and reduce corruption. Including state-owned enterprises in the budget and debt targets would also create greater incentives for fiscal discipline. Many aspects of these practices are in place, for example, in New Zealand.
- Governments also need to ensure SOEs are properly funded to achieve their economic and social mandates, such as in Sweden. This is critical in responding to crises—so that public banks and utilities have enough resources to provide subsidized loans, water, and electricity during this pandemic—and in promoting development goals.
- Ensuring a fair playing field for both SOEs and private firms would have positive effects by fostering greater productivity and avoiding protectionism. Some countries already limit preferential treatment of state-owned enterprises, like Australia and the European Union.

Well-governed and financially healthy state-owned enterprises can help combat crises such as the pandemic and promote development goals.

Source: Gaspar, Vitor, Paulo Medas and Ralyea John. 2020. "State-Owned Enterprises in the Time of COVID-19" *IMF Blog* (blog), May 7, 2020.

Table 12: Criteria for Assessing Fiscal Risks

Category	Nature
Managerial independence	***Pricing policies:*** Are prices of the SOE in line with international benchmarks (for traded goods and services); set at cost coverage (nontraded goods); is the tariff-setting regime compatible for the long-term viability of the SOE and compatible with private firms (regulated services)? ***Employment policies*:** Is this independent of civil service law? Does the government intervene in wage setting and hiring?
Relations with the government	***Subsidies and transfers:*** Does the government provide direct or indirect subsidies or explicit and implicit loan guarantees to the SOE, not offered to private firms? Does the SOE provide special transfers to the government? ***Quasi-fiscal activities:*** Does the SOE perform uncompensated functions or incur cost not directly related to its business objective? ***Regulatory and tax regime:*** Is the tax and regulatory regime in the industry the same for the SOE as for private firms? When appropriate, is the fiscal relationship with the SOE being managed by the large taxpayer unit?
Governance structure	***Periodic outside audits:*** Are these carried out by a reputable private audit firm according to international standards and are audit reports published? ***Publication of comprehensive performance reports:*** Are these published on an annual basis? ***Shareholders' rights:*** Are minority shareholders' rights effectively protected?
Financial conditions and stability	***Market access:*** Can the SOE borrow without a government guarantee and at rates comparable to private firms? ***Less-than-full leveraging:*** Is the SOE's debt-to-asset ratio comparable to that of private firms in the industry? ***Profitability:*** Are the SOEs' profits comparable to those of private firms in the industry, or if no comparable private firm exists, higher than the average cost of debt?
Other risk factors	***Vulnerability:*** Does the SOE have sizable contingent liabilities, or is it a source of contingent liabilities for the government, say, through guaranteed debt? Is there a currency mismatch between revenues and debt obligations? ***Importance:*** Is the SOE large in areas such as debt service, employment, customer base? Does it provide essential services?

Source: Adapted from World Bank Group 2014.

Box 20: Guarantees and Contingent Liabilities – Key Terminologies

A **government guarantee** legally binds a government to take on an obligation should a clearly specified uncertain event materialize. Thus, with a loan guarantee, the government will be committed to making loan repayments on behalf of a non-sovereign borrower that defaults. Governments provide a number of loan guarantees (for example, to farmers, small businesses, home buyers, students, and SOEs) and other financial guarantees, including trade and exchange rate guarantees, income, profit and rate of return guarantees, and minimum pension guarantees. Guarantees are a common feature of PPP contracts and other purchase arrangements between the government and the private sector.

A guarantee is a broader set of obligations of government that gives rise to an **explicit contingent liability**. Beyond guarantees, such obligations arise mainly from government insurance schemes, including deposit, pension, war-risk, crop and flood insurance, but they can also be the result of warranties and indemnities provided by the government, and outstanding and potential legal action against the government. It should be noted that pension and social security obligations of the government (as distinct from guaranteed minimum pensions under private pension schemes or government insurance of pension savings) are not contingent liabilities. While these are contingent for individuals given uncertain life expectancy, aggregate pension and social security obligations can be measured with some precision.

An **implicit contingent liability** arises when there is an expectation that the government will take on an obligation despite the absence of a contractual or policy commitment to do so. Such an expectation is usually based on past or common government practices, like providing relief in the event of uninsured natural disasters and bailing out public enterprises, public financial institutions, subnational governments, or strategically important private firms that get into financial difficulties. The government may also be expected to cover some costs that are extraordinary (for example, those related to war reparations, and national reconciliation and reunification).

Source: Fiscal Affairs Department, International Monetary Fund. 2005. *Government Guarantees and Fiscal Risk*.

These criteria cannot be applied mechanically and require significant information on the SOEs beyond what is readily available. Identification of SOEs that pose large fiscal risks, therefore, need to be part of an in-depth assessment of fiscal risks related to these enterprises. An assessment performed by the IMF on SOEs identified that very few SOEs were meeting the standards required to assess fiscal risks in comparison to their commercial counterparts. In this regard, the IMF developed revised criteria to identify fiscal risks.

Establishing the SOEs' baseline financial conditions and the financial relationship with the government budget as well as predicting how that budget relationship would be affected by changes in macroeconomic conditions, developments in the industry where the SOEs operate, and operational management of the SOEs are important. Factoring in quasi-fiscal activities is also important for establishing this baseline (refer Box 21).

Some country case studies on how countries are managing their fiscal risks arising from SOEs are outlined in Box 22.

The state as an owner must engage in deliberations on the illustrated categories

Box 21: Examples of Quasi-Fiscal Activities

- Charging less than commercial prices
- Provision of noncommercial services (for example, social services)
- Pricing for budget revenue purposes
- Paying above commercial prices to suppliers

In **Tajikistan**, for example the main quasi-fiscal activities for SOEs are pricing of goods and services at below-market or below-cost recovery levels; provision of noncommercial services by SOEs; soft budget subsidies like tolerance of SOE arrears; barter arrangements between government and SOE or between SOEs themselves; operating inefficiency like unbilled consumption, theft, and so on; subsidized lending and rescue operations and bailouts; and subsidies related to the exchange rate system.

Sources:

International Monetary Fund. 2007. *Manual on Fiscal Transparency*.

World Bank. 2014. *Policy Notes on Public Expenditures, Policy Note No. 5, Fiscal Risks from State-Owned Enterprises*. The World Bank, Washington, DC.

Box 22: South Africa – Managing Fiscal Risks from SOEs

South Africa has a relatively well-developed oversight framework for monitoring SOE performance. The Public Financial Management Act (PFMA) and Treasury Regulations require SOEs to submit corporate plans annually, covering a period of three years, and outlining the strategic objectives, agreed with the government, key performance indicators for assessing the entities performance, a risk management plan, and a financial plan. The financial plan must include projections of revenue, expenditure and borrowings, asset and liability management, capital expenditure programs and dividend policies.

The PFMA sets controls on borrowing and contingent liabilities of SOEs. The Minister of Finance must authorize the issuance of guarantees or indemnitees. Some SOEs must also obtain the Minister's approval before borrowing and all SOEs may not borrow in foreign currency above a prescribed limit set by the minister. Entities that are permitted to borrow must submit annual borrowing programs to the National Treasury as well as quarterly reports on actual borrowing.

A Fiscal Liability Committee has been established within the National Treasury to advise the Minister on these matters as well as short and medium-term risks related to SOEs. The committee receives reports on the financial performance of SOEs and their compliance with any condition attached to fiscal support, which are assessed as part of its aggregate fiscal risk monitoring.

SOEs are required to submit audited annual financial statements in accordance with generally accepted accounting practices within five months of the end of the financial year to the shareholder minister and the National Treasury. SOEs are also required to submit quarterly reports to their shareholder minister.

Source: International Monetary Fund. 2016. *Analyzing and Managing Fiscal Risks—Best Practices*. Washington, DC.

and supplement the questions with context-specific risk factors to be able to adequately and accurately assess fiscal risk. **The state can reduce its exposure to fiscal risks from SOEs by**

- Reducing the overall state participation in commercial activities and the size of quasi-fiscal activities;
- Limiting exposure to contingent liabilities by ensuring that there is a clearly defined set of criteria to govern the provision of any explicit government guarantees, prohibit or control the issuance of guarantees by SOEs to third parties, and where appropriate, restrict the sale or use of their assets as collateral in financing transactions;
- Strengthening governance arrangements, for example, through appointing independent boards based on the transparent and merit-based nomination processes, holding them accountable for financial performance, ensuring there is operational autonomy, and legislating high standards of financial reporting and subjecting annual accounts to external audit;
- Legislating explicit no-bailout clauses to reduce exposure;
- Ensuring there is transparent and appropriate compensation for SOEs executing quasi-fiscal activities to achieve government goals and that subsidies for these activities are appropriately expensed in the budget;
- Finally, as for other risks, ensuring there is fiscal space to absorb retained risks through, for example, a general contingency reserve to cover any call on government guarantees to public corporations or to cover the unforeseen costs in case of their restructuring or liquidation.

Table 13 outlines an example of step-by-step fiscal risk management of SOEs given by IMF.

Cross-cutting theme: climate change and resilience

The adverse effects of climate change on the economy are likely large but difficult to predict, and therefore they increase fiscal risks, whereby fiscal outcomes may differ substantially from projections. Assessing and managing fiscal risk from climate change can prevent an abrupt increase of public debt and improve governments' ability to raise new debt or refinance it. Since SOEs affect the government's budget and also form part of the public sector balance sheet, any adverse effect from climate change that have an impact on SOE's operations and finances will also have a bearing on the country's overall fiscal outcome and balance sheet.

Key policy instruments: There are various strategies that the state/ownership entity can adopt to improve fiscal risk management including climate change.

- **Identifying fiscal risks:** Fiscal risks may arise out of the financial, moral, and legal

Table 13: Fiscal Risk Management for SOEs[32]

1. Identify and quantify	2. Mitigate			3. Provision		4. Accommodate
	Direct controls	Indirect controls (regulation and charges)	Risk transfer instruments	Expense	Contingencies	
Quantify explicit exposures; Monitor financial performance; Scenario analysis or stress testing	Reduce the size of the SOE sector	Hold boards accountable for per-formance; Reporting require-ments	Explicit no-bailout clauses	Appro-priate expected subsidies and QFAs	Provision for cost in case of restructuring	Fiscal headroom for residual risks

Source: Adapted from IMF 2016.

Table 14: Identification of Climate Related Fiscal Risks

Risk factor	Climate-change-induced risks	Potential fiscal risk
Climate-sensitive SOEs	Climate-sensitive SOEs suffer losses due to extreme weather events.	Sovereign loan guarantees are called; Expectation that the government will cover SOE losses.
Commodity prices	Increased frequency and severity of extreme weather events increase the volatility of global commodity prices such as crude oil, petroleum, and so on.	Sudden change in commodity prices may affect the overall SOE revenue pool and in turn the state's dividend share. It may also generate contingent liabilities.
Public-private partnerships	Climate change may potentially threaten the financial viability of PPPs.	PPPs may entail contractual obligations and/or implicit public guarantees with important fiscal implications.
Natural disasters	Climate change increases the frequency and severity of natural disasters.	Disasters can disrupt production in fiscally important sectors and may require large-scale relief and reconstruction spending.
Public health emergencies	Rising temperatures and extreme weather events increase the risk of epidemics.	Epidemics can radically increase health spending and may adversely affect employment, production, and trade.
Judicial awards	Courts may determine that an SOE is liable for climate-adaptation measures.	Adverse court judgments may result in huge unexpected spending and contingent liabilities.

Source: Adapted from Pigato 2019.

obligations of SOEs/public corporations and their stakeholders and private-public partnerships, and there need to be systematic, harmonized and decentralized responsibilities to identify fiscal risks and produce a more comprehensive appraisal (Table 14).

- **Quantifying fiscal risks:** Once fiscal risks are identified, they need to be quantified. The macroeconomic costs of climate change can be grouped into three categories: mitigation, adaptation, and residual costs. Mitigation includes all costs incurred by policies that slow the pace and limit the severity of climate change, particularly via reduced GHG emissions. Adaptation includes all costs incurred by efforts, both preventive and remedial, to reduce the social, environmental, and economic impact of climate change. Residual costs are effects of climate change that cannot be offset through mitigation or adaptation.

  Most macroeconomic models focus on assessing mitigation costs and residual costs. **Integrated Assessment Models (IAMs)** are used to quantify the damages caused by climate change and the cost of efforts to limit its extent. These models apply damage functions that approximate the relationship between global temperature changes and climate-related phenomena such as rising sea levels, more frequent cyclones, lost agricultural productivity, and degraded ecosystem services. Most IAMs treat climate-related damages as a polynomial function of global mean temperature and examine its impact on the stock of capital at either the regional or the global level. Apart from IAMs, a general equilibrium model can capture the impact of climate change by estimating its effect on the depreciation rate of physical capital. In this model, adaptation reflects the extent to which public bodies/SOEs reduce the negative influence of climate change on the capital depreciation rate.

- **Disclosing fiscal risks:** Disclosing fiscal risks can improve management. It can also improve risk identification, by increasing public accountability and lead third parties to provide information voluntarily. This is also important to inform private investment decisions induced by the SOE investments (for example, housing built around new public infrastructure and utilities which also need to internalize the risks). These risks should be presented in the performance agreement signed

between the state and SOE with a ceiling in terms of the risk appetite.

- **Reducing fiscal risks:** Investments in a risk management capacity, physical risk reduction and climate-smart technology, for example, increased use of clean energy to progressively reduce GHG emissions intensity; reducing freshwater consumption per unit of production, and so on can minimize fiscal costs and risks. As most countries have yet to fully internalize climate change into development planning and sector regulations, opportune adaptation measures can usually be found to reduce fiscal risks. Making SOEs and their public assets more resilient to the effects of climate change reduces the government's direct exposure to possible future financial losses. Public investments, fiscal incentives, and regulatory measures that increase the resilience of private assets and economic activity to climate change indirectly reduce fiscal risks. Fiscal tools, such as price policies (for example, carbon taxation, subsidies for mitigation action and low carbon investment); spending and investment; and public guarantees to secure private sector participation, are critical. Beyond this, the state can also set liability caps to reduce the size of contingent liabilities, such as, expenditure for natural disaster relief and recovery.
- **Managing residual fiscal risk:** The residual fiscal risk can be managed via a range of risk transfer and risk financing tools. Governments can implement some of these measures before the risk materializes (ex ante measures). For instance, governments can establish dedicated reserve funds; or insure/reinsure against specific climate-related risks; or emit catastrophe bonds, that is, bonds, the interest repayment of which is delayed, reduced, or forgiven in case a disaster occurs. There may be a benefit in cross-country collaboration, such as, to collectively ensure against risks from natural disasters. Ex post financing measures also exist, such as budget reallocation, taxation, or borrowing from multilateral organizations or foreign countries.

Table 15 presents a taxonomy of how governments are managing climate change risks, including risk reduction, risk financing, and residual risk management. Also see Box 23 on the next page.

Building capacity for oversight of SOEs

Putting in place a system for overseeing SOEs that meets all the requirements discussed above can be challenging for developing or emerging market economies, as it requires time and resources. Advanced economies have spent many years building and refining

Table 15: Approaches for Managing Climate Change Risks

Theme	Sub-theme	Action
Risk reduction	Reduce vulnerability	• Diversify economy into climate-resilient production and livelihoods • Mainstream climate change into public investment management systems
	Reduce exposure to hazards	• Improve buildings codes, land-use planning, and zoning • Strengthen natural buffers (reefs, beaches, forests, and so on) • Improve ecosystem management
Risk financing	Risk retention	• Contingency and reserve funds • Ex ante contingent credit • Ex post borrowing
	Risk transfer and pooling	• Insure public assets • Multicountry sovereign disaster insurance • Catastrophe bonds
Residual risk management	Post-disaster response	• Livelihood support • Budget reallocation • Humanitarian relief

Source: Adapted from Pigato, 2019

Box 23: Good Practice in Climate Fiscal Risk Management

Africa Region: More than 30 African countries are signatories to the treaty that establishes the African Risk Capacity (ARC). ARC pools risk between countries exposed to different weather risks, strengthening their management.

Caribbean Region: In 2007, countries in the Caribbean Region established the Catastrophe Risk Insurance Facility, the first multi-country risk pool. The pool aims to reduce liquidity constraints that massive natural disasters, such as, earthquakes and cyclones, impose on small developing economies. Since 2007, it has made disbursements of about US$130.5 million.

Colombia: The country has estimated fiscal risks from natural disasters by considering its (i) public property exposure and (ii) the exposure of private property of underprivileged groups, for which, the government took responsibility. It has also improved its climate-related fiscal risk management capacity, for instance, by signing a Catastrophe Deferred Drawdown Option, that is, a contingent line of credit that guarantees immediate liquidity upon the occurrence of a natural disaster.

Ethiopia: The country has set up a contract, referred to as weather derivative, in which an international reinsurer covers against the precipitation level falling below the Ethiopia Drought Index (EDI).

Mexico: The country has taken a number of ex ante risk financing and transferring measures. For instance, in 2006, Mexico shifted part of its public sector catastrophe risk to capital markets and the reinsurance sector. It has also established a Fund for Natural Disasters (FONDEN), to which it allocated a share of the annual budget, and this helps cover natural disasters' losses that Mexican states and federal agencies would not be able to cover independently.

Philippines: The 2013 Fiscal Risk Statement of the Philippines' government incorporated a debt sustainability analysis that included a natural disaster scenario analysis.

Source: World Bank Group, Climate Action Peer Exchange (CAPE). 2018. *About us.*

these systems. In less-advanced economies, a cautious step-by-step approach is required.

In many countries, inefficiencies and fiscal risks are concentrated in a relatively smaller number of SOEs, which should be subject to the most intensive monitoring. Moreover, many of the 'best practice' solutions discussed above have a substantial cost and require a high degree of competence within the government and the SOEs. Some of these reforms may not be practicable in the short term in low-capacity countries. In such cases, a risk-based and sequenced approach to building an oversight regime for SOEs is strongly recommended.

- In the short term (up to one year), the government could ensure that a full inventory of public sector entities with commercial or quasi-commercial functions is taken and that these entities are classified according to the latest international standards (GFSM 2001/2014). The government must also ensure that a basic reporting framework for SOEs that are high risk, or have a large fiscal or budgetary impact, is established and that the role and responsibilities of the President's Office, the Ministry of Finance, and line ministries participating in the oversight of SOEs are determined.
- In the medium term (up to three years), the legal framework relating to the SOEs could be established (or revised), providing the Ministry of Finance (or another approved entity) with the required power to review the financial plans of SOEs and monitor their performance. An SOE ownership policy should be developed. The Ministry of Finance should strengthen its capacity to supervise SOEs and the financial oversight unit could start publishing a consolidated annual report on SOEs.
- In the long term (more than three years), the government could further enhance the framework for monitoring the financial performance of SOEs by developing a more elaborate set of performance indicators and targets. The cost of delivering public service obligations and other quasi-fiscal activities should be fully funded in the budget and disclosed in the financial reports prepared by the government and the SOEs, and the government could carry out a review of the economic and financial status of business enterprises and whether they should continue to be classified as SOEs.

Topic seven: State-board relations and communication

SOEs, including any enterprise, in which the state is a minority shareholder, should identify their shareholders and keep them duly informed in a timely and systematic fashion about material events and forthcoming shareholder meetings. They should also provide them with sufficient background information on issues that will be subject to the decision. It is the responsibility of SOE boards to make sure that the enterprise fulfils its obligations in terms of information to the shareholders, for which specific communication policies are often developed to help manage shareholder relations. Furthermore, there are several situations, for which the **SOE board needs the support of its shareowners, particularly the state**, which include the following:

- Obtaining financial support from the state (in the form of loans, guarantees, and so on)
- Changing the capital structure of the SOE
- Issuance of shares/dividends
- Exploring alternative financing sources
- Appraisal and approvals of major investment decisions
- Mergers and acquisitions
- Changing/updating strategy and direction
- Addressing corporate governance concerns and poor SOE performance

Conversely, the state's responsibility as an owner is to know and understand the context in which SOEs operate. A surprising number of ownership entities (and especially coordinating bodies) do not meet with boards and management of the companies in their portfolio and thus know little about them or about the sectors in which they operate. An initial meeting should have some basic goals: to introduce the ownership entity and its role and mission, to identify key points of contact in the company for future communication, and to address initial questions about critical missing information, especially financial reporting.

The mentioned topic explores the dos and don'ts for effective state-board relations and communications, which will support the state to act as an active and informed owner as well as the SOE board to better manage the SOE's direction and performance.

Ensuring healthy state-board relations hinges on the following principles:

- The state refraining from exerting undue political influence over the SOE—this is typically manifested in the form of board appointments, interference with board and management decisions (managing conflicts of interest and related-party transactions), and company strategy. This results in a negative impact on SOE's performance and competitiveness.
- The state refraining from micromanagement of SOE operations through the issue of numerous circulars, prescribing the aspects in great detail that should be the prerogative of SOE management (for example, approving CEO's foreign trips, sub-contracting decisions, hiring, and so on.)
- The board ensures transparency and timely and accurate disclosures of all the information required by the state in its capacity as an owner—this includes financial and nonfinancial performance reporting, reporting on other conflicts of interest and related-party transactions that need to be disclosed to ensure good corporate governance.

To facilitate the said relationship, active engagement between the state and the board is required. This would require assigning clear responsibility for managing the state-board relationship as well as developing formal and informal lines of communication to facilitate the same. At the same time, it is also important to ensure equitable treatment of all shareholders including minority shareholders. This is further discussed in Part I, Module 3: Protecting minority shareholder and stakeholder rights.

State-board relations and communication also involve active participation by the state in the Annual General Meeting (AGM) as well as periodic meetings to review the SOE's performance and corporate governance practices. The state should move from pure compliance driven supervision to more risk-based supervision (further discussed in Part III, Module 4 Risk governance). The role of state representatives on the SOE boards also acts as an important communication channel between the state and the SOE board. These communication channels are further discussed in Part II – the Board.

Topic eight: Monitoring SOE performance via performance agreements

Monitoring SOE performance is a core function of the state as an owner to ensure transparency and accountability in the use of public funds. The state's ownership entity (ies) must see that each company meets the targets and objectives set for it and must act if the objectives are not met. A fundamental challenge for ownership entities in creating performance frameworks is that SOEs are usually established (and continue in government ownership) because they have both commercial and non-commercial objectives.

In many cases, the nonfinancial goals will carry financial costs, making it difficult for the board and senior executives of the SOE to resolve their competing priorities. Information asymmetries can also allow managers to conceal poor performance or exceed their mandate. These asymmetries can also affect the negotiation and monitoring of performance because inside managers have a far better understanding of the performance and operations of their company than external reviewers.

A sound performance-monitoring framework addresses these inherent tensions by explicitly identifying the core financial and nonfinancial objectives of the SOE and by spelling out the government's priorities for the various strategic objectives of each SOE. In this process, the ownership unit must develop appropriate performance targets that reflect these priorities.

Performance agreements form an important tool to support the establishment of a formal performance-monitoring framework for SOEs. A large part of preparing performance agreements is to set company mandates and strategies. Clearly defining the mandate of each wholly owned company is necessary for defining accountability, determining the scope of public services or other special obligations, and forming a basis for more specific targets for the company's operations.

Once the mandate is agreed upon, an ownership entity can develop a framework for communicating the government's expectations for SOE performance to each SOE and the public. **Performance agreements are widely used for this purpose and typically include the following elements:**

- Its mandate and the scope of activities that the company (including subsidiaries) will undertake
- A short description of the company's vision and strategy
- A clear description and explicit financial cost estimate of the company's non-commercial objectives, such as access, coverage, and affordability for low-income consumers
- Financial and nonfinancial performance indicators as well as targets for those indicators, to measure the performance of the company against its strategy (see Sweden's example in Box 24 on the next page)

Box 24: Snapshot of Financial and Nonfinancial Targets for Sweden's SOEs

Financial targets using indicators like return on equity (profitability), equity/assets ratio (capital structure), dividend.

Sustainability targets like gender distribution for chairman, directors, CEO, and senior management; energy consumption; CO2 emissions; customer and employee satisfaction using customer satisfaction index, share of motivated employees, and so on.

Public policy targets vary sector-wise and may not be uniformly applicable to all the SOEs.

Source: Government Offices of Sweden. 2017. Annual Report State-Owned Enterprises 2016.

- Standards of corporate governance
- Risk management – State's risk appetite across different types of risks such as business risk, financial risk, legal and regulatory risk
- Frequency and procedures for reporting
- A statement describing the dividend policy (refer Box 24 for country example)

Before the performance agreement is finalized, the ownership entity and the SOE must discuss it and negotiate its contents. To properly negotiate the agreement, the ownership entity normally has good knowledge of the industry based on research, experience, and dialogue with the company. In many countries, the performance agreement is made public and presented to the parliament to establish the links in accountability. The government's expectations of the SOE be formally, clearly, and publicly communicated. Figure 13 illustrates the process of negotiating performance agreements.

Monitoring Performance Agreements

– Monitoring the company's performance against the agreed objectives and performance targets of the company as set out in the performance agreement is generally done on an annual basis; but for more important portfolio companies, more regular monitoring (biannual or quarterly) may be warranted.

The monitoring process can be streamlined by requiring SOEs to provide standard-form financial and nonfinancial data. These forms have varying degrees of complexity, from simple spreadsheet-based templates to dedicated online data entry portals. More sophisticated systems can facilitate data analysis by identifying trends, producing cross-sector or intertemporal analysis, and generating aggregate reports.

Where more complex uses of the data are not required, the risk of elaborate data entry systems is that they fall into disuse. Where possible, the data required should conform to the existing data requirements imposed on the company. For instance, requirements should preferably align with the relevant accounting

Figure 13: Process for Negotiation of Performance Agreements



Source: Adapted from World Bank Group 2014.

Box 25: Germany's Reporting System to Monitor SOE Performance

In 2016 the German Federal Ministry of Finance implemented a 'standardized monitoring system' (Standardisiertes Beteiligungs Monitoring, SBM) for state-owned SMEs on request of the German Parliament. Currently, the SBM is conducted at the beginning of each year based on the company's financial statements for the previous fiscal year. The uniform calculation of financial ratios and description of each company's business situations in one standardized data sheet per SOE increase transparency and comparability within the portfolio of the federal holdings' management.

Source: OECD. 2020. *Implementing the OECD Guidelines on Corporate Governance of State-Owned Enterprises: Review of Recent Developments.* OECD Publishing, Paris.

standards that the SOEs must adopt for their financial statements. However, the state needs to gradually advance from purely compliance-driven supervision to a more risk-based and performance-focused oversight. The state's role in the risk governance of an SOE is discussed in Part III, Module 4 Risk governance.

Periodic monitoring instils a culture of accountability that serves multiple aims:

- Initially, the ownership entity can ensure that the SOE is completing all periodic reports and actions (for example, preparation of annual financial statements and external audits) and delivering them on time.
- All variances between the actual financial and nonfinancial results and the agreed results (as set out in the relevant performance agreement) should be documented.
- SOE management can be asked to document reasons for any unexpected variances, or the principals of the SOE can give explanations in face-to-face meetings with the ownership entity.
- Large or unjustified variances from planned results should be reported up through the system. As a result, for instance, the major issues arising out of the performance review could be discussed between the chairman of the SOE and the head of the government ownership unit. Depending on the national accountability structure, significant issues could be reported to the minister or a legislative oversight committee.
- Variances may give rise to consequences under the performance agreement.
- Periodic public disclosure can be made of SOE performance against the agreed objectives or relevant benchmarks and can act as a strong incentive for managers and boards to improve the performance.

Some of the critical success factors for successful negotiations of performance agreements are included in Figure 14 on the next page.

Cross-cutting theme: integrity and anti-corruption

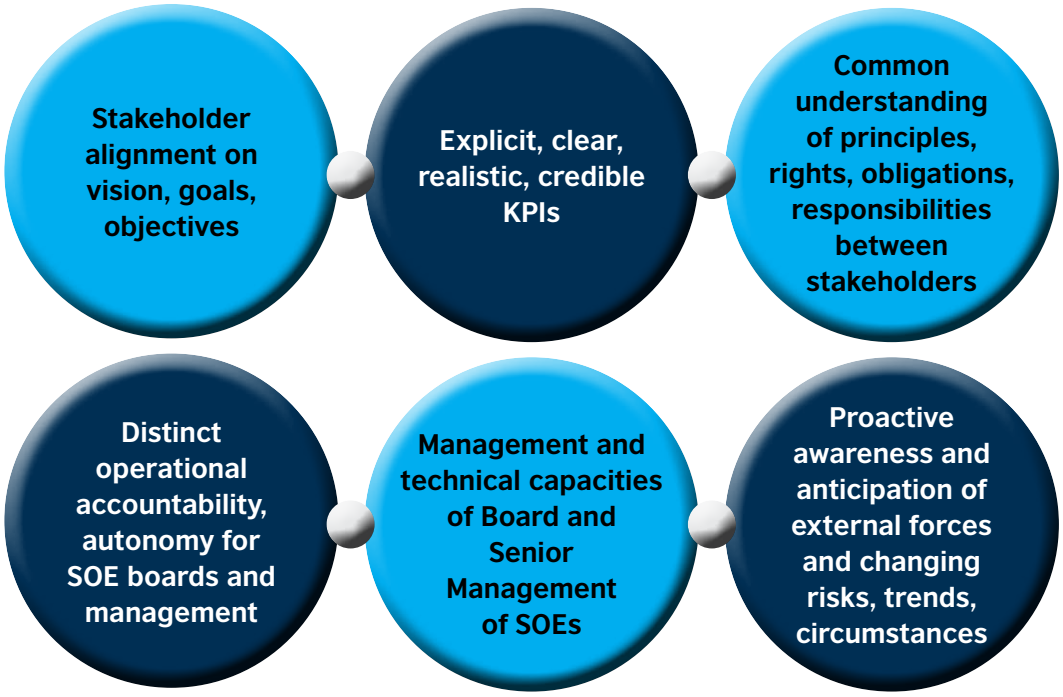
The state should act as an active and informed owner concerning anti-corruption and integrity in the companies they own. Its respective and **prime responsibilities regarding anti-corruption and integrity in SOEs should include, but are not limited to**

- Assessing SOE compliance with applicable corporate governance standards and evaluating their alignment with the state's expectations about integrity and anti-corruption. Sources used in monitoring and assessment should facilitate an adequate understanding of SOEs' corruption-risk management.
- Developing capacity in the areas of risk and control to best monitor and assess SOEs' application of relevant standards and owner expectations and engaging in discussions about corruption-risk mitigation efforts with SOE boards.
- Building a disclosure policy that identifies what information SOEs should publicly disclose, the appropriate channels for SOE disclosure and SOE mechanisms for ensuring quality of information. With due regard to SOE capacity and size, the types of disclosed information should follow

those suggested in the SOE guidelines as closely as possible and could additionally include integrity-related disclosures. The state should consider developing mechanisms to measure and assess the implementation of disclosure requirements by SOEs.

- Disclosing all financial support by the state to SOEs in a transparent and consistent fashion.
- Using, as appropriate, benchmarking tools to assess the overall risk exposure of the state through its ownership of SOEs. Where appropriate, such tools should also be used to encourage improvements in corruption-risk management among SOEs.

Figure 14: Critical Success Factors for Negotiating Performance Agreements



Source: Adapted from World Bank Group 2014.

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Appendix A1.2A Accountability provisions in SOE's legal framework

The legal framework governing SOEs must contain provisions to the following effect to define accountability of each stakeholder:

Classification of entities: The legal framework must spell out the criteria for the classification of different types of SOEs operating in the country, say those that do not draw on the state's annual budget for revenues and those that do. The state shall from time to time review the classification and form of an entity or a group of entities to assess whether the classification and form are the best suited to the efficient, effective, and economical achievement of the mandate of the entity.

Portfolio minister: The portfolio minister for an SOE shall be the minister assigned with the ministerial responsibility for the SOE by the Head of State or parliament. The law must state the agency to whom the portfolio minister remains accountable and the responsibilities within its purview. He/she is tasked with the SOE under his or her responsibility to achieve the performance specified in the performance agreement. The portfolio minister is also responsible for approving the annual plan for the ministry and together with the Minister of Finance, for approving the Business Plan/Corporate Statement of Intent for an SOE. The law may further state actions that the portfolio minister is prohibited from doing such as awarding procurement contracts, matters relating to the hiring, dismissal, promotion, pay or other or employment arrangements, and so on. The law may also stipulate the nature and frequency of reporting arrangements.

Minister of Finance: Define the minister's responsibilities regarding SOE's governance. This can include the following:

- Reviewing and approving the financing intentions including the forecast financial statements and dividend proposal in the Business Plan of the SOE;
- Approving the government loans and guarantees for SOEs;
- Approving significant financing proposals for SOEs;
- Setting and enforcing the government's ownership expectations for SOEs;
- Monitoring the financial performance and risks of SOEs;
- Approving the Code of Corporate Governance to be applied to SOEs; and so on.

Board of SOE: The law should stipulate the responsibilities of the board of an SOE. The primary objective should be to operate as a successful business and to earn a similar return on the owners' funds over the medium term as that earned by comparable businesses not owned by the state. In case this law is the only one dealing with SOEs and there is no separate framework law, these provisions will have to be elaborated further.

Performance Contract and Business Plan (BP): The board may be required to submit details required under a Performance Contract or Agreement (known as Statement of Corporate Intent (SCI) in some jurisdictions) with the portfolio ministry and BP for the SOE and all its subsidiaries to the portfolio minister and Minister of Finance by a specified time. The law may, by way of schedules, specify the content of these documents. The procedure to devise a suitable dividend policy may also be specified in the law. In addition to these, the board may be required to submit periodic reports, a Mid-Year Report and an Annual Report for the SOE and its subsidiaries, including financial statements within a specified period. The Act may also provide for public disclosure of these documents.

Annual Plan for the ministry: The law must specify the procedure and timing for submission of the Annual Plan by the ministry. The Annual Plan of a ministry shall include the following:

- Strategic priorities for the medium term that reflect the goals and plans;

- Description of how the entity is responding to the changing environment including the description of significant changes from the previous Annual Plan;
- Nonfinancial performance including measurable indicators;
- Payments on behalf of the government including grants, benefits, and subsidies to be paid;
- Significant capital developments;
- Description of intentions to develop the capability for physical, intellectual, human, and other resources including measurable indicators where feasible;
- Summary budget, which shall include forecast financial statements;
- Financial and other assumptions;
- Statement of fiscal risks; and
- Other matters required by the finance minister.

The ministry may also be required to submit mid-year and audited annual reports within a specified timeline. These may be required to be published on the ministry's official website.

Other matters: The law may further state the accounting standards applicable to SOEs and whether SOEs are required to follow the state's financial year.

Schedule on contents of Annual Report for a ministry: Each Annual Report of a ministry or agency shall include the following:

- Strategic priorities and outcomes in the Annual Plan;
- Nonfinancial performance delivered including measurable indicators;
- Significant variations in performance from the Annual Plan;
- Payments made on behalf of the government including grants, benefits, and subsidies to be paid;
- Progress with significant capital developments;
- Advances or issues in capability for physical, intellectual, human, and other resources including measurable indicators where feasible;
- Financial performance, which shall include audited financial statements;
- Financial and other assumptions;
- The auditor's report on the financial statements;
- Report on fiscal risks;
- The remuneration paid to each director including the value of benefits in kind for the agency (not applicable to ministry);
- Statement on Public Service Obligations (PSOs) undertaken during the year by various SOEs; and
- Other matters required by the minister responsible for finance.

Schedule on the contents of Performance Agreement/Statement of Corporate Intent of an SOE: Each SOE shall have a Statement of Corporate Intent for the entity and its subsidiaries with a medium-term scope and a focus on the forthcoming financial year and shall include the following:

- The objectives of the group;
- The corporate governance of the group and measures to strengthen it;
- The nature and scope of the activities to be undertaken;
- The ratio of consolidated owners' funds to total assets, and definitions of those terms;
- The accounting policies;
- The expected performance for the medium term of the group concerning its objectives;
- A statement of the principles adopted in determining the annual dividend together with an estimate of the amount or proportion of annual earnings after tax (from both capital and revenue sources) that is intended to be distributed to the government;
- The information to be provided to the portfolio and finance ministers by the SOE during those financial years, including the information to be included in the in-year reports;
- The procedures to be followed before any member of the group subscribes for, purchases, or otherwise acquires shares in any company or other organization;

- Any activity, for which the board of directors seeks compensation from the government (whether or not the government has agreed to provide such compensation);
- A statement of social responsibility; and
- Such other matters as agreed upon by the portfolio and finance ministers and the board of directors.

Schedule on contents of Business Plan for an SOE: Each SOE shall have a Business Plan that shall include the following:

- Details for the forthcoming financial year of the expected performance targets and other measures by which the performance of the group may be judged with its objectives in the Statement of Corporate Intent, which shall include the performance indicators required by the minister responsible for finance;
- Explanation of variations in performance from the previous Business Plan;
- Forecast financial statements including an estimate of the anticipated profit for each of the three forthcoming years and the dividend to be paid to the government, with sufficient detail for the forthcoming financial year to enable meaningful assessment against those expectations after the end of that financial year;
- Any proposed major investment and financing transaction;
- A statement of any arrangement or proposed arrangement to provide goods or services for less than the cost of those services or to receive services from a government entity for less than the cost to provide the goods or services;
- A statement of risks and intended management of these;
- Other matters as are agreed by the portfolio and finance ministers and the board of directors; and
- Additional information prescribed for a plan in the establishment law of the SOE.

Schedule on contents of an Annual Report for an SOE: Each SOE shall have an Annual Report that shall include the following:

- A report of the operations of the SOE and those of its subsidiaries during that financial year with information as is necessary to enable an informed assessment of the operations of the entity, including a comparison of the performance of the entity with the Statement of Corporate Intent and Business Plan;
- The dividend payable to the government by the SOE for the financial year, to which the report relates;
- Audited consolidated financial statements for that financial year consisting of statements of financial position, profit and loss, changes in financial position, and such other statements as may be necessary to show the financial position of the SOE and its subsidiaries and the financial results of their operations during that financial year;
- The auditor's report on the financial statements;
- Report on fiscal risks;
- Statement on Public Service Obligations (PSOs) undertaken during the year;
- Report on compliance with the statement of social responsibility;
- The remuneration paid to each board director including the value of benefits in kind;
- The remuneration paid to senior management including all the benefits in kind presented in the form of the number of employees within salary bands; and
- Such additional information, as is necessary, to enable an informed assessment of the activities of the SOE against the Statement of Corporate Intent and Business Plan.

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Corporate Governance

Leadership Training Toolkit for SOEs

Part I Module 3
Protecting minority shareholder and stakeholder rights



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Module 3: Protecting minority shareholder and stakeholder rights

This session (module) covers the following topics:

1 Importance of minority protection



2 Shareholder rights – minority and golden shares

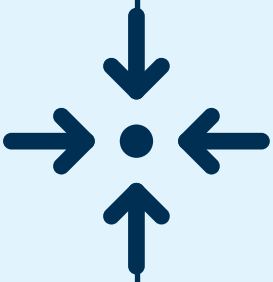


3 Key stakeholders in SOEs, their role, and relationships in SOEs



Learning objectives

By the end of this module, the participants will be able to



- **Identify the stakeholders of SOEs and describe their role in SOEs**
- **Describe in detail the rights of minority shareholders**
- **Define minority shareholders and golden shares in SOEs**

Agenda

Total time: 2 hours 10 min

Time	Topic
30 min	Importance of minority protection, international good practices, and key elements
30 min	Shareholder rights: minority and golden shares
30 min	Case study
40 min	Key stakeholders in SOEs with a focus on stakeholder identification/mapping, stakeholder engagement, and external communication mechanism

Topic one: Importance of minority protection, international good practices, and key elements

Minority shareholders in SOEs

The legal definition of minority shareholders, as per Merriam Webster dictionary, is "a shareholder whose proportion of shares is too small to confer any power to exert control or influence over corporate action." When the shares of an SOE are held by stakeholders other than the state, those stakeholders are referred to as minority shareholders. There is a fundamental difference between the positions of minority shareholders in an SOE, compared to the position of minority shareholders in a normal business enterprise.

The relationship between the state as a controlling or significant shareholder and the minority shareholders is particularly delicate in SOEs, particularly in those commercial SOEs that are not listed (listed companies are subject to increased regulation as part of the listing compliances, and increased scrutiny by regulators). As a dominant shareholder, the state may be in a position to abuse minority shareholders, as the former can make decisions in GSMs without the approval of the latter. It is also usually able to control the board's composition. Moreover, the state is likely to have other political and policy objectives, which might be implemented at a cost to the minority shareholders.

In several jurisdictions, government policies conflict with or undermine minority shareholder rights. Government policy on board appointment or approval of extraordinary transactions may simply ignore the presence of other shareholders. Similarly, shareholder rights related to control changes or capital increases are sometimes not respected when the government plans the sale of a major stake or when the SOE plans a capital increase at the government's request. SOE policies should acknowledge and respect shareholder rights as spelt out in law and relevant corporate governance codes or policies. For example, in India, Peru, and South Africa as well as in many OECD countries, shareholder rights are recognized through the relevant company acts and rules for listed companies; such documents prohibit companies from discriminating between shareholders and reinforce government SOE policies as well.

The mentioned rights may be defined in the general legal framework concerning companies, that is, the commercial company code, the company law, or corporate governance codes. They also may be more specifically defined or referred to in the charter of an SOE or in specific founding laws, where they exist. Finally, the equitable treatment of other shareholders may be a general principle adopted by the ownership entity or the government in relation to SOEs. This is the case, for example, in Norway, where the first one of the government's 10 principles of good corporate governance for SOEs is that all shareholders shall be treated equally.

A crucial condition for protecting minority shareholders is to guarantee a high degree of transparency among all shareholders. However, few countries document the provisions taken, if any, to ensure that the ownership entity does not make any potentially abusive use of the information it receives as a controlling shareholder. In the case of listed SOEs, listing requirements and regulatory authorities oversee SOEs and shareholding entities in this regard. In Italy, it is specifically required that listed SOEs do not share such information to the ownership entity that it does not share with the minority shareholders, to fulfil the requirements regarding equal treatment of shareholders.

For non-listed SOEs, specific mechanisms and procedures would need to be put in place by the ownership entity and at the SOE level. It is not clear whether such mechanisms exist in many OECD countries and if they are effective in ensuring easy and equitable access to information by minority shareholders of SOEs.

Golden shareholder

Traditionally, when SOEs have undergone partial privatization, the state has retained a so-called golden share that gives it special rights beyond its voting shares (for example, approving control changes or other major transactions or in making a certain number of board appointments). These rights might be enumerated in the company articles, included in a licensing agreement accompanying the privatization, or be attached to shares with special rights. In many countries today, the state no longer retains such power because the same is seen as an unnecessary restriction on shareholder rights. However, at a minimum, these special rights should be fully disclosed.

The special rights or golden shares have usually been introduced in the context of privatization; they allow the state to divest itself of national flagships but without relinquishing its control over them. Whilst from the financial benefits of privatization, the state retains specific power over the future ownership, control, or strategic conduct of a private company. As such, it can significantly affect the wealth of private shareholders unpredictably.

As mentioned, the 'special rights' come in all shapes and sizes: in some instances, they are stipulated in overall framework laws underpinning the government's privatization programs, with specific decrees for individual companies. In others, they consist of special shares directly inserted in the articles of association of a privatized company. The beneficiaries vary since special rights can be attributed to the government directly or to any other entity of public authority. They may grant those public authorities a bevy of exceptional privileges, for example, the right to oppose investments beyond a certain threshold, vetoes of mergers and acquisitions, prior approval of other strategic management decisions, or enhanced voting power by limiting other investors' voting rights.

Given the special rights accorded to the state, golden shares may negatively affect the rights of minority shareholders. Therefore, its use should be restricted to special circumstances. In this regard, the 2015 G-20/OECD Guidelines on Corporate Governance says that, "The use of golden shares should be limited to cases, where they are strictly necessary to protect certain essential public interests such as those relating to the protection of public security and proportionate to the pursuit of these objectives."

Topic two: Shareholders' rights

The OECD Principles of Corporate Governance name several **basic rights of shareholders:**

- The right to attend and vote in the shareholders' meeting, including voting for board members
- The right to share in the profits of the SOE and receive dividends proportional to share ownership
- The right to participate in major decisions, including changes to the company's articles, issuance of new shares, and approval of extraordinary transactions
- The right to expect transparent procedures for control changes, and under certain circumstances, the ability to sell shares on the same terms as the main shareholder or to block the transaction.
- The right to understand the capital structure of the SOE, including any special right retained by the state (golden shares), different classes of shares the SOE may have, and shareholder agreements between the state and other significant shareholders.

Good practice dictates that board members pay attention to the interests of all shareholders equally. Not only is this a fair, and in some jurisdictions, a legal obligation,

but also it is important for maintaining the confidence of those investors and for sustaining the share price of the SOE and its access to capital.

Company laws and national corporate governance codes set out the rights that all shareholders should enjoy so that all shareholders are treated equitably. Many of these rights will be spelt out in the company law, which typically governs an SOE that has other shareholders. If an SOE is formed under its act, then the founding law or articles of association should contain similar provisions for non-state shareholders. When SOEs have strategic investors from the private sector, the rules on the equitable treatment of shareholders are normally established through detailed shareholder agreements between the strategic investor and the government. However, when private sector shareholders are more dispersed—including large SOEs that may have millions of shares held by individuals, pension funds, insurance companies, and mutual funds—general policy controls are important for ensuring equitable treatment of all shareholders.

Encouraging participation in the shareholders' meeting: In many SOEs, minority shareholders are actively encouraged to participate in general shareholder meetings. This is usually done by the adoption of specific mechanisms at the company level, including facilitating voting in absentia or developing the use of electronic means to reduce participation costs. These mechanisms often also include facilitating employee-shareholder participation or a system, facilitating the collection of proxy votes from employee-shareholders, as employees in many countries are the most numerous individual shareholders in partially privatized enterprises (refer Box 26 for example).

Allowing representation of minority shareholders on SOE boards: Empowerment of minority shareholders may be achieved in different ways. For instance, to nominate a board candidate, small shareholders may be allowed to provide input to the nomination committee (if the board has one). Alternatively, small shareholders may be permitted to nominate candidates directly, if, for example, a certain percentage of shareholders support the choice. At the time of board elections, a cumulative voting rule can be used, in which shareholders may not only vote 'yes' or 'no' but also cast all their votes (for all their shares) for a single nominee. Alternatively, the election process could designate one or two board positions, for whom only small shareholders may vote or adopt some form of proportional representation.

Protecting against abusive related-party transactions: Transactions, in which board members, management, or influential shareholders have a conflict of interest, are prone to abuse. In private sector companies, all too often related-party transactions have channeled resources away from the company and minority shareholders. In SOEs, most of the guidance on these conflicts of interests focuses on the role of the board and disclosure. For example, India's corporate governance guidelines for central public sector enterprises call for potential related-party transactions to be reviewed by the audit committee, approved by disinterested board members, and disclosed to the public.

Box 26: Examples of Minority Shareholder Participation in Annual Meetings

Brazil's Sabesp provides 30 days' notice of its annual meeting (rather than the standard 15) and widely publicizes the event. In addition, Sabesp's bylaws allow shareholders to deliver documentary evidence of their status at any time up to the moment the meeting is called to order. (The usual practice in Brazil is to require documentary proof of share ownership at least 48 hours before the meeting.)

In Burkina Faso, even SOEs wholly owned by the government, are required to have an annual meeting presided over by the council of ministers and the prime minister and open to the public. During the meeting, problems are exposed, directives issued, and resolutions taken. The ability of the public to participate helps explain the success of these meetings.

Source: World Bank Group. 2014. *Corporate Governance of State-Owned Enterprises: A Toolkit.* Washington, DC: World Bank.

In addition to the above discussed good practice requirements, listed companies including listed SOEs—will often require shareholder approval of any related-party transaction that exceeds a certain size or crosses another specific threshold. In some jurisdictions, only disinterested shareholders—usually those that are not the controlling shareholder—may approve a related-party transaction before it takes place. Rules such as these may be established as statutory requirements for all SOEs or may be part of the articles for specific SOEs.

Grant of preemptive rights: In several OECD countries, pre-emptive rights under the general company legal framework serve to protect minority shareholders. Qualified majorities for certain shareholder decisions may also be useful and are granted according to the general company law in many OECD countries, or by specific SOE bylaws. In Austria, for example, minority shareholders enjoy significant rights at GSMs via threshold arrangements. In the Slovak Republic and for votes on fundamental matters, the approval of two-thirds of shareholders is required, and it is possible to extend further this requirement to more than two-third of present shareholders.

Finally, qualified majorities for some board decisions might also be made mandatory in the case of some SOEs. This is the case in Belgium, where special majorities have been stipulated in shareholders' agreements in the decision-making power of the boards of the telecommunications and airport companies, where private investors hold a significant part of the shares. Similarly, in Spain, specific requirements or procedures for specific transactions are set out in the Public Limited Companies Act.

Regarding the right of redressal, minority shareholders do enjoy in most OECD countries the same rights in SOEs as in other companies, based on the general company legal framework. In Poland, for example, based on the Commercial Companies Code (CCC), every shareholder, who voted against a resolution that was adopted by the GSM, and who holds even only one share, can challenge this resolution in the courts. One can sue the company for an annulment of a resolution, which contravenes the statutes or good practices, harms the interests of the company, or aims at harming a shareholder.

Topic three: Key stakeholders in SOEs

Stakeholders are commonly defined as actors that have personal interests in the corporation, affect its functioning, are committed to specific actions on its behalf, and whose personal interests the company is obliged to consider in its actions.

The key stakeholders of firms within the realm of corporate governance include shareholders, directors, and managers. However, compared with private sector companies, SOEs are different due to the uniqueness of their key stakeholder (that is, the state), strong political and administrative influences exercised upon SOEs, as well as ambiguous goals and performance objectives of SOEs. Moreover, while describing the state as the key stakeholder, it is also imperative to remember the fiduciary responsibility of the state, which makes the public (and taxpayer) a distinct stakeholder of the SOEs.

Hence, from the modern corporate governance in SOEs' point of view, management boards' members, supervisory boards' members (in case of two-tier board system), the Minister of Finance and the ministry officials constitute the SOE's key corporate governance actors. Also, SOEs' employees, trade unions representing them, local communities, regulators and ruling political coalitions, and the informal institutions such as civil society organizations (CSOs), which tend to be particularly important in emerging markets, are the other key stakeholders of SOEs.

The stakeholder groups for an SOE are as follows:

- State and other shareholders
- Directors and employees
- Suppliers and vendors
- Communities affected by SOE operations
- Public and taxpayers

Figure 15 illustrates some of the obligations of the SOE toward various stakeholder groups.

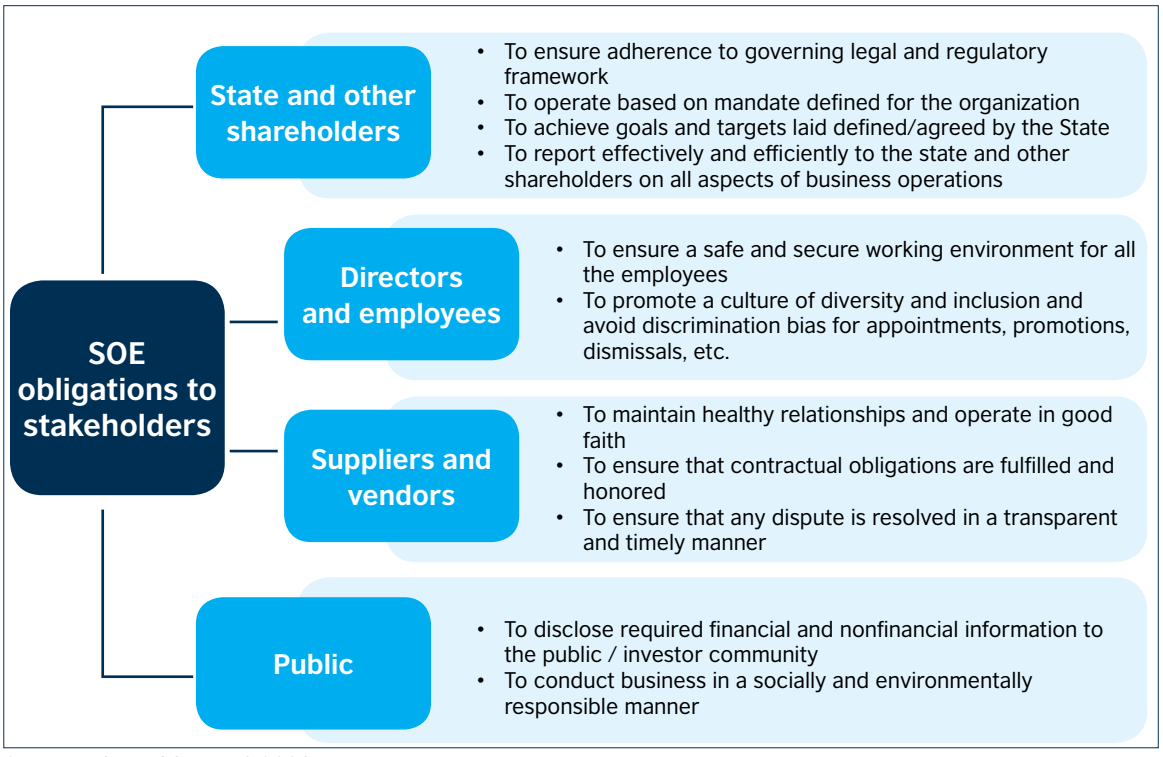
In comparison with private sector enterprises, **SOEs tend to have a greater obligation to stakeholders. These obligations relate to**

- Interaction with government, for example, Ministry of Finance, portfolio ministry, central state ownership entity, supreme audit institution (SAI), and so on
- Communication and engagement with all stakeholders, for example, state as the owner, civil society organizations, taxpayers, or public at large
- Disclosure and reporting to all stakeholders, for example, in some countries, SOEs are subject to national access to information policies, unlike private sector companies

Stakeholder mapping involves creating a visual diagram to help analyze and prioritize stakeholder groups. Such a mapping is undertaken by the management of the SOE. Once a company identifies important stakeholder groups, it must then ensure that the engagement takes place with appropriate representatives of that group. For engagement to be perceived as credible, it should be as open and transparent as possible. Not all community members will have the same interests or opinions. Even shareowners can have very different opinions and interests, based on the different information they have. Transparent stakeholder engagement allows reducing information asymmetry and better-informed discussions among stakeholders.

Engagement and dialogue with stakeholders lead to better decisions/implementation. The broader practice of 'stakeholder engagement' emerged in the 1990s, as it became clear that companies needed to be aware of a wide variety of stakeholders affected by their operations or affecting their operations and build long-term relationships of constructive engagement. Besides shoring up the corporate reputation, this approach has been shown to help companies anticipate and manage risk more effectively as well as to

Figure 15: SOE Obligations to Stakeholder Groups



Source: Adapted from IFC 2008.

identify new business opportunities by tapping unique stakeholder perspectives. Engagement, as opposed to 'top-down' management, is often characterized by dialogue—a two-way process, in which stakeholders are not merely consulted or listened to, but the company makes a sincere attempt to respond to stakeholder concerns in seeking to determine shared values around areas or issues of mutual interest or common concern.

Consultation tends to be a one-way flow of information, where a company solicits input from stakeholder groups. Dialogue is a more robust conversation. It allows companies to provide context for their operational issues, and also means recognizing the potential for engagement to influence the behavior of regulators, investors, consumers, competitors, and suppliers. Online consultations are important to ensure inclusiveness and transparency. They can be complemented by face-to-face meetings, notably with stakeholders that are the most closely linked or affected by a company. Open houses, public forums, and disclosure may suit the needs of other stakeholder groups. Formal engagement can take many forms, from partnerships with nongovernmental organizations (NGOs), to formal community engagement programs or advisory bodies.

In addition to being an important part of corporate accountability, stakeholder engagement can be useful as a learning and information tool for company leadership. While board members are often tasked with maximizing shareowner value, different blocks of shareowners may have different interests and ideas about how value should be maximized. Engagement and dialogue can help the board better represent these disparate interests and reduce the risk of capture by vested interests. This is particularly important regarding climate change risks, given the strong externalities which are not always internalized by the different stakeholders.

Effective stakeholder engagement promotes corporate learning and innovation. This is possible when the engagement is transparent, inclusive, and responsive, and is undertaken with the intent that useful information will be applied. If companies think about critical stakeholders as a strategic asset, a source of information and learning that can be a competitive advantage in shaping and informing the direction of the company, it makes sense to engage with stakeholders early and often to build trust and understanding through defining mutually understood shared values that address their respective interests.

Follow-through is important to any relationship and this certainly applies to relationships with stakeholders. Whether or not a company can implement what it has learned from stakeholders, there is an obligation to report, to make it clear that stakeholder concerns and interests were heard, considered, and valued. In addition to reporting to specific stakeholder groups, sustainability or triple-bottom-line reporting provides companies with an opportunity to communicate environmental, social, economic, and governance performance to a wider range of stakeholder groups. It can also involve reporting on the process of stakeholder engagement itself, providing transparency about who was consulted or engaged on what topics, and with what results.

Standards for stakeholder engagement have been established to guide companies in improving their engagement efficiency and effectiveness with key stakeholders. These include the AA1000 Stakeholder Engagement Standard and the IFC Performance Standard one (included in references for further reading).

Reporting should include a clear understanding of key stakeholder groups—who they are and their main needs and positions —as well as a description of stakeholder engagement processes and a summary of how the company is responding to and addressing stakeholder priorities. In addition, there should be evidence of how feedback and engagement processes have been integrated into the company's decision-making processes, supported with examples of results from this integration.

Handout H1.3A: IFC Progression Matrix for Shareholders Rights

	1. Basic Practices	2. Intermediate Practices	3. Good International Practices	4. Leadership
• **Exercise of Ownership** • **Rights by the State**	• The state has identified an entity, agency or unit within the state administration to exercise its ownership rights on the SOE.	• The ownership entity monitors SOE performance and voices any concerns through formal channels.	• The ownership functions, with respect to all SOEs, are centralized in a single entity under one ministry. • A performance agreement or MOU is in place between the ownership entity and the SOE and is made publicly available. • The State has not been vested with golden shares or other types of special rights which would allow the state to block major corporate decisions.	• The ownership functions, with respect to all SOEs, are centralized in a single independent entity. • Formal ownership policy is in place and publicly available. • The framework to monitor SOE performance includes adequate valuation methods and systematic benchmarking against both private and public-sector entities.
• **Minority Rights**	• All shareholders of the same class have equal voting, subscription, and transfer rights. • Minority shareholders receive adequate notice and the agenda for all shareholders' meetings and are permitted to participate and vote at shareholders' meetings.	• Effective representation of minority shareholders through cumulative voting or similar mechanisms and economic rights such as inspection rights, exit rights, and tag-along rights. • The SOE has a dividend policy and does not issue dividends to the state outside of the scope of this policy. • Policies are clearly communicated and enforced regarding the treatment of minority shareholders during of control transitions, including privatizations and re-nationalization.	• Effective shareholder voting mechanisms are in place to protect minority shareholders from concentrated ownership or strong conflicts of interest with controlling shareholders (e.g., supermajority or "majority of minority" provisions). • Shareholders vote on executive compensation.	• Treatment of shareholders consistent with best international market practices. • Executive compensation subject to shareholder approval.
• **Protective Rights**	• 4. Holders of all securities of the same type and class have access to equal information (fair disclosure). • 5. Shareholders are provided with accurate and timely information regarding the number of shares of all classes held • by the state and other major shareholders.	• Well-understood policy and practice of full and timely disclosure to shareholders of all material related-party transactions and shareholder agreements. • Rules on related party transactions specifically address transactions with the government and other SOEs and require recusal by interested shareholders and board members. • Annual report discloses material risks to minority shareholders associated with the state ownership, other controlling shareholders, ownership concentration, cross-holdings, and voting-power imbalances.	• 6. Well-understood policy and practices of material transactions that could potentially affect the rights of minority shareholders.	• Related-party transactions (over 2.5% of net assets or $150,000) subject to shareholder approval or stricter requirements. • No special type of shares is held by the state.

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Corporate Governance

Leadership Training Toolkit for SOEs

Part I
Caselets

CASE STUDIES

1. Business case for corporate governance reforms at an agricultural chemical manufacturer

Background

Founded in 1955, a state-owned manufacturer of plant protection chemicals underwent partial privatization and got its shares listed on the national stock exchange. Because it had been solely under state oversight earlier, the SOE had limited experience with the corporate governance systems that characterized joint stock/listed companies in countries with more developed capital markets. The SOE's understanding of the value of corporate governance emerged as the result of practical, day-to-day operational experience. In addition, better governance was linked to the strategic goal: for the company to succeed in its plans to expand internationally and enter the European market, it would need to upgrade its governance.

Corporate governance reforms implemented by SOEs

Table 16 summarizes the key corporate governance related changes made by the SOE.

Tasks

What do you think has been the impact on the organization of making these corporate governance changes?

In each category in the table below, identify whether you expect the impact to be

- None
- Weak
- Moderate
- Strong
- Substantial

Table 16: Summary of Key Changes

Theme	Key challenges	Key changes
Board composition	The five-member board did not include any women or independent directors. Directors were continually re-elected, with terms extending up to 12 years. Lack of diversity in gender, skills, experience, and viewpoint limited discussion and negatively affected decision-making.	• Increased the number of board members to seven • Identified new directors based on skills, knowledge, and expertise • Appointed two female directors • Appointed independent director with expertise in internal audit • Altered the mix of executive and non-executive directors.
Board effectiveness	Without a corporate secretary to coordinate, communicate, and track board processes and activities, the board was not as efficient or effective as it could have been.	• Created a full-time corporate secretary position • Hired a qualified individual for the corporate secretary role
Transparency and disclosure	The SOE did not share information about its policies and procedures. This posed risks to shareholder protections—a core value for the company. The lack of disclosure also meant that the SOE had not been in line with international corporate governance standards, making expansion into new markets difficult.	• Redesigned website to include a section for investor relations and corporate governance • Uploaded relevant information to the site for easy access by shareholders, investors, and the public • Added new information as it became available; updates continue promptly

Source: Adapted from World Bank 2014.

Table 17: Impact Level for Each Category

Category	Impact level
Board composition	None / Weak / Moderate / Strong / Substantial
Board effectiveness	None / Weak / Moderate / Strong / Substantial
Transparency and disclosure	None / Weak / Moderate / Strong / Substantial

Source: Adapted from World Bank 2014.

Trainer notes

Distributes the case study handout. Allows 30 minutes for reading and discussion.

Key discussion points

ABC puts a high value on its governance. Good corporate governance practices are central to its operations and help it leverage its relations with its customers, donors, and commercial lenders. During the first round of corporate governance reforms, ABC established key board committees to enhance the board's independence and effectiveness. ABC underwent an IFC Corporate Governance Assessment in 2008. The review led to several key corporate governance reforms at ABC. The impact of these reforms is reviewed in Table 18 below.

Table 18: Impact of Corporate Governance Reforms

Category	Impact level
Board composition	Substantial (by appointing a diverse board that includes women directors, the SOE is a model for other SOEs in the country, sending a message to the business community about the importance of representation from varying backgrounds, experiences, and perspectives)
Board effectiveness	Strong (appointment of a corporate secretary led to a stronger corporate governance system that aided the SOE to lay down a robust foundation for future prosperity and sustainability)
Transparency and disclosure	Substantial (addition of a standardized approach to disclosure led to the SOE's listing on the blue-chip index of the National Stock Exchange)

Source: Adapted from World Bank 2014.

2. Adoption of a transparent and structured nomination process, based on professional criteria for the selection, and removal, of board members

Background

In Egiland, there is currently an absence of a well-defined legal and regulatory framework that specifies the selection criteria and nomination process of the board of directors. The Minister of Public Sector Business nominates and appoints the board of directors of public enterprises with input from the General Assembly, which collects and reviews applications from candidates.

In several SOEs, the directors do not seem to have a strong command of the strategic issues in the sector, in which the company operates, mainly because of the absence of a clear and transparent nomination process. In practice, nomination processes for board posts in Egiland are often based on criteria other than competence, and board membership is sometimes used as a compensation award for retirees.

In Egiland, a director's length of service as a board member and tenure on various board committees is not properly defined for most companies, and the attendance records of board members at board and committee meetings are not standardized, as is the practice in most companies. Meanwhile, the qualifications of board members are not disclosed, the links between remuneration and company performance and commercial and non-commercial objectives are not well

defined, and the remuneration policies for executive and non-executive directors are not developed.

Tasks

As a representative of the state, contemplate the following:

- What reforms can be implemented to adopt a transparent and structured nomination and removal process in Egiland? This can be based on the World Bank Toolkit and the OECD guidelines
- What measures can be introduced to avoid politicized boards in SOEs?
- What sort of criteria can be introduced for the professional selection of board members? What mechanisms can be introduced to facilitate dialogue with SOEs to understand their skill requirements to define the selection criteria?

As a representative of an SOE in Egiland, contemplate the following:

- In what ways might the existing nomination process factors affect (directly or indirectly) the enterprise mission, performance, and long-term outcomes negatively and/or positively?
- All things being possible, what three changes would most contribute to long-term success, and why? What are the obstacles/challenges in the way of such changes?

Trainer notes

Distribute the case study handout. Allow 30 minutes for reading and discussion

Questions to focus discussion

- How important are legal reforms to ensure a transparent and professional process for board member selection and appointment?
- What tools can be used to define selection criteria and identify suitable candidates for board nomination?
- What is the impact of poor/inadequate nomination and removal processes on the SOE's performance?

3. State-board relations and communication—the dos and don'ts

Breakout groups' exercise (self-generated real case) (Groups of 3, 4, or 5 depending on size or plenary)

Tasks

Consider the SOE/Public Enterprises (PE) state-board relationships you have been associated with, or observed from either perspective:

- Half the breakout groups assess the relationship from the state perspective – noting the purpose, nature, frequency, and modes of communication. The other half breakout groups assess from the SOE/PE perspective.
- From the perception of each of the sides of the relationship and communication: What were the key factors affecting the functionality/dysfunctionality of the relationship, also enterprise performance and state desired outcomes?
- From the vantage point of each of the sides: What changes would you recommend for both state and enterprise to mutually optimize their separate and shared goals?
- What are the obstacles/challenges in the way of such changes?

Trainer notes

Divide the participants into groups and explain the exercise; allow 30 minutes for discussion.

Questions for focus group discussion

- What are the key issues and challenges affecting state-board relations?
- How do good state-board relationships contribute to the SOE's performance and competitiveness?
- What tools can be used to improve communication between the state and the boards of SOEs?

Part II



The Board

Leadership Training Toolkit
for SOEs

Introduction to Part II: The Board

> *"An effective board must comprise of highly qualified and competent directors capable of exercising objective, independent judgment to guide strategy development and monitor management."*
> – World Bank's Toolkit on Corporate Governance of State-Owned Enterprises

Part II explores the establishment of a balanced board, roles and responsibilities of the board in state-owned enterprises (SOEs), directors' duties and liabilities, board practices, and improving board professionalism. Throughout this Part, the discussion focuses on one-tier boards, which is the most prevalent form of board structure. Accordingly, 'Board' in this section refers to a supervisory board in the case of a two-tier system.

Table 19: Coverage of OECD Guidelines on Board of SOEs in Part II

OECD Guidelines	Coverage
Rationales for state ownership	
The State's role as an owner	☑
State-owned enterprises in the marketplace	☑
Equitable treatment of shareholders and other investors	☑
Stakeholder relations and responsible business	☑
Disclosure and transparency	☑
The responsibilities of the boards of state-owned enterprises	☑

Figure 16: Contents of Part II

Module 1	**Board composition and structure**	• This module provides an overview of the establishment of a balanced board, professionalizing board selection and nomination
Module 2	**Board's roles, director's duties and liabilities**	• This module explains the roles and responsibilities of the board of an SOE and legal duties and responsibilities of directors
Module 3	**Board practices**	• This module describes the key practices of board including preparation and conducting a meeting, follow up of meeting
Module 4	**Improving board professionalism and effectiveness**	• This module examines the role of CEO and Board Chairman, optimizing board size, and policy framework for board operations. It also covers establishment of sub committees and board evaluation process.



The Board

Leadership Training Toolkit for SOEs

Part II Module 1
Board composition and structure



Photo: ©Benjamin Child/Unsplash.com

Part II Module 1: Board composition and structure

This session (module) covers the following topics:

1 Characteristics of a balanced board including gender aspects



2 Optimizing board size



3 Types of directors and their leadership attributes

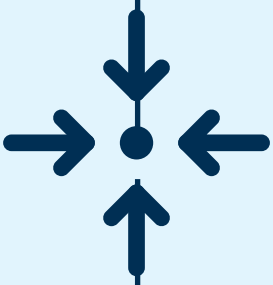


4 Establish specialized board committees



Learning objectives

By the end of this module, the participants will be able to



- **Describe the specialized committees established to support board functions**
- **Determine the optimum size of a board in SOEs**
- **Define types of directors and their leadership attributes**
- **Identify the characteristics and benefits of a balanced board**

Agenda

Total time: 3 hours 05 min

Time	Topic
30 min	Characteristics of a balanced board
15 min	Optimizing board size
30 min	Exercise
35 min	Types of directors and their leadership attributes
45 min	Establish specialized board committees (audit committee, sustainability committee, risk committee, Human resoruce [HR] committee)
30 min	Case study – Board committees at Ravells

Topic one: Characteristics of a balanced board

Establishing boards in SOEs

Boards play a central role in corporate governance and performance of SOEs. The board has the ultimate responsibility, including its fiduciary duty for developing corporate strategies and overseeing SOE performance. In this capacity, the board acts fundamentally as an intermediary between the state as a shareholder and the company and its executive management. This role is as important in SOEs as in private companies.

There are two main board models around the world: one-tier board (unitary board system) and two-tier board (dual system). The unitary board system is characterized by a single board that governs the company (this board might include both executive and non-executive members). The dual system is characterized by distinct supervisory and management bodies. The former is commonly referred to as the supervisory board, the latter as the executive board (see 'one-tier board' and 'two-tier board', below)[1]. In countries adopting the dual system, the terminology is 'supervisory board' instead of 'board of directors', and 'management board' instead of 'senior management team'. The United Kingdom has a unitary board model with a single tier of management, comprising executive and non-executive directors (if the company has appointed them) serving collectively and equally liable under the eyes of the law. This differs from many countries in continental Europe, where a two-tier structure is implemented, differentiating between directors with an operational role and supervisory directors responsible for the oversight of the managerial board.

Refer to Appendix A2.1A for the difference between one-tier and two-tier board systems. The term 'board' in this Kit, refers to the supervisory board in case of a two-tier board system.

With an increasingly prevalent practice of 'commercialization' of SOEs in recent decades and growing expectations for improved performance, many governments have made efforts to professionalize boards of directors and sought to make boards perform better by ensuring their independence and shielding them from ad hoc political intervention. Governments have taken a number of steps to implement the three-layered approach in line with their company laws to improve the efficiency and performance of boards of SOEs. In an increasing number of countries, SOE boards have evolved from oversight bodies entrusted with compliance toward driving performance and establishing corporate strategy.

Assuring a strong and autonomous role for SOE boards of directors is an issue that most countries grapple with. In some countries, SOE boards are not adequately empowered to play such a role, due to direct ministerial appointments of executive management and/or ad-hoc and informal means of instructions and communication. In others, board members may not be qualified to fill this role; one of

One-tier board	Two-tier board
It comprises a board of directors composed of both executive and non-executive members. It delegates day-to-day business to the management team. Found in the United States, the United Kingdom, and Commonwealth countries.	This refers to a board of directors that divides supervisory and management duties into two separate bodies. The supervisory board, comprising non-executive directors, oversees the management board, comprising executive directors. Common in France, Germany, and Eastern Europe. Not all styles of two-tier boards are identical.

the reasons for this can be the recruitment problems linked to the board fees. This could potentially have a negative impact on the performance of boards. More remains to be done to improve board performance and efficiency by implementing the aspirational standards of governance and accountability established by the internationally agreed standard OECD Guidelines on Corporate Governance of State-Owned Enterprises. (*Select G-20/OECD Guidelines specific to the board is placed in the Annex A1 for reference.*)

Some issues that commonly affect the smooth functioning of SOE boards across most of the countries are

- Size of the board
- Increased political influence and government representation on boards
- Lack of independence and accountability of board members
- Conflict of interest of board members
- Lack of guidelines for selection and nomination of board members
- Capacity issues of board members

Based on the experiences of SOEs in several countries, key measures to improve the effectiveness of the board have been identified. Each of these good practices is discussed in detail in the subsequent sections.

These good practices include the following:

- Creating balanced boards. A balanced board features the following characteristics:
  - Reduced government representation on boards
  - Inclusion of more independent directors
  - Inclusive and gender-sensitive board
  - Adopting professional criteria for selection and dismissal of directors
  - A developed and structured nomination process
- Defining and implementing board responsibilities
  - Clearly delineating the role of the board in the management and supervising the SOE
  - Increasing the role of the board in setting strategy and performance objectives
  - Managing conflicts of interest
  - Appointing and retaining qualified management
- Enhancing board professionalism and effectiveness

Creating balanced boards

A typical board usually consists of three different types of directors:

- Executive directors, who are the CEO and other senior full-time executives of the company
- Non-executive directors, who are not part of the executive team or are not employed by the company
- Independent directors, who in the purest form, are directors with no material relationship to the company

Modern good practice suggests that boards are increasingly introducing independent directors to enhance objectivity and independence.

In the case of SOEs, board composition varies by country and by type of SOE, by size and complexity, and by being listed or not listed on the stock exchange. However, many SOE boards still primarily comprise executive directors and non-executive directors, who are mainly government representatives. Government representatives are mostly civil servants, who can be from the ownership entity or from other ministries. In some cases, ministers and other political appointees may also sit on SOE boards. Non-executive directors from the private sector, academia, think tanks, and other external sources may be appointed as representatives of the state, but this type of appointment is not very common. In some countries, employees are also represented on the board.

As mentioned in topic one of this module, one of the fundamental issues of boards in SOEs is the increasing government representation and political influence on the functioning of the boards. Boards, composed mainly of government representatives, lack the objectivity and skills vital to well-functioning boards. They are often appointed to pursue policy goals, and in some cases, to compensate for shortages of appropriately skilled directors from the private sector. However, their appointment raises a number of issues. They typically lack the independence and the necessary qualifications and skills to be effective board members.

Confusion among board members over which role a government representative may be playing, could give rise to conflicts of interest. A government representative's presence may distort board deliberations and give them a disproportionate influence in board discussions. When a government representative is appointed directly from the relevant line ministry, the board is more vulnerable to conflicts of interest and the appointee may be motivated more by a desire to please the shareholder than by acting in the best interests of the SOE. Together, these factors weaken board autonomy, accountability and access to relevant industry and specialized skills.

The next steps illustrate the way to create a balanced board.

- **Reducing government representation on boards:** The process of creating balanced boards includes reducing government representation on boards. For this, countries are taking several key steps that include
  - Prohibiting ministers and other political appointees from serving on boards
  - Restricting the number of government representatives on boards while increasing the share of private sector members
  - Prohibiting government officials who have a regulatory role from serving on boards
- **Bringing in independent directors:** Detailed definition of independent directors is discussed in the next section, 'Types of Directors'. Appointing independent directors enables SOE boards to operate at greater arm's length and address issues with unbiased judgment for the benefit of the SOE. Independent members can alter the board discourse, setting the stage for a more open discussion and allowing an opportunity for dissenting voices to be heard when key decisions are being considered. Many countries have made it obligatory to have independent directors on SOE boards, for both listed and unlisted companies. Essentially, independent directors are selected from the private sector and the goal is to bring objective viewpoints and better governance skills to boards, to expand board willingness and ability to represent other stakeholders' interests, and to bring fresh views to strategic directions and market approaches. The boards' independence is ensured in the following manner:
  - Tightening the standards and rules of disqualifying relationships, including current employment by the firm and dimensions of potential connectedness. This implies that there is no ambiguity in the definition of independence in the regulatory framework of the country
  - Increasing penalties and incentives, such as legal liability for fiduciary duty breach, reputational sanctions, and stock-based compensation
  - Development of intra-board structures, such as task-specific committees and designation of a 'lead director'. Task-specific committees include the audit committee, the compensation committee, and the nominating committee, with a majority of independent directors
- **Inclusive board:** Board gender diversity has always been the subject of intense theoretical debates. Three main dimensions have emerged from these debates. The first dimension is based on public policy and holds that diversity should be promoted as a value in itself, to redress social inequalities and market failures. The second promotes

the business case for diversity. Gender diversity is believed to contribute to better financial results. The third focuses on psychological and sociological aspects of small group decision-making. It points out that enhanced board diversity improves the quality of the decision-making process in the boardroom. In culmination, the social justice perspective is one of the most prominent and appealing approaches to gender diversity. Promoting women in the board is simply the right thing to do as a matter of fundamental fairness, equal opportunity, and non-discrimination. For an SOE, promoting this social justice dimension is a part of its social objectives of establishment. Other aspects of an inclusive board would take age diversity, ethnic diversity, skills, experience and qualifications, and so on into consideration in addition to gender diversity, which is discussed in subsequent sections.

- **Appropriate skills, experience, attributes** (*This is discussed in the next two sections.*)

Note: Corporate governance progression matrix discussed in the earlier module discusses the steps in transitioning to more balanced boards.

Topic two: Optimizing the board size

Rationale – The size of an SOE board affects the quality of its deliberations and oversight. Indeed, very large boards are negatively correlated with financial performance. Although increasingly rare, boards of 30 or more members are not uncommon in some countries, with the board used as a representative body to recognize the interests of key stakeholders. The trouble with large boards is that they tend to require time-consuming consensus-building between constituencies, prevent detailed examination of complex issues, and make decision-making cumbersome. A board with too few members may not allow the company to benefit from an appropriate mix of skills and experience.

Consequently, companies should choose a board size that will enable them to

- Hold productive and constructive discussions;
- Make prompt and rational decisions; and
- Efficiently organize the committees' work.

Suggested benchmarks for board size – In OECD countries, the maximum size allowed for SOE boards ranges from 9 to 15 members (OECD 2005). In Malaysia, the recommendation is for government-linked companies is to have no more than 10–12 members. Large internationally prominent SOEs seem capable of functioning in this range: Singapore Airlines, the Development Bank of South Africa, and the Brazilian oil company Petrobras each have nine. A recent survey of state-owned development banks shows that on average, the boards of 90 surveyed banks are composed of eight members, with 22 percent of banks having more than 10 members (de Luna-Martinez and Vicente 2012).

How small can boards get before they begin to lack key skills—or before board members become excessively cozy with management? There is no clear evidence to answer this question. Statutory minimums reach as low as two members; but with one-third independent members and at least two independent board members to serve on the audit committee, the smallest recommended board size is six. For SOEs in developing and emerging markets, adopting a board size in a similar range—somewhere between 6 and 12 members—seems prudent. The SOE's needs and resources should determine the precise size.

Topic Three: Types of directors and their attributes

One of the characteristics of SOE boards, as compared with private sector boards, is the tradition in most countries (and sometimes legal requirement) to have direct representatives of the owner (public sector) representatives on the board. The question of how public and private representatives are combined on the board is central. Also, unlike in many private companies, the division is not merely between independent directors and 'the rest'.

In continuation of the illustration regarding types of directors in SOEs in Topic 1 of this module, various categories of directors that typically constitute the board in an SOE are

- Executive and non-executive directors
- Independent directors
- In most countries, employee representation on the boards is also encouraged

Executive directors hold an operational position in the company. The executives that one typically finds on boards are the chief executive officer (CEO), the chief operating officer (COO), and/or the chief financial officer (CFO). These directors are the best informed about the company's business and its challenges, since they daily make decisions about the company's operations. They are ultimately responsible too for the company's operating results.

Non-executive directors do not hold an executive position and they may or may not be independent. Non-executive directors contribute greater impartiality in their judgments. They can provide the board with additional external experience and knowledge, and may have useful contacts that can be used for the company's benefit.

Independent directors 'Independent Director' means a director who has no direct or indirect material relationship with the company other than membership on the board and who

(a) Is not, and has not been in the past five years, employed by the company or its affiliates;

(b) Does not have, and has not had in the past five years, a business relationship with the company or its affiliates (either directly or as a partner, shareholder (other than to the extent, to which shares are held by such director pursuant to a requirement of applicable law in the country relating to directors generally), and is not a director, officer, or senior employee of a person that has or had such a relationship);

(c) Is not affiliated with any non-profit organization that receives significant funding from the company or its affiliates;

(d) Does not receive and has not received in the past five years, any additional remuneration from the company or its affiliates other than one's director's fee and such director's fee does not constitute a significant portion of one's annual income;

(e) Does not participate in any share option [scheme]/[plan] or pension [scheme]/[plan] of the company or any of its affiliates;

(f) Is not employed as an executive officer of another company, where any of the company's executives serve on that company's board of directors;

(g) Is not, nor has been at any time during the past five years, affiliated with or employed by a present or former auditor of the company or any of its affiliates;

(h) Does not hold a material interest in the company or its affiliates (either directly or as a partner, shareholder, director, officer, or senior employee of a person that holds such an interest);

(i) Is not a member of the immediate family (and is not the executor, administrator, or personal representative of any such person,

who is deceased or legally incompetent) of any individual, who would not meet any of the tests set out in (a) to (h) (where the one is a director of the company);

(j) Is identified as an independent director in the annual report of the company distributed to the shareholders; and

(k) Has not served on the board for more than 10 years.[2]

For purposes of this definition, 'material interest' shall mean direct or indirect ownership of voting shares representing at least 2 percent of the outstanding voting power or equity of the company or any of its affiliates.[3]

Personal attributes of directors

Effective boards will have a balance of well-chosen and competent directors, who, with the chairman's leadership and guidance, provide a cohesive group to shape the company's destiny, safeguard its interests, and ensure its profitable performance.

A framework for directorial leadership has been developed and validated over the past 20 years by Professors Victor Dulewicz and Malcolm Higgs from Henley Management College in the United Kingdom. Their framework has been published in many academic journals and used in a wide variety of organizations in the private, public, and voluntary sectors. A Leadership Dimension Questionnaire (LDQ), which uses this framework to assess these dimensions for individual directors, is commercially available. This framework (refer Table 20) covers the main areas expected to be found in the boardroom, although the breadth and depth of these requirements will vary according to a board's circumstances and demands.

Table 20: Director Leadership Framework

Intellectual dimension (IQ)	Managerial dimensions (MQ)	Emotional and social dimensions (EQ)
Critical analysis and judgment attributes: • Probes the facts • Identifies advantages and disadvantages, and discerns the shortcomings of ideas and proposals • Makes sound judgments and decisions based on reasonable assumptions and factual information • Aware of the impact of any assumptions made	**Resource management attributes:** • Plans ahead, organizes all resources and coordinates them efficiently and • Effectively • Establishes clear objectives • Converts long-term goals into action plans • Monitors and evaluates staff's work regularly and effectively, gives sensitive and honest feedback	**Self-awareness attributes:** • Is aware of own feelings and has the capability to recognize and manage these in a way that one feels to have the control • Has a degree of self-belief in one's capability to manage one's emotions and to control their impact in a work environment
Vision and imagination attributes: • Imaginative and innovative in all aspects of one's work • Establishes sound priorities for future work • Clear vision of the future direction of the organization to meet business imperatives • Foresees the impact of changes on one's vision that reflects implementation issues and business realities	**Engaging communication attributes:** • A lively, enthusiastic communicator • Engages others and wins support • Clearly communicates instructions and vision to staff • Communications are tailored to the audience's interests and are focused • Communication style inspires staff and audiences, conveys approachability and accessibility	**Emotional resilience attributes:** • Performs consistently in a range of situations under pressure and adapts behavior appropriately • Balances the needs of the situation and task with the needs and concerns of the individuals involved • Retains focus on a course of action or need for results in the face of personal challenge or criticism

Strategic perspective attributes: • Sees the wider issues and broader • implications • Explores wide range of relationships, balances short- and long-term considerations • Sensitive to the impact of one's actions and decisions across the organization • Identifies opportunities and threats • Sensitive to the implications of external factors on decisions and actions	**Empowering attributes:** • Gives staff autonomy, encourages them to take on personally challenging, demanding tasks • Encourages staff to solve problems, produce innovative ideas and proposals, and develop their vision and a broader vision • Encourages a critical faculty and a broad perspective and encourages the challenging of existing practices, assumptions, and policies	**Intuitiveness attributes:** • Arrives at clear decisions and drives their implementation when presented with incomplete or ambiguous information using both 'rational' and 'emotional' or intuitive perceptions of key issues and implications
	Developing attributes: • Believes others have the potential to take on ever more demanding tasks and roles, encourages them to do so • Ensures that direct reports have adequate support • Develops direct reports' competencies and invests time and effort in coaching them so that they contribute effectively and develop themselves • Identifies new tasks and roles to develop others • Believes that critical feedback and challenge are important	**Interpersonal sensitivity attributes:** • Is aware of and takes the needs and perceptions of others into account in arriving at decisions and proposing solutions to problems and challenges • Builds from this awareness and achieves the commitment of others to decisions and actions • A willingness to keep one's thoughts open on possible solutions to problems and to actively listen to and reflect on the reactions and inputs from others • Influence – influencing others • Persuades others to change views based on an understanding of their position and a recognition of the need to listen to this perspective and provide a rationale for change
	Achieving attributes: • Willing to make decisions involving significant risk to gain an advantage • Those decisions are based on core business issues and they are likely affect the success • Selects and exploits activities that result in the greatest benefits to the organization and its performance • Unwavering determination to achieve objectives and implement decisions	**Motivation attributes:** • Drives energy to achieve clear results and make an impact • Balances short and long-term goals with a capability to pursue demanding goals in the face of rejection or questioning
		Conscientiousness attributes: • Displays clear commitment to a course of action in the face of challenge and match 'words and deeds' in encouraging others to support the chosen direction • Shows personal commitment to pursuing an ethical solution to a difficult business issue or problem

Source: Adapted from IFC 2008.

Topic four: Establish specialized board committees

The establishment of board committees can be instrumental in enhancing the efficiency of SOE boards, reinforcing their competency, and underpinning their critical responsibility. They may also be effective in changing the board culture and reinforcing its independence and legitimacy in areas, where there is a potential for conflicts of interests, such as procurement, related-party transactions, and remuneration issues. The use of specialized board committees, especially in large SOEs, in line with practices in the private sector is considered a good practice. Special committees that may add value to boards include those in the fields of audit, remuneration, strategy, ethics, risk, and procurement.

It is essential to have a non-executive chair specialized board committee and include sufficient number of independent members into it. The proportion of independent members as well as the type of independence required (for example, from management or the main owner) will depend on the type of committee, the sensitivity of the issue to conflicts of interests, and the SOE sector. The audit committee, for example, should be composed of only independent and financially literate board members in terms of the best practice on audit committee composition. To ensure efficiency, the composition of board committees should include qualified and competent members with adequate technical expertise.

The existence of specialized board committees should not excuse the board from its collective responsibility for all matters. Specialized board committees should have written terms of reference that define their duties, authority, and composition. Specialized board committees should report to the full board and the minutes of their meetings should be circulated to all board members.

Internal committees enable boards to handle complex issues more efficiently, concentrating expertise in areas such as financial reporting, risk management, and internal controls. They provide useful and independent input to key policy decisions. Good practice indicates that the most common board committees include the audit committee, nomination committee, remuneration committee, and risk management committee, the last being especially important for financial institutions. Other board committees can include corporate governance, corporate social responsibility (CSR), and operational areas such as marketing and human resources. To maximize the objectivity and independence of the committees and of the board as a whole, good practice also suggests that the majority of the members—including the chair—be independent directors. Boards should delegate functions to committees carefully to ensure that the board as a whole still decides on the key issues under its responsibility. Formal terms of reference may be useful for defining the scope of each committee's work.

SOEs' use of board committees varies greatly between and within countries and tends to reflect the prevailing private sector models in their respective countries. OECD countries and countries with long experience in corporate governance—such as India, Malaysia, and South Africa—have SOEs with well-established committees. In countries with nascent governance frameworks and limited capacities, the audit committee is frequently required, but other committees may not exist. Within countries, specific board committees may be needed more frequently in large companies and in companies listed on the stock exchange than for other SOEs.

Audit committees are important for all SOEs, financial and nonfinancial. SOE ownership entities in countries such as Canada, France, India, Malaysia, and Thailand provide detailed guidance on the composition, responsibilities, and power of the audit committee. In Thailand, this guidance is provided through a committee manual; in Malaysia, through the 'Green Book'

on improving board effectiveness; and in India, through its corporate governance guidelines for SOEs. National codes of corporate governance and listing rules for companies traded on stock exchanges frequently require an audit committee and details of its composition, power, and responsibilities. In SOEs without board committees, good practice suggests that the priority should be to establish an audit committee because of its importance.

The audit committee should be carefully composed and judged by the full board on its performance and role. Strengthening its capacity is also essential. Where audit committees are required, their function and ability to access accurate and comprehensive information about SOE activities and the integrity of internal controls may be weak. In many cases, the audit committee itself might view its task as perfunctory, or it might lack a proactive attitude toward its responsibility. Members may not be consistently qualified or prepared to serve on a more technically oriented committee. In addition, SOE boards themselves may lack the technical skills and focus to adequately understand and oversee internal controls and disclosure.

Box 27 (on the next page) provides details on the establishment and functioning of an audit committee.

Remuneration and nomination committees are increasingly commonplace in SOEs in countries with more sophisticated frameworks and in larger and listed SOEs. Their role and composition are detailed in Table 21.

Risk management committees are also gaining importance, especially in financial institutions and also in other large SOEs, although many are still at a nascent stage. The board's main role in risk management is to provide oversight. Through risk oversight, the board should[4]

- Establish the organization's risk appetite/ tolerance level:
- Identify and monitor operational, managerial, and strategic enterprise risks and know the degree of flexibility in how these risks are to be treated;
- Ensure that an effective risk management system is in place; and
- Oversee management actions, especially as they relate to excessive risk-taking, and provide input to management regarding critical risk issues in a timely manner.

Table 21: Role and Composition of Remuneration and Nomination Committees

Remuneration Committee	Nomination Committee
• ***Role.*** The committee considers matters relating to executive remuneration. The committee approves changes to incentive and benefit plans of senior managers, may be involved with remuneration decisions for the company as a whole, and reviews strategic human resource decisions.	• ***Role.*** The committee is responsible for considering matters relating to the composition of the board, including the appointment of new directors and succession plans for the chair, other key board positions, and senior executives. The committee sometimes has corporate governance responsibilities, including conducting an annual performance evaluation of the board, its committees, and individual directors.
• ***Composition.*** The committee is ideally composed entirely of independent directors. The CEO, CFO, and head of human resources may have direct reporting relationships to the committee. Outside experts often support the work of the committee. It usually meets less frequently than the audit committee does.	• ***Composition.*** The committee is ideally composed entirely of independent directors. Outside search or governance consultants often support the work of the committee. It usually meets less frequently than the audit committee does.
• ***Value.*** The committee adds most value when the boards are given discretion to set executive remuneration.	• ***Value.*** The committee adds more value when boards are given discretion to nominate new members of the board and to carry out board evaluations.

Source: Adapted from World Bank 2014.

Box 27: Establishing an Audit Committee

An audit committee can assume ultimate responsibility for the control environment and provide a qualified and objective viewpoint on some of the most challenging issues the board may face. However, an effective audit committee requires expertise that existing SOE board members may lack. Audit committees are usually required to have at least two or three non-executive independent members, who make up a majority, including the chair. The best practice suggests that the committee should consist of only independent directors. All the members should be familiar with financial matters, and at least one should have a relevant financial or accounting background.

Ideally, most or all of these members should be from the private sector; it may also be suitable to have one or two committee members with a financial or accounting background from the securities regulator, central bank, Ministry of Justice, or the Ministry of Finance if that government body does not otherwise play an ownership or policy role in the SOE. A board without an audit committee should still have at least a few independent members who are qualified to carry out similar functions. However, in some countries, audit committees constitute a mix of directors and outside expertise in the form of consultants.

Audit committee duties vary somewhat across jurisdictions. However, good practice suggests the following core activities:

- Oversight of the internal audit function and responsibility for ensuring adequate resources and independence for this task
- Responsibility for oversight and for ensuring the adequacy of the SOE's internal controls
- Responsibility for ensuring that the SOE complies with financial reporting requirements and produces quality financial statements according to the policies
- Advice on the choice of external auditor and coordination with the external auditor on the scope, fees, and findings of the audit
- Responsibility of monitoring compliance

Beyond these core functions, the audit committee may also be required or encouraged to take on other duties:

- Overseeing and reporting on risk or risk management (this may also be done by a risk committee or the board as a whole)
- Reporting on and ensuring compliance with rules on related-party transactions and other rules on conflicts of interest
- Reporting on and ensuring compliance with rules on reporting possible error and wrongdoing inside the company (whistle-blowing)
- Ensuring compliance with legal and regulatory requirements more generally

To carry out these functions, the audit committee must have sufficient authority to do the following:

- To investigate matters within its terms of reference
- To have full access to SOE documents and the ability to question SOE employees
- To meet with external or internal auditors without executives present
- To obtain outside professional advice
- To have access to internal reports on misconduct and whistle-blowers

As with other board committees, the audit committee should meet regularly, between once a quarter and once a month, and its members should be able to devote sufficient time to prepare for and participate in meetings. The committee should also have written terms of reference.

Source: World Bank Group. 2014. *Corporate Governance of State-Owned Enterprises: A Toolkit.* Washington, DC: World Bank.

Specific roles of the board in enterprise risk management (ERM) can be categorized in terms of conformance and performance as outlined in Table 22.

Table 22: Role of the Board in ERM

Conformance	Performance
• Ensures the board's accountability for risk and internal controls • Defines the organization's risk appetite • Monitors the risk management process • Monitors key performance indicators (KPIs) and key risk indicators (KRIs)	• Determines the ERM objectives • Steers and approves the ERM strategy • Approves risk management policies • Makes risk management decisions based on KPIs and KRIs • Works with the CEO and the chief risk officer (CRO) in managing risks

Source: Adapted from World Bank Group 2014.

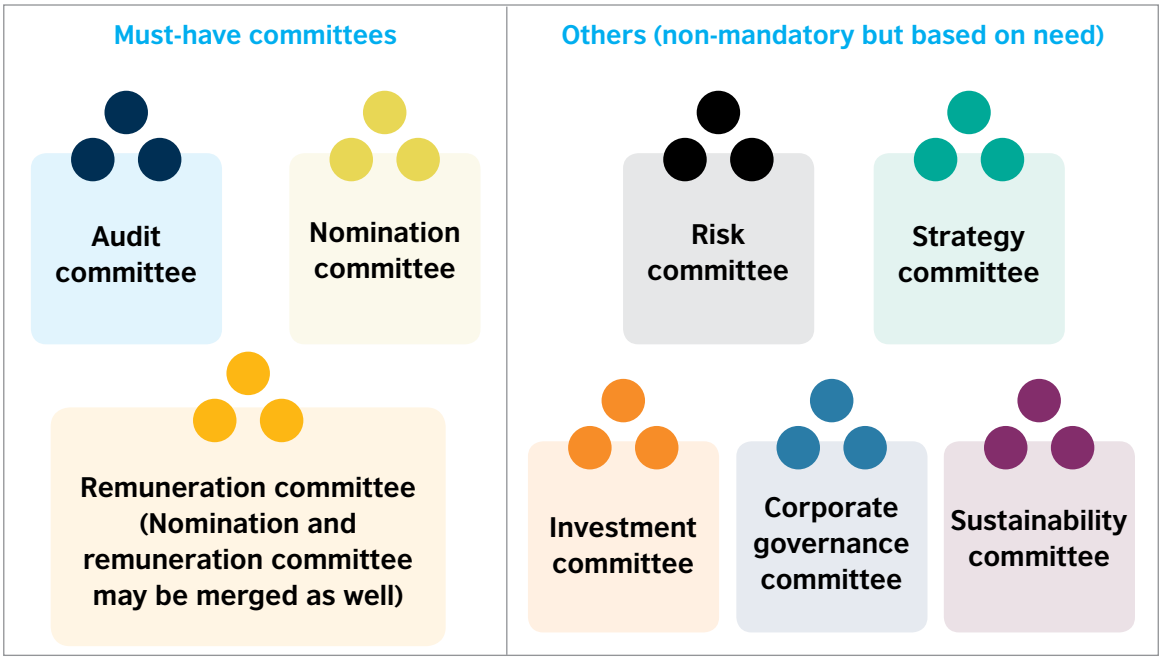
It is best to take a flexible approach with board committees based on the size and complexity of the SOE, the availability of skills, and the decisions of the board. Some suggestions on must-have and optional board committees are outlined in Figure 17.

Board committees can be progressively created:

- The first step is to ensure that an audit committee is in place, with at least one independent member, to oversee internal audit and controls. Over time, the goal is to ensure that the committee is composed primarily of independent members and eventually has independent members with primary authority over internal audit.
- For smaller SOEs or in countries, where capacity is lacking, the functions of other committees—such as nomination, remuneration, risk management, and corporate governance—could be carried out by the full board and then gradually delegated to committees, as experience and skills are gained.

Good practice requires that committees be chaired by or composed of independent directors; the lack of such directors in countries with low capacity may mean that independence will need to be phased in over time. For example, a first step could be to create an audit committee, with at least one independent director, and progressively increase the number of such directors so that it is composed primarily, or entirely of such directors over time. The activities of all committees should be disclosed in the SOE annual report.

Figure 17: Suggested Must-Have Board Committees



Source: World Bank 2014.

Notes:

1 IFC. 2018. *Governance and Performance in Emerging Markets - Empirical Study on the Link Between Performance and Corporate Governance of IFC Investment Clients*. Washington, DC: IFC. Available at: https://www.ifc.org/wps/wcm/connect/9eb97e0b-22b8-4ac7-a2ca-fc501e809f08/Governance_and_Performance_in_Emerging_Markets.pdf?MOD=AJPERES&CVID=mBVyx6P

2 Depending on the availability of qualified independent directors in a particular country, the term could be shortened to seven (7) years.

3 Consult with local counsel as to the relevant percentage, if any, specified by local law (which may apply to publicly listed or unlisted companies, or both). For example, in the United Kingdom, a shareholder is treated as having a material (disclosable) interest in a publicly listed company if it holds 3 percent of the shares; in the United States, the equivalent threshold is 5 percent.

4 Choi, Ivan. 2013. *When Do Companies Need a Board-Level Risk Management Committee?* IFC Publication. https://www.ifc.org/wps/wcm/connect/f7c51769-9a79-4546-b40c-9965cde12beb/PSO+31.pdf?MOD=AJPERES&CVID=jS3hRL

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The Board

Leadership Training Toolkit for SOEs

Part II Module 2
Board's roles, director's duties, and liabilities



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Part II Module 2: Board's roles, director's duties, and liabilities

This session (module) covers the following topics:

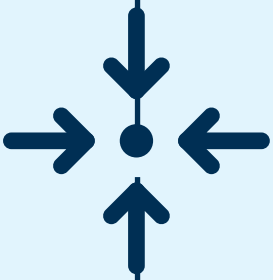
1. Board's roles and responsibilities
2. Role of the treasury representative/Role of the monitor
3. Differentiate managing versus directing and identifying dilemmas
4. Director's legal duties and liabilities






Learning objectives

By the end of this module, the participants will be able to



- **Describe the board's governance roles and responsibilities**
- **Differentiate managing versus directing and identifying dilemmas**
- **Analyze directors' legal duties and liabilities**

Agenda

Total time: 2 hours 50 min

Time	Topic
45 min	Board's roles and responsibilities including ethical challenges, anti-corruption and integrity, codes of ethics/conduct, and whistle-blowing
20 min	Role of the state representative/ Role of the monitor
30 min	Managing versus directing and identifying dilemmas
45 min	Director's legal duties and liabilities/Good practices in managing directors' roles and responsibilities/Managing conflict of interest
30 min	Case study

Note: Legal and regulatory frameworks vary greatly from country to country, as will the degree to which laws define directors' duties and responsibilities. While some jurisdictions offer detailed guidance through case law or regulations, many countries' laws are yet to be developed. The following notes are based on best practices in common-law countries. These notes provide general guidance—they are not intended, nor should they be used, as a source of technical advice for a specific situation. Directors must seek independent and professional advice in every specific area of legal duties and liabilities.

Topic one: Board's roles and responsibilities

Good practice as defined in the G-20/OECD's Guidelines on the Corporate Governance of State-Owned Enterprises (OECD 2015), calls for the board's role to be clearly defined and founded in the legislation, preferably in the company law.[5] In practice, however, while SOE boards have broad nominal power, they are often not assigned specific responsibility in key areas, and the respective roles of the board and the state as the owner are blurred, or power is explicitly reserved for the state when it should be within the competency of the board. Even when boards have explicit responsibility, they may not be able to exercise it fully and may have little effective influence over their legitimate responsibilities.

The government or ownership entity may have good reasons for establishing policy or standard procedures in many areas and even for being involved directly in some matters. Yet strategic and operational control by the government can lead to interference in fundamental company matters, with suboptimal results. Government intervention dilutes the authority of the board, undermines board accountability, and opens the door to political interference and a lack of focus on performance. It can also lead to less motivated and engaged board members and create an opening for lead management to pursue conflicting objectives (those of government owners and those of the board).

Key responsibilities of a conventional board in an SOE:

- To review and guide corporate strategy, major plans of action, risk policy, annual budgets, and business plans; set performance objectives; monitor implementation and corporate performance; and oversee major capital expenditures, acquisitions, and divestitures
- To set periodic review, monitor the effectiveness of the company's governance practices, and make changes as needed
- To select, define compensation of, monitor, and, when necessary, replace key executives; oversee succession planning
- To set policy for key executive and board remuneration in line with the longer-term interests of the company and its shareholders
- To ensure a formal and transparent board nomination and selection process
- To monitor and manage potential conflicts of interest of management, board members, and shareholders, including misuse of corporate assets and abuse in so-called related-party transactions
- To ensure the integrity of the SOE's accounting and financial reporting systems (including independent audit) and the operation of control systems such as risk management and financial and operational control; uphold compliance with the law and relevant standards
- To oversee disclosure and communications

The key to ensuring that an SOE board can function effectively is a clear delineation of the respective roles of the state as a shareholder, of the board, and of the management, including what the board is required to do and when the state, as the owner, should provide explicit approval or oversight. These different responsibilities are usually established through laws, corporate governance codes and guidelines, or the companies' articles of association. In South Africa, for example, board responsibilities are based on the national corporate governance code for listed companies (public and private), with additional guidance provided for SOEs and the relevant ministry. Equally important is the fulfilment of these different roles in practice to ensure accountability and to put the board to full use.

Guiding strategy and major decisions

As board capacity and overall SOE governance improve, the board's focus should shift from merely supervisory to setting strategy and

performance objectives, but it will need to be empowered by the ownership entity to do so. State approvals can be streamlined or eliminated in many cases, especially for contracts and other management decisions in the normal course of business, consistent with the broader guidance provided by the owner. Countries have begun to delegate major decisions to SOE boards, particularly those of larger SOEs or listed SOEs, but may still fall short of full delegation (refer Box 28 for a country case study on delegation of the decision-making powers to SOE boards in India).

Although clarifying the roles of the owner and the board of directors in setting the strategy and making key decisions is essential to set clear boundaries and ensure accountability, it is not enough. **Empowerment of SOE boards in these areas has additional requirements:**

- Clear guidance should be provided on how the state as an owner makes decisions, such as approving major transactions and ensuring that the board carries out decisions without needing shareholder approval.
- Safeguards should be designed and put in place to deal with political intervention in board matters.
- Since corruption remains a serious problem in many SOEs, proper accountability and integrity mechanisms should be established. These should require fair and responsible behavior on the part of boards toward shareholders and stakeholders. Codes of conduct and whistle-blower policies should be developed and implemented by SOE boards as vital accountability mechanisms in the empowerment process, while probity and integrity should be ensured without sacrificing efficiency.

Managing conflicts of interest

Conflicts of interest arise when a board member's personal interests are contrary to those of the SOE. Potential conflicts can include commercial conflicts (in which a board member, a manager, or one of their relatives has an interest in a contract or transaction with the SOE, either directly or indirectly, for

Box 28: Delegating Decision-Making Powers to SOE Boards in India

In India, delegation of board decision-making power through guidelines issued by the Department of Public Enterprises (DPE) and as outlined by the corporate governance code for all public sector enterprises (CPSEs) owned by the central government, has helped empower the boards of CPSEs, especially the larger ones. A formal system of delegation, based on company performance, determines, which decisions are the exclusive purview of the board and which must be shared with the relevant ministry.

Currently, there are 7 Maharatnas and 16 Navratnas (the largest SOEs and among the largest companies in India) that have the most freedom. Miniratnas, smaller companies, have somewhat less freedom. Meanwhile, some power is delegated to all profit-making SOEs. Thresholds for such actions as capital expenditures and joint ventures, subsidiaries, and mergers and acquisitions are set. Operations below the threshold require no approval by the ministry, while those above the threshold do.

Table 23: Thresholds Triggering Requirement for Ministry Approval of SOE Actions, India

SOE category	Threshold	
	Capital expenditures (US$)	Joint ventures, subsidiaries, and mergers and acquisitions (US$)
Maharatna	No limit	US$1.1 billion or 15% of net worth
Navratna	No limit	US$220 million or 15% of net worth
Miniratna (category 1)	US$110 million or 100% of net worth	US$110 million or 15% of net worth
Miniratna (category 2)	US$55 million or 50% of net worth	US $55 million or 15% of net worth

Source: World Bank Group 2014. *Corporate Governance of State-Owned Enterprises: A Toolkit.* Washington, DC: World Bank.

example, ownership in another company) and political conflicts (in which a government representative pursues a policy goal contrary to the interests of the SOE). When a board member is facing a conflict of interest, the standard approach to managing that conflict is to declare that conflict to the board, abstain from voting on the matter involved, and in some cases, abstain from participating in a board discussion on that matter.

Board members also face other potential conflicts. These include using information that they acquired as a board member in their own interest to the detriment of the company or using it to trade in securities markets. Board members also need to be aware of conflicts involving other board members and managers and act objectively in such cases (refer Box 29 for country case studies).

Clear policies for related-party transactions should be established for SOEs. The definition and guidelines for related parties of SOEs should include the directors, executive management, and their related interests. The guidelines should also address requests for transactions, potentially preferential or not, by government officials, members of parliament, other SOEs, and relevant persons. If mandates are developed for SOEs, those transactions requested by government entities that fall outside the mandated business plan might also be captured as 'related-party' transactions or as reportable and disclosable events.

Many countries now require that SOEs have a code of ethics or conduct that applies to the board and other employees. Besides confirming the imperative for board members to act with care and loyalty, such codes usually outline how to manage conflicts of interest and what sort of behavior is considered acceptable or unacceptable. For example, India requires a code of conduct for central public sector enterprises that include such provisions and touches on related themes such as misuse of business opportunities by board members.

Box 29: Country Case Studies on Managing Conflicts of Interest

Lithuania: According to Government Resolution No. 631, the 'conflict of interest' shall mean the situation, where a member of a board of SOE or municipality-owned enterprise fulfilling his duties or an assignment must take a decision (or participate in adoption thereof) or fulfil an assignment related to his private interests. The candidate must have to submit a declaration that the one's participation in the selection procedure of directors does not result in a conflict of interest.

India: Under Section 184 of the Companies Act, 2013 directors of a company (including SOEs) are required to disclose their concern or interest in any company or companies or bodies corporate, firms, or other association of individuals, which shall include shareholding as well. It also states that every director of a company, who is in any way, whether directly or indirectly, concerned or interested in a contract or arrangement or proposed contract or arrangement entered into or to be entered into, shall disclose the nature of his concern or interest at the meeting of the board, in which the contract or arrangement is discussed and shall not participate in such meeting. Such disclosures are made by giving a notice in writing.

Japan: Corporate governance and directors' duties are regulated by the Companies Act and the company's articles. Listed stock companies are also regulated by the Financial Instruments and Exchange Law. Securities Listing Regulations are published by the securities exchanges (including the Corporate Governance Code). The Tokyo Stock Exchange (TSE) is the largest securities exchange in Japan. In case of listed SOEs without a board, if a director intends to carry out any transaction between the company and oneself (for oneself or for a person other than oneself) that results in a conflict of interest, approval for the transaction must be obtained at a shareholders' meeting. For companies with a board, if a director intends to carry out any transaction involving conflicts of interest, an approval must be obtained at a board meeting. A director with a conflict of interest cannot participate in the board meeting.

Sources:

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- Yamaguchi, Katsuyuki, Shinji Dohi and Mamiko Komura, Nishimura & Asahi. 2019. *Corporate Governance and Directors' Duties in Japan: Overview.* Thomson Reuters Practical Law.

Cross-cutting theme: integrity and anti-corruption

Conflicts of interest refer to the influence on decision-makers that may detract from the objectives established for the SOE, and/or that serves for personal or political gain. In the public sector, managing conflict of interest aims to ensure that government decisions are not influenced by individual interests. The OECD Guidelines for Managing Conflict of Interest in the Public Service state that "while a conflict of interest is not ipso facto corruption, there is increasing recognition that conflicts between the private interests and public duties of public officials, if inadequately managed, can result in corruption."

SOEs can seek to adequately manage perceived or real conflicts of interest, knowing that a "too-strict approach to controlling the exercise of private interests may conflict with other rights, or be unworkable or counter-productive in practice." **A modern approach to managing conflict of interest involves the following steps,** implementation of which is tracked in the OECD's 'Report on Implementation' (2007):

- Identifying risks
- Prohibiting unacceptable forms of private interest
- Raising awareness of the circumstances, in which conflicts can arise
- Ensuring effective procedures to resolve conflict-of-interest situations

As all SOE decision-makers, including the board members and executive management, could become subject to conflict of interest, SOEs and state ownership entities should ensure that adequate mechanisms for addressing conflict of interest, if it does arise, are in place. Board members should disclose any conflict of interest to other board members, and then disclose information on how they are being managed by the board. Conditions for disqualification should also be clear. Declaration of conflict of interest of not only the board but of other decision-makers in an SOE on a cyclical basis would be beneficial to mitigate opportunities for it to go unnoticed.

Choosing the CEO and overseeing the management

Good practice calls for empowering the board to appoint, and subject to clear terms, remove the CEO, which reinforces the key function of the board in overseeing management and ensures that the CEO is accountable to the board rather than to the government. It also reduces the scope of government interference in operational decision-making.

For these reasons, some countries have made changes to explicitly strengthen the power of the board (refer Box 30).

To facilitate a transparent and professional process, governments should specify in the laws and regulations about qualification and experience criteria for both appointment and removal of directors and provide guidelines for nominating and selecting the CEO, including minimum qualifications, competitive contracting, and the development of a structured and transparent selection process. Various approaches have been used for the selection process (refer Box 31 on the next page).

About the selection of the top management team, good practice from various jurisdictions calls for the CEO to do the same. When

Box 30: Country Case Studies on Strengthening Board Powers for Selecting the CEO and Overseeing the Management

- Countries such as Australia, Germany, New Zealand, Norway, and Sweden now explicitly empower the board to choose the CEO.
- Romania and a smaller number of other emerging market economies are doing the same.
- Certain countries have adopted an intermediate approach. South Africa, for example, allows the board to select the CEO subject to final approval by, or in consultation with, the ownership entity and other shareholders.

Source: World Bank Group. 2014. *Corporate Governance of State-Owned Enterprises: A Toolkit.* Washington, DC: World Bank.

Box 31: Country Case Studies on Approaches to the Selection Process for CEOs

In Malaysia, the boards of government-linked companies have a nomination committee with independent board members to lead the vetting of suitable candidates.

In Romania, the law requires that CEOs be selected based on a transparent and competitive process, and in the case of transport companies the process has been contracted out to private headhunters.

In Serbia, the new public enterprise law calls for the creation of a special committee to select CEOs through a process of competitive tendering.

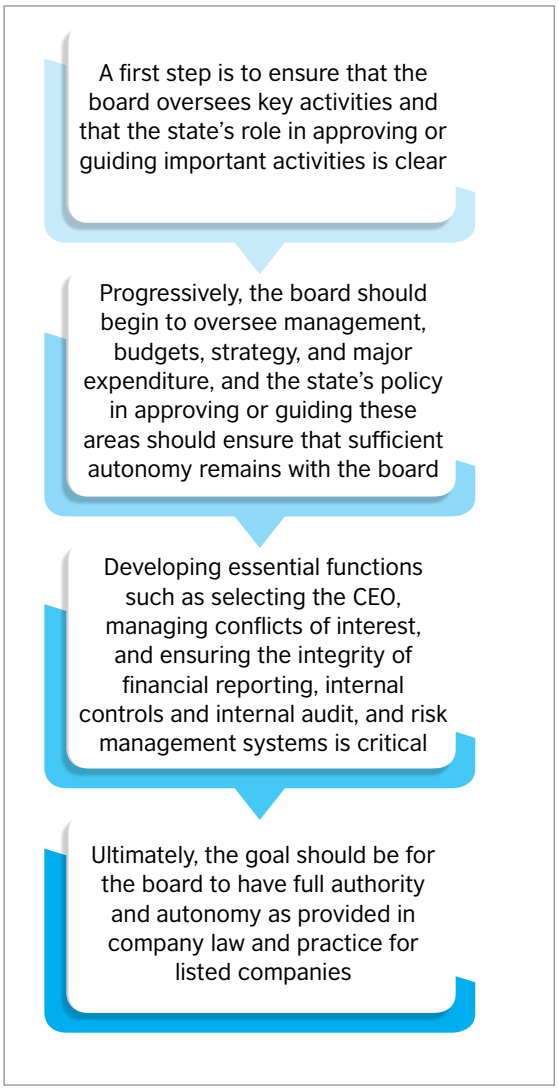
Source: World Bank Group. 2014. *Corporate Governance of State-Owned Enterprises: A Toolkit*. Washington, DC: World Bank.

this is the case, boards normally review the appointment of senior executives, their responsibilities, the terms of their appointment, and the authorities and reporting lines of the SOE's top managers. In some two-tier board systems, the supervisory board is typically responsible for choosing the management board; the same stands out to be a long-established practice in Germany and is now followed in Estonia and Poland as well. However, in some countries with two-tier boards, the government picks the members of both, leading to the same potential problems when the government selects managers in a one-tier system.

SOE boards should also fulfil their role in evaluating management performance. This activity should cover the achievement of financial and operational results as well as the success of implementing board strategy, establishing effective internal controls and risk environment, and ensuring the accuracy and integrity of financial statements.

Empowering boards and delegating greater powers can take place progressively, as a board becomes more skilled, objective, and professional. This can be done step- by-step as outlined in Figure 18.

Figure 18: Step-by-Step Process for Empowerment of Boards



Source: Adapted from World Bank 2014.

Cross-cutting theme: climate change and resilience

Climate change is no longer just an ethical environmental issue. It has fast become a matter of corporate governance and business sustainability, with regulators around the world increasing oversight and pressure on greater corporate disclosure of climate change risks. This effort is notably led by central banks considering the systemic risks climate change

can pose to state-owned financial institutions and the broader financial sector.[6] At the same time, litigation against SOEs and their boards on climate change exposures has accelerated pace. As a result, the implications of climate change on the personal liabilities of SOE directors are increasingly apparent.

World Bank in collaboration with PwC (2019)[7] has outlined the following corporate governance principles to address the risks related to climate change in Figure 19.

Figure 19: Corporate Governance Principles to Address Climate Change Risks



CLIMATE ACCOUNTABILITY

SUBJECT DEMAND

BROAD STRUCTURE

MATERIALITY ASSESSMENT

EXCHANGE

REPORTING & DISCLOSURE

INCENTIVIZATION

STRATEGIC INTEGRATION

Source: Adapted from World Economic Forum 2019.

- **Climate accountability.** The board is ultimately accountable to the shareholders for the long-term stewardship and sustainability of the SOE. Accordingly, the board should be accountable for the SOE's long-term resilience concerning the potential shifts in the business landscape that may result from climate change (climate transition). Failure to do so may constitute a breach of directors' duties. The board should also be responsible to shareholders for overseeing the effective management of climate-related risks and opportunities. As a foreseeable financial issue within mainstream investment and planning horizons, climate change should enliven directors' governance duties in the same way as any other issue presenting significant financial risks.
- **Command of the climate subject.** The board should ensure that its composition is sufficiently diverse in knowledge, skills, experience, and background to effectively debate and take decisions informed by an awareness and understanding of climate-related threats and opportunities. Executive and non-executive directors can contribute to good climate governance in different ways. While non-executive directors are not operationally responsible for the business, they may bring specific knowledge to certain subject matter or perspectives concerning the risks and opportunities of climate change. Executive directors, on the other hand, are operationally accountable and should have greater insight into how climate risks and opportunities are managed within the organization. SOEs in sectors particularly exposed to climate transition (energy and transport sectors) and/or to climate risk (infrastructure, utilities) would need to ensure adequate expertise in their boards to be able to ensure the required stewardship.
- **Board structure.** To maintain oversight of the SOE's climate resilience and governance, a board should determine how to most effectively embed climate into its board and committee structures. Given that board structures vary across jurisdictions (for example, one-tier versus two-tier boards), there are numerous ways to embed climate into these structures. Regardless of the board structure, the approach to embedding climate considerations should enable sufficient attention and scrutiny to climate as a financial risk and opportunity. Typically, climate considerations are explicitly included in the SOEs' governance, investment, and risk committees. State-owned financial institutions should also integrate climate considerations and risks

in their credit committees. The selected structure should also allow for effective connection and communication with the relevant members of the executive management.

- **Material risk and opportunity assessment.** The board should ensure that the management assesses the short-, medium-, and long-term materiality of climate-related risks and opportunities for the SOE on an ongoing basis. The board should further ensure that the organization's actions and responses to climate are proportionate to the materiality of climate to the SOE. As climate change is expected to affect the business landscape over a longer term than most typical SOE budgeting and reporting cycles, it can lead some SOEs to overlook risks or opportunities that may become material in the medium to long term. It is, thus, essential to consider short-, medium-, and long-term periods in material assessments in the SOE. There must also be a clear method and framework for conducting climate-related materiality assessments.
- **Strategic and organizational integration.** The board should ensure that climate systemically informs strategic investment planning and decision-making processes and is embedded in the management of risk and opportunities across the organization. Once the board is aware of the extent to which climate change might drive material risks and opportunities for its operations, it can begin to integrate climate-change considerations into the organization's strategy. How a SOE positions itself on short-term decisions (for example, investment project decisions) will have long-term and potentially profound implications on the sustainability and resilience of the organization (for example, investments in non-sustainable carbon-intensive assets or infrastructure in climate hotspots). When decisions with long-term implications are taken without consideration of how climate might alter the future business landscape, they may be taken with no explicit regard for important risks. Moreover, the long-term resilience of an organization may require fundamental strategic changes in some organizations' business models, which will take significant time to be implemented. Given the highly uncertain and variable nature of how climate change will affect the business landscape over different time frames, strategic decision-making should be informed by scenario analyses and the results of these scenarios integrated into strategic planning decisions. Boards should be confident that the strategic decisions they take would not compromise the resilience of the organization under any future climate scenario.
- **Incentivization:** The board should ensure that executive incentives are aligned to promote the long-term prosperity of the SOE. The board may want to consider including climate-related targets and indicators in their executive incentive schemes, wherever appropriate. The top management should cascade these targets and incentives through to lower levels of management. In markets, where it is commonplace to extend variable incentives to non-executive directors, a similar approach can be considered.
- **Reporting and disclosure.** The board should ensure that material climate-related risks, opportunities, and strategic decisions are consistently and transparently disclosed to all stakeholders — particularly to investors, and where required, regulators. Such disclosures should be made in financial filings, such as annual reports and accounts and annual sustainability reports, and be subject to the same disclosure governance as financial reporting.
- **Exchange.** External exchange includes engagement within industry groups as well as transparent climate-policy engagement. SOEs should maintain awareness of the consistency of their messaging across all types of external engagement.

Some country case studies on contemporary governance practices in dealing with Climate Change risks are outlined in Box 32 on the next page.

SOEs generally help pursue development strategies of the particular sector or act as tools or facilitators to buy foreign technologies and know-how. SOEs should help promote the government's agenda for sustainability, and board members should embed sustainability into the mission of the SOE, along with corporate strategy and policy. This should be in line with the government's agenda on sustainability.

Box 32: Contemporary Governance Practices in dealing with Climate Change Risks

The private sector has been proactive in its governance practices for climate-change-related risks and the SOEs, that comprise more than 10 percent of the world's largest firms (World Economic Forum 2011), must follow suit.

Climate Change Board Committee - Firms that are proactive in acknowledging and understanding climate change risk have already established a firmwide committee, with representatives from the businesses and key functions, such as risk, communications, investor relations, legal, and compliance.

Often, these committees are co-chaired by a senior line-of-business leader, reflecting the fact that this is a business-first issue, and, in effect, co-led by the risk or sustainability leader. Such committees are empowered by the board and management to oversee the firm's approach to identifying and managing climate-related risks and opportunities associated with their organization, customers, and clients.

Example: PepsiCo has identified climate change as a business risk through its Integrated Risk Management Framework, a process that identifies, assesses, prioritizes, manages, and monitors the risks affecting the company across its operations. Long-term climate risks are considered by both the PepsiCo Board of Directors, including its Public Policy and Sustainability Committee, and the PepsiCo Risk Committee.

Chief Sustainability Officers - For a long while, sustainability was viewed as an internal-facing activity, focused on the firm's own environmental and social strategy, and how it is communicated to external stakeholders. As such, executives in charge of these activities have often sat within investor relations. The focus on climate change risk management is quickly changing the role and stature of those overseeing sustainability—chief sustainability officers (CSOs), sustainable finance directors, and ESG directors are being created or having their role materially broadened and elevated.

This new breed of CSOs is being charged with driving climate change risk into the fabric of a firm's strategy and operations. They must work closely with business lines to capitalize on climate-related opportunities and with the second line to formulate the firm's climate risk management strategy. Increasingly, these sustainability oversight roles are being repositioned to report to a chief administrative or chief operating officer, signaling their broader, strategic role.

Example: Companies such as Google, Procter and Gamble, Nike, MasterCard, Coca-Cola, SAP, Siemens, TATA Power, and so on have appointed dedicated CSOs.

Source: Ernst & Young Global Limited. 2020. *Being Business-Minded About Climate Change.* https://assets.ey.com/content/dam/ey-sites/ey-com/en_gl/topics/banking-and-capital-markets/ey-being-business-minded-about-climate-change.pdf?download.

Topic two: Role of the state representative on the SOE board[8]

SOEs with significant public policy objectives may warrant a state ownership entity representative on the board of the SOE. The representation of state officials on the boards of SOE can be of advantage as this provides for a liaison role and a channel of communication between the state and the SOE. The number of such state representatives acting as directors for an SOE may be defined in the governing legal framework, unless there is a clear prohibition for the same.

Such directors have a dual role to play: first, as a director of the company and second, as a representative of the state. The state representative should be allowed to function freely and use his judgement without any formalized briefing by the state before a board meeting with discretion whether to seek a briefing or make a report. The state representative has a crucial role to play in supporting the SOE's understanding and implementation of shareholder's policies (both financial and nonfinancial policies such as climate change and transition, gender diversity, and so on). (State policies are discussed in Part II, Module 4). Further, in SOEs that have dedicated public sector obligations, it is preferable to have directors from the public sector since a good understanding of the government process and decision-making are vital in these SOEs.

It is also the case that when ministers and public servants serve as SOE directors, they face conflicts of interest that may impede their ability to act in the SOE's best interest. While state representatives can play a very crucial role, in many countries, this is seen as a way to enhance the income of senior bureaucrats, leading to multiple mandates and appointments that are not competency-based, rather based on seniority or political affiliations. When SOE directors are selected primarily based on their political influence, the government's ability to hold them accountable for performance is also diminished. There is also the risk that at times, the state representative may have no voice in the operations of the SOE when there is a strong

Director's role on an SOE board is summarized below:

- Such a director should identify himself with the objects and goals of the enterprise, engage in joint thinking on equal terms, and not assume a superior status.
- He/she should not reserve his/ her position on matters before the board. However, others on the board should not expect him/ her to commit to the state in respect of matters, which require to be referred to the state.
- In all subsequent examinations of the board-approved proposals, his/ her role should be mainly elucidatory, and he/ she should not sit in judgement over the board.
- Reference to the state for approval, sanction, and so on should be addressed to the state representative on the board whose responsibility should be to process the matter and obtain the necessary approval promptly.
- On proposals where the state's views must be necessarily sought, the state representative must ensure that the same is properly presented before the board while a decision on such proposals is being taken. The board should only take such decisions when the state representative is present in the board meeting.
- The representative may also be involved in periodic financial oversight of the SOE like other board of directors with the specific responsibility for reporting to the state. Similarly, they may also play a crucial role in strategy development and monitoring its implementation to ensure SOEs alignment with envisaged public policy objectives.

presence of independent directors or they may have an excessive voice interfering in day-to-day management activities.

There is a growing recognition that certain public sector representatives are not acceptable to SOE board members. For example, Nordic countries have gone further than most jurisdictions to formally limit the weight of politicians in SOE boards. Active politicians including members of parliament, ministers, state secretaries, as well as civil servants, who within their remit exert regulatory or controlling authority over the SOE, cannot be elected to the board of directors in Norway.

Despite the conflicts discussed above, ministers and public servants continue to serve on SOE boards. Therefore, it is significant that the government allows SOEs full operational autonomy to achieve their defined objectives and refrain from intervening in SOE management through its appointed representative. As mentioned earlier, for the SOE to function effectively, it requires a clear delineation of the respective roles of the state as a shareholder, of the board including the state representative director; including what the board is required to do and when the state, as an owner, should provide explicit approval or oversight.

The number of directorships a state representative may hold should also be defined in the legal framework. An officer should not have too many directorships on the boards of SOEs so that he/she can do adequate justice to his/her role as a state representative.

Cross-cutting themes – Integrity and anti-corruption

Corruption can plague SOE's financial growth and its valuations and investor perceptions and lead to misallocation of scarce government resources. Lack of independent and professional SOE board members weakens the ability for oversight of the companies' operations and management, facilitating bribe-taking and political or third-party influence over SOE resources. Inadequate scrutiny in the nomination process, lack of oversight and unclear objectives make assessing managerial performance difficult. They also make it easier for government officials to interfere in company affairs for political gain.

The appointment of board members by public officials might be driven by political motives, either financial or otherwise. For instance, the Petrobras scandal in Brazil was in part used as a financing vehicle for political activity. Petrobras, the largest oil company in Brazil, is an SOE. In 2014, public prosecutors and the Brazilian Federal Police began an investigation ('Car Wash') that would reveal a major corruption scheme centered on Petrobras. It involved billions of dollars in kickbacks from large contracts paid by suppliers to executives of the oil company and politicians, a cartel of contractors that overcharged Petrobras, and Swiss bank accounts (Lima-de-Oliveira 2019).[9]

It is a prime responsibility of the state to ensure that boards have the necessary authority, diversity, competencies, and objectivity to autonomously carry out their function with integrity. The corporate governance framework should ensure that the board is accountable to the company and to the shareholders, and, where legislated, subject to parliamentary control, recognizing citizens as the ultimate shareholder. This includes, among others, that[10]

- Politicians, who are in a position to influence the operating conditions of SOEs materially, should not serve on their boards. Civil servants and other public officials can serve on boards under the condition that qualification and conflict of interest requirements apply to them. A pre-determined 'cooling-off' period should as a general rule be applied to former politicians.
- An appropriate number of independent members–non-state and non-executive– should be on each board and sit on specialized board committees.
- Any collective and individual liabilities of board members should be clearly defined. All board members should have a legal obligation to act in the best interest of the enterprise, cognizant of the objectives of the shareholder. All board members should

have to disclose any personal ownership they have in the SOE and follow the relevant insider trading regulation.

- Members of SOE boards and executive management should make declarations to the relevant bodies regarding their investments, activities, employment, and benefits, from which a potential conflict of interest could arise.
- Board members should be selected based on personal integrity and professional qualifications, using a clear, consistent and predetermined set of criteria for the board as a whole, for individual board positions and for chair, and subject to transparent procedures that should include diversity, background checks, and as appropriate, mechanisms aimed at preventing future potential conflicts of interest (for example, the use of asset declarations).
- Mechanisms should exist to manage conflicts of interest that may prevent board members from carrying out their duties in the company's interest and to limit political interference in board processes. Potentially conflicting interests should be declared at the time of appointment and the declarations should be kept up to date during board tenure.
- Mechanisms to evaluate and maintain the effectiveness of board performance and independence should be in place. These may include, among others, limits on the term of any continuous appointment or the permitted number of reappointments to the board as well as resources to enable the board to access independent information or expertise.

As an ombudsman of the state, the representative has added responsibilities to ensure integrity and transparency in the SOEs performance and reporting in addition to ensuring one's integrity. The state representative must abide by the approved code of conduct of the board and the whistle-blower policy; disclose his personal interest in the SOE, if any; exercise adequate care and caution while dealing with unpublished price-sensitive information; and make adequate disclosures in line with the legal framework.

Topic three: Differentiate managing versus directing and identifying dilemmas

Directors often find themselves confronted with conflicting pressure. Some board tasks address the company's performance, while others deal with conformance with the law and other standards. Some require the board to be inward-looking, while others require an outward-looking approach. Some are future-focused; others are past- and present-focused. As a result, most boards continuously face dilemmas. Some of these include

- Being entrepreneurial to drive the business forward while exerting prudent control
- Knowing enough about the company to answer for its actions, yet being able to stand back from day-to-day management
- Sensitive to the pressure of short-term issues and yet being informed about broader and long-term trends
- Broad knowledge about local issues and awareness of national, international, and even global opportunities, competition, and other influences
- Focus on business's commercial activities while acting responsibly toward the other stakeholders including the state

In this regard, it is essential to know the difference between the role of directors and managers (refer Table 24 on the next page).

Table 24: Major Differences between Direction and Management

	Directors	Managers
Decision-making	Required to determine the future of SOE and protect its assets and reputation. They also need to consider their decisions related to stakeholders and the regulatory framework	More concerned with implementing board decisions and policies
Duties and responsibilities	They have the ultimate responsibility for the SOE's long-term prosperity. Directors are normally required by law to apply skill and care in exercising their duty to the company and are subject to fiduciary duties. They can be personally liable if they are in breach of their duties or act improperly. They can be held responsible sometimes for the company's acts.	Not bound usually by directional responsibilities
Leadership	Provide intrinsic leadership and direction at the top of the organization.	Day-to-day leadership is in the hands of the CEO; managers act on the directors' behalf.
Ethics and values	Play a key role in determining the company's values and ethical positions	Must carry out the ethos, taking direction from the board.
SOE's administration	Responsible for the SOE's administration	Related duties associated with the SOE's administration can be delegated to management, but this does not relieve the directors of their ultimate responsibility.
Statutory provisions	In many countries, numerous statutory provisions can create offenses of strict liability under which directors may face penalties if the SOE fails to comply.	These statutory provisions do not usually affect managers.

Source: Adapted from World Bank 2014.

Topic four: Director's legal duties and liabilities

Boards of directors have two principal fiduciary duties toward the company: the duty of care and the duty of loyalty.

- The *duty of care* is an obligation to exercise reasonable diligence and care in performing acts that could potentially harm shareholder interests. This duty requires board members to inform themselves on all issues that could affect the SOE and to make fully informed decisions. One practical implication is that board members need to satisfy themselves that control systems are functioning properly and providing good information. The duty of care also requires that board members act professionally, avoid serving on too many other boards, and receive adequate training and other support.
- The *duty of loyalty* is generally defined as a duty of allegiance to the SOE and its interests. A common interpretation is that this duty requires board members to raise the value of the enterprise for its owners. Additionally, it requires board members to prevent their personal interests from prevailing over the interests of the SOE or its shareholders. The board members should not allow the interests of others—including managers, other board members, and prominent government or political officials—to prevail over those of the SOE.

Other fiduciary duties include the following:

- ***Act in good faith in the company's interest.*** Directors must act in good faith in what they consider the company's

interests; they should not have a personal motive in making decisions. In many jurisdictions, a 'business judgment rule' exists. In these jurisdictions, there is a presumption that in making a business decision, the directors acted on an informed basis, in good faith, and the honest belief that the action taken was in the best interests of the company. When a director can demonstrate that the one has acted with all due loyalty and exercised all possible care, the courts will not second guess the director's decision and defer to one's business judgment. A court will not challenge a decision made by directors unless it is clearly fraudulent or negligent; this is irrespective of whether it was a 'good decision' in light of subsequent developments.

- ***Proper purpose.*** The company's constitution, relevant shareholder resolutions, and board minutes determine the specific power that directors possess and the manner in which they can be exercised. These powers must be used for the purposes intended and the company's benefit. Acting honestly, a director will have performed one's duty if the one reasonably believes that a transaction is for the company's benefit.
- ***Not to make secret profits.*** If a director makes a personal profit arising out of one's relationship with the company without any intimation about this transaction to the company, even if the director is acting honestly and in the company's interest, that profit normally belongs to the company. Further, the director is under a duty to account to the company for the profit. This principle has been extended by the courts in many countries to profits arising out of the directors' making personal use of company information or usurping a corporate opportunity.
- ***Avoiding conflicts of interest.*** Directors must not let their personal interest conflict with their duty to the company. They may put themselves in a position, where there is a potential conflict between their personal interests and their duties to the company, but they must always prefer the company's interest to their own.
- ***Declaring an interest.*** Directors should declare the nature of the interest at the first board meeting, where the question of entering into a contract in which they have an interest is considered. Failure to do so is a criminal offense in many countries, and fines can be imposed. The director may be liable to repay any profit made, and the company may void the contract or transaction. When the interest arises only after a contract has been proposed or made, the director should declare the interest at the next board meeting, whether that contract is to be considered at that meeting.
- ***Loan to directors.*** Loans from the company made either directly or indirectly to directors are normally prohibited in most countries unless otherwise specified.

Once implicit and dependent on legal precedent in many countries, these duties are increasingly explicit in company law. This is true both in common-law countries, where these duties originated, and in civil-law countries, where the duties must be explicit in law to have legal standing. Board members of SOEs that come under company law should also be legally bound to carry out these duties. If an SOE does not set out explicit legal duties for board members, these duties should be covered in a code or policy that applies to the SOE.

One implication of explicit legal duties is that they require board members to act in the interest of the shareholders and avoid treating any group of shareholders unfairly; this is a challenge when the controlling shareholder is the state. Another implication is that board members may be sued for taking negligent actions or those not in the interest of the company. For members of private sector boards, the possibility of being sued—whether by shareholders, the company, or regulators—varies widely. Practically unknown in some countries, such suits are common enough in others that board members feel compelled to take out insurance against them. In many countries, the insurance cannot indemnify directors for breach of trust (for example, willful crimes against the company itself). For SOE board members, liability varies even more.

Those who are civil servants may have no liability or have distinct liability as government or state employees. In some jurisdictions, those, who are not civil servants, may still be treated as state employees and have a related liability. This liability depends very much on the legal framework for SOE and government employees. SOE board members may also face the possibility of investigation by state auditors, anti corruption bodies, or other state vigilance entities.

Director's rights – Directors in most countries normally have the right to the following:

- Information to carry out their duties
- Access to company information, such as accounting data or records
- Discharge their duties without interference from co-directors
- Participate in the company's management and both attend the board meetings and vote at them
- Receive reasonable notice of meetings
- Obtain outside advice if necessary, for example, beyond the management of the company (Examples of advice may be in a company's valuation, pension liabilities, a major transaction such as a takeover, or in determining if a takeover offer is 'fair'.)
- Delegate (This may involve the delegation of action to implement a board decision to executive management or to board committees, but a director is not able to delegate the leadership responsibility itself.)
- Claim reimbursement of expenses.

Notes:

5 The term 'board' in this Kit, refers to the supervisory board in case of a two-tier board system.

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The Board

Leadership Training Toolkit for SOEs

Part II Module 3
Board practices and procedures



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Part II Module 3: Board practices and procedures

This session (module) covers the following topics:

1 Role of company secretary

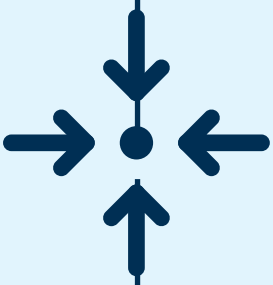
2 Meeting preparation and conducting meetings

3 Follow-up and in-between meetings

4 Communicating with the state/shareholder

Learning objectives

By the end of this module, the participants will be able to



- **Explain the role of a company secretary**
- **Identify good practices for preparing and conducting effective board meeting**
- **Clarify board meeting roles and responsibilities for the chairman, directors and corporate secretary**

Agenda

Total time: 1 hour 40 min

Time	Topic
20 min	Role of company secretary
10 min	Meeting preparation
10 min	Conducting meetings
10 min	Follow-up and in-between meetings
10 min	Communicating with the state/shareholders
40 min	Group activity: Board meeting simulation

Topic one: Role of the company secretary

The company secretary plays an important role in improving board professionalism and effectiveness, by facilitating the board's duties and obligations. The company secretary is primarily responsible to coordinate compliance with all laws and regulations as laid down in the respective country.

The term 'company secretary' is commonly used in the United Kingdom and other commonwealth countries. In the United States, Canada, Eastern Europe, and post-Soviet states, the term 'corporate secretary' is more common. Another commonly used term is 'board secretary'.

The company secretary is responsible for[11]

- Identifying and advising why certain corporate governance best practices should be adopted by the organization. This may be a result of compliance with laws, regulations, standards, and codes, or because the practices make good operational sense for the organization.
- Implementing within the organization those best practices through the creation and maintenance of cultures and relationships. This usually requires the corporate secretary to answer the 'how we implement' question, which requires corporate secretaries to have emotional intelligence skills as well as technical skills.
- Facilitating communication between board members, the board and management, the chairman and the CEO, the company and its shareholders, and the company and its stakeholders.

The role of the company secretary in board practices include conducting board meeting, which in turn involves preparing the agenda for the board minutes, recording the board proceedings, and the minutes of board meetings, ensuring that board members have access to the information required to facilitate board decisions, among others.

Table 25 describes the role of the company secretary at various stages of the board proceedings.

Table 25: Role of the Company Secretary

Board practice	Company secretary's role
Preparing board meetings	Prepares agenda promptly with the chairman Distributes board on time and keeps members well informed
Conducting board meetings	Maintains a record of the meeting to produce the minutes Addresses the chairman on procedural matters
Follow-up	Produces and distributes minutes of the meetings Recognizes confidentiality of board discussions outside the meeting

Source: Adapted from World Bank Group 2014.

Topic two: Meeting preparation

Setting the agenda for the meeting

Regular board meetings are essential for good business and accountability. In ascertaining the competitiveness of SOEs, it is important to inculcate the best practices among the board regarding board practices. This is particularly significant in conducting regular meetings of the board. In this regard, it is essential to lay down the best regarding the agenda and execution of the meeting.

The board agenda determines the issues under discussion. The chairman and the corporate secretary with input from the CEO of the SOE generally put it together. In principle, the nature or number of items that the board may wish to consider is limitless. Any director can request the chairman to include a matter on the board agenda. The chairman must offer directors the opportunity to suggest items, which cannot be reasonably denied. In the end, it is each director's responsibility to ensure that the right matters are tabled. **Key success factors for setting the agenda include the following:**

- Agendas should strike a balance between reviews of past performance and forward-looking issues.
- Strategic issues require ample time for debate, so the agenda should allocate discussion time.
- Some issues will need to be brought to the board several times as projects progress and circumstances develop.
- Care should be taken not to consume too much board time on routine or administrative matters.
- The agenda should show the amount of time allocated for each item, without unduly restricting discussion.

Drafting an agenda annual calendar

Boards in successful SOEs develop an agenda annual calendar to regulate the activities of the board. **This allows specific issues to be allocated enough time throughout the year's meetings.** Certain items will need to be fixed in association with the financial reporting cycle, but other topics are less time-specific and can be included on the board agendas when there are fewer items to discuss. A sample annual calendar is provided in Figure 20.

Figure 20: Illustrative Annual Calendar

STANDING ITEMS
• Approve minutes of previous meeting • Approve unbudgeted capital expenditure over $xxx • Review actual versus budgeted financial results • Approve board committee reports
FEBRUARY
• Previous year performance assessment • Dividend declaration for shareholders • Growth strategy discussion • Strategy review
MARCH
• Financial performance against other SOEs and private players in the same field
APRIL
• Business plan review for the next financial year
JUNE
• Review/approve strategic plan • Review of chairman's personal objectives • Dividend declaration for shareholders • Annual meeting resolutions • Set meeting schedule for next calendar years
SEPTEMBER
• Annual organization matters (committees, officer elections) • Dividend declaration for shareholders • Annual shareowners meeting • Review financial performance versus other SOEs and private players • Appoint external auditors
OCTOBER
• Strategic plan review
DECEMBER
• Approve annual budget • Management development update • Dividend declaration • Strategy review

Source: Adapted from IFC 2008.

Meeting location

The board meetings should take place at a venue that is convenient to the directors (normally SOE office). Boards are increasingly holding at least one board meeting at other locations so that the directors can see the other sites.

Meeting frequency

Board meetings should be held regularly, at least four times in a year, with a maximum interval of four months between meetings. As a rule of thumb and in line with best practice, six to ten meetings are likely to constitute an appropriate number of SOE board meetings per year, particularly when committees meet between board sessions.

Board briefing papers and reports

Board materials should be summarized and formatted so that board members can readily grasp and focus on the most significant issues faced in the SOE, in preparation for the board meeting. The quantity of information provided may not bear a relationship to its quality. Less information, if effectively organized, is often better.

If a proposal is more complex or requires additional explanation, the board should consider delegating the matter to a board committee or arranging one-on-one briefings by the proposal's promoter with each director. The SOE directors should inform the chairman whether the information they receive is insufficient for making sound decisions and monitoring responsibilities effectively.

Director's time input in meeting preparation

Directors typically should allocate at least as much time for preparation as for the board meeting itself. With strategy retreats or 'away days', travel, reading, meeting preparation time, and attendance at ad hoc and committee meetings, directors usually spend three or four days per month for a single, non-executive director position.

The time spent preparing for audit committee meetings is normally longer than that for most other board meetings. Given the time commitment of directors becomes an issue, the SOE may wish to limit the number of external appointments that directors can hold. Directors should always evaluate the demands on their time before allowing themselves to be considered for an appointment. The SOE directors should disclose any other board or external appointment to the nomination committee before their appointment and regularly update the board.

Briefing papers are ideally expected to be

SHORT

- Board papers associated with a particular agenda item need not be more than four to six pages, with any further detail provided in annexes.

TIMELY

- Information should be distributed at least five business days before the meeting.

CONCISE

- This allows board members, particularly the independent directors of the SOE, who are not as familiar with the workings of a state corporate institution to fully consider the issues before the meeting.

FOCUSED

- The papers should present the issue for discussion, offer solutions on how to effectively address the issue, and provide the SOE management's view on which action is to be taken.

Topic three: Conducting meetings

Board meeting duration

The duration of meetings should be tailored to the issues requiring board consideration. Ideally, board meetings should last no more than four hours and conclude with lunch or dinner so that members can continue more informal conversations.

It is usual for boards to have lengthy strategy discussions, which are often held as separate, dedicated meetings. SOEs may consider dedicating two days of board activity for these 'strategy retreats' or 'away days', as is practiced in most private corporate establishments.

Some of the challenges in conducting board meetings in two-tiered board systems are outlined in Box 33.

Information requirements for board meetings

The mentioned requirements will vary among companies. In general, directors should expect to receive the following regular items at least five working days before the board meeting:

- **An agenda**: This should ideally not exceed one page.
- **Minutes from the last meeting:** Minutes will be discussed in more detail in the third topic of these notes. They should ideally not exceed four pages.
- **Management accounts:** These should not ideally exceed 10 pages.
- **Papers relating to specific agenda items:** These will vary in length but should not exceed 20 pages, even for the most complex items. The reports should be precisely structured with headings such as 'Purpose', 'Background', 'Issues', 'Impact', and 'Recommendations'. Whenever possible, the report's writer should list one's name as the author with responsibilities for its contents, the date and contact details. Many SOE chairmen privately express the view that their board papers are often double the length that they should be.

The chairman's role in board meetings

It is the chairman's responsibility to ensure that sufficient time is allowed for discussion of complex or contentious issues faced in the SOE. The objective is to create a board consensus around the decision.

If a director believes that decision-making is unduly hurried or that insufficient time has been allocated and unrealistic deadlines have been set, they should discuss these concerns with the chairman as soon as possible after the meeting.

Ample time should be allotted for interactive discussions among the SOE directors and

Box 33: Board Meeting Challenges in Two-Tier Board Systems

The separation of decision-management from decision-control in the two-tier board model may generate additional obstacles to non-executive directors to monitor management. Fewer joint meetings between executive and non-executive directors of two-tier boards compared to one-tier boards (Spencer Stuart 2013) may make it more difficult for the directors to build trust relationships, thereby potentially undermining the communication and flows of information between both boards. Furthermore, the absence of insider information may make it more difficult for non-executive directors on a supervisory board to fully understand and ratify strategic initiatives of the management board, thereby possibly frustrating decision-making processes. In addition, the distance of supervisory board members from the decision-making processes may make it more difficult for non-executive directors to provide resources to the firm, thereby missing value-creation opportunities.

Source: Bezemer, Pieter-Jan, Peij Stefan, Kruijs Laura de and Maassen Gregory. 2014. "How two-tier boards can be more effective." *Emerald Group Publishing Limited* 14 (1): 15-31.

managers. Management presentations should not consume more than one-third of the allotted time. Sometimes, to gain additional time, directors may arrange informal talks outside board meetings. These can be helpful if they are transparent, and decisions are only made at formal meetings. Board decisions for the SOE should always be made at properly constituted board meetings and must be formally recorded in the board minutes.

Delegation of responsibilities to board committees

There should be clear terms of reference for each board committee. Even if the board delegates some of its responsibilities to a committee, the board remains the ultimate decision-making authority and retains responsibility for all board decisions. For this reason, boards should follow their committees' work closely. The committees must draft and develop board reports after each committee meeting. In most cases, committees will make recommendations to the board for approval. The SOE board should undertake a formal and rigorous evaluation of each committee's performance annually as part of the board's performance evaluation responsibilities.

Voting practices at board meetings differ worldwide for different SOEs. In some SOEs, it is usual for a majority vote to signify board approval. In this situation, decisions are made quickly and minority dissent is accepted. However, many corporate governance experts argue that boards should be collegial and consensus must be attained on every agenda item without the need to take a vote. In this case, the chairman will often require skills in obtaining unanimity among the directors, even though the debate initially may have involved substantial constructive dissent.

Topic four: Follow-up and in-between meetings

Minutes

Minutes are the written record of a board or committee meeting. They must, at a minimum, contain the following details:

- Meeting location and date
- Names of attendees and absentees
- Principal points arising during the discussion
- Board decisions

Minutes record what happens at a meeting in a particular order, regardless of whether the meeting followed the written agenda. The minutes are important legal documents and by law, must be kept methodically by the SOE. They also serve as important reminders of action to be taken between meetings.

Minutes should strike a balance between being a bare record of decisions and a full account of discussions. On more routine housekeeping matters or more sensitive personnel issues, a brief record is appropriate. For most items, there should be a summary of the matter discussed and the issues considered. The final decision must be recorded clearly and concisely. This amount of attention is desirable to show that the board has acted with due care and complied with any legal duty and obligation.

The person drafting the minutes should always be mindful that in extreme circumstances, the information could be used as evidence in litigation. Given a director disagrees with a board decision, one may ask to have one's disagreement recorded in the minutes. This could be important to avoid future liability for any decision that involves a breach of law or misuse of the board's powers. In general, remarks should not be attributed to individual directors.

Table 26: Key Aspects for Recording Board Minutes[12]

Who drafts the minutes?	• The corporate secretary drafts and holds a record of the minutes of all board meetings.
By when should minutes be prepared?	• Minutes should be prepared within five working days after the meeting and must be kept in the SOE archives.
Who submits the minutes?	• The CEO, or the corporate secretary at a subsequent meeting for review and approval normally submits board minutes. • If members of the board or committee agree that the minutes appropriately reflect what happened at the meeting, the minutes are approved and their approval is noted.
What happens if there are errors?	• If there are errors or omissions, the minutes must be corrected. Changes should be made immediately and the amended minutes must be approved as amended.
How can last-minute amendments be avoided?	• It is a good practice to provide directors with a draft copy of the minutes five business days after the board meeting and before the next meeting. This allows directors to be reminded of the decisions involving action before the meeting and also avoids delay at the next meeting.
When should a director approve the minutes?	• Generally, it is not considered appropriate for the director to approve minutes for a meeting that one did not attend. The director thus should have attended the meeting and also thoroughly gone through the details before approving them.

Source: Adapted from World Bank Group 2014.

Table 26 provides key aspects to comply when recording minutes.

Meetings for non-executive staff

Some SOEs have developed the practice of regularly scheduling executive meetings of the non-executive directors. These sessions are normally held on the same days as the regularly scheduled board meetings. The chair of the nominations or corporate governance committees normally presides at these sessions.

While confidentiality is an essential element in conducting and executing meetings of the board, it is also imperative that the rights of the minority shareholders are protected. While all board papers and proceedings should be considered to be highly confidential and great care should be taken not to discuss or disclose any board meeting content or proceedings outside the boardroom, all directors, that is, both independent and executive should be given the right information to ensure that the board is aware of the decisions and supervision of the implementation is made possible.

Topic five: Communicating with the state/shareholder

Communicating with the state

IFC's private sector opinion on The State of Governance at State-Owned Enterprises says that "Getting governance right at SOEs is daunting because of the added complexity of their operating model." In this regard, the OECD guidelines say that "The State should act as an **informed and active owner**, ensuring that the governance of SOEs is carried out in a transparent and accountable manner, with a high degree of professionalism and effectiveness."

SOE boards need to keep the state abreast with the details on all board meetings and the decisions made therein. This is also pertinent, given that in most developing economies, the state is a majority shareholder and thus is liable for the performance of the SOE.

To this end, the SOE must keep the state informed on the following practices as outlined in Figure 21.

Figure 21: Information to be Reported to the State by the SOE

- Inform the state on the impending meeting 5 business days in advance
- Circulate the meeting agenda with the intimation notice
- Communicate and circulate the minutes of the meeting for approval
- Circulate the key decision points on issues discussed for approval
- Record state approval on minutes and decision points
- Act on decisions agreed upon following state approval

Source: Adapted from World Bank 2014.

Communicating with non-state shareholders

Per the OECD guidelines, the SOEs should observe high standards of transparency and be subject to the same high-quality accounting, disclosure, compliance, and auditing standards as listed companies regarding their shareholders.

One of the elements involved in ensuring this transparency is by ensuring adequate communication on Board practices with the shareholders. Discussions on financial and nonfinancial information as well as the performance of the board are matters of concern for shareholders and thus all information regarding these aspects needs to be communicated to them.

To this end, either the company may choose to engage in town halls with their shareholders and the board, or they may choose to distribute the information in the form of annual reports, newsletters, and so on. **Generally, companies communicate with shareholders in three main ways:**

- Through releases to the market via stock exchanges
- Through information provided directly to shareholders
- At general meetings of the company

Firms are now increasingly using electronic media to share communication with their shareholders. **This communication usually pertains to the following:**

- Information briefings to media and analysts
- Notices of meetings and explanatory materials
- Financial information including annual reports
- All other company announcements

This communication process with general stakeholders of the SOEs bears similarity with private sector enterprises. However, since SOEs have a distinct characteristic of having the government as the major shareholder, all communication about SOEs inadvertently must follow the communication mechanism

set by the government. Depending upon the ownership pattern in the country (centralized, decentralized, dual-track or twin model), communication channels with the major shareholder are defined for the SOEs.

The board needs to ensure a policy on communication with the shareholder that identifies which director(s) would be the point of contact for the shareholder.

The SOE must establish and comply with clear communication channels that have been determined for shareholder interactions. This would entail assessing what would be the most effective communication channel, what channel would allow for directors and shareholders to be on the same page, and so on.

The SOE like its private sector counterparts must appreciate the value of a certain level of two-way interaction with its shareholders. In dealing with the issues that are being faced by the SOE, there may be times when a board meeting does not entail a clear-cut resolution strategy. It must be recognized that on occasion, interactions with shareholders may be of value.



Handout H2.3A: Red flags for boards

Activity

INSTRUCTIONS

The following red flags highlight the best practices associated with board practices among SOEs. As a director of well-governed SOEs, you should be able to answer 'Yes' to most of these questions. If you find yourself consistently answering 'No' or 'Do not know', then you should consider disclosure and transparency to be a priority for your board to consider.

Table 27: Questionnaire for Red Flags for Boards

Question	Y/N
Do the meetings finish on time?	
Are many of the issues discussed on the agenda?	
Are directors rarely absent?	
Are meetings consistent in duration set in line with the subjects being addressed in the meeting?	
Are you presented with strong analysis and thorough reports?	
Does the board receive effective and concise presentations?	
Are directors sufficiently provided with the required information?	
Are you presented with enough time before the Board meeting to prepare?	
Is the information kept confidential within the boardroom?	

Source: Author's consolidation.

Handout H2.3B: Board roles

Activity

INSTRUCTIONS:

Go through the table below and divide the group into a functioning board of a single SOE. Identify different roles for the chairman, director, board members, and corporate secretary. Conduct a mock meeting in line with the duties illustrated below.

Table 28: Duties of Chairman, Directors, Non-Executive Directors, and Company Secretary

Board practice	Chairman's role	Directors' role	Non-executive directors' role	Corporate secretary's role
Preparing board meetings	• Prepares agenda on time with the corporate secretary • Ensures agenda is focused on priorities • Ensures directors receive material information on time • Liaises with other board members	• Prepares briefing papers as appropriate including management accounts • Reads board briefing papers and keeps informed • Prepares for board discussion of agenda items	• Reads and reviews board briefing papers • Prepares for board discussion on provided agenda items and keeps informed	• Prepares agenda on time with the chairman • Distributes board materials on time and keeps members well informed
Conducting board meetings	• Maintains control of proceedings without dominating discussions • Facilitates decision-making by stimulating debate, drawing on all contributions, encouraging constructive discussions, ensuring that genuine disagreements are aired and resolved, steers the board toward a consensus • Ensures that decisions reached are properly understood and recorded	• Ensures regular attendance • Acts objectively and receptively to other perspectives • Does not dominate the discussion • Recognizes collective decisions	• Ensures regular attendance • Acts objectively and receptively to other perspectives • Does not dominate the discussion • Recognizes collective decisions	• Maintains a record of the meeting to produce the minutes • Addresses the chairman on procedural matters
Follow-up	• Coordinates minutes in association with the corporate secretary • Recognizes confidentiality of board discussions outside the meeting	• Reads the minutes • Recognizes confidentiality of board discussions outside the meeting	• Reads the minutes and attends executive sessions • Recognizes confidentiality of board discussions outside the meeting	• Produces and distributes minutes of the meetings • Recognizes confidentiality of board discussions outside the meeting

Source: Author's consolidation based on PwC analysis.

Notes:

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The Board

Leadership Training Toolkit for SOEs

Part II Module 4
Improving board professionalism and effectiveness



Photo: ©Etiamos/123rf.com

Introduction to the module

The OECD's guidelines on corporate governance of state-owned enterprises lay a strong emphasis on the board's ability to effectively carry out its intended functions.

The implementation of the guideline requires certain interventions to help improve the board's professionalism and effectiveness. Specific guidelines have been enumerated by the OECD to provide further guidance on developing interventions to achieve this objective. These include the following:

- The chair should assume responsibility for boardroom efficiency, and when necessary in coordination with other board members, act as the liaison for communications with the state ownership entity. Good practice calls for the chair to be separate from the CEO.
- Mechanisms should be implemented to avoid conflicts of interest preventing board members from objectively carrying out their board duties and limit political interference in board processes.
- SOE boards should consider setting up specialized committees, composed of independent and qualified members to support the full board in performing its functions, particularly concerning audits, risk management, and remuneration. The establishment of specialized committees should improve boardroom efficiency and should not detract from the responsibility of the full board.
- Under the chair's oversight, the SOE boards should carry out an annual, well-structured evaluation to appraise their performance and efficiency.
- SOE boards should set executive remuneration levels that are in the long-term interest of the enterprise.

This module examines these guidelines in further detail, elaborating on various interventions that can be explored to effectively implement these guidelines as illustrated in Figure 22.

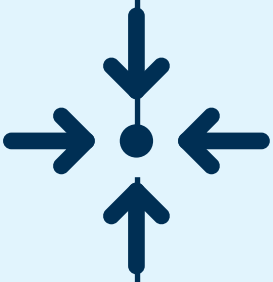
Figure 22: Interventions to Strengthen Board Professionalism and Effectiveness



Source: Adapted from World Bank 2014.

Learning objectives

By the end of this module, the participants will be able to



- **Understand policies and procedures for effective functioning of the organization**
- **Understanding the board evaluation process**
- **Develop solutions to improve a board's effectiveness**

Agenda

Total time: 3 hours

Time	Topic
30 min	Chairman and CEO – Role separation
30 min	Develop formal (written) policies and procedures for board operations
20 min	Board evaluation systems
30 min	Exercise
20 min	Characteristics of a dysfunctional board
30 min	Remuneration policies for the board
20 min	Board director training

Part II Module 4: Improving board professionalism and effectiveness

This session (module) covers the following topics:

1. Separating role of Chair and CEO



2. Formalizing board policies and procedures
(Board operations, conflict of interest, remuneration policies)



3. Board evaluation methods



4. Director training



Topic one: Chairperson and chief executive officer – role separation

Role of the chairperson – The chair has a crucial role to play in promoting board efficiency and effectiveness. It is the chair's task to build an effective team out of a group of individuals. This requires specific skills, including leadership, the capacity to motivate teams, the ability to understand different perspectives and approaches, the capacity to diffuse conflicts as well as personal effectiveness and competence. The chair of the board should act as the primary point of contact between the enterprise and the ownership entity.

Role of the CEO – The CEO is the highest-ranking executive in charge of management, responsible for managing the operations and resources of the organization. The CEO also typically forms the main point of communication between the board of directors and management. It is regarded as good practice that the chair is separate from the CEO. This begets the question as to why these roles should be separated.

Need for separation of roles of chair and CEO – Separation of the two roles helps to ensure a suitable balance of power, improves accountability, and reinforces the board's ability to make objective decisions without undue influence from the management. An adequate and clear definition of the functions of the board and its chair helps prevent situations where the separation might give rise to inefficient opposition between the two enterprise officers. It is similarly considered a good practice that the head of the management board (where applicable) does not become the chair of the supervisory board upon retirement.

Relevance to SOEs – Separation of the chair from the CEO is particularly important in SOEs, where it is usually considered necessary to empower the board's independence from management. The chair has a key role in guiding the board, ensuring its efficient running and encouraging the active involvement of individual board members in the strategic guidance of the SOE. When the chair and the CEO are separate, the chair should also have a role in agreeing with the ownership entity on the skills and experience that the board should contain for its effective operation.

Where one person is both the CEO and board chair, the CEO typically dominates the board, undermining the board's ability to oversee the enterprise. Generally, having a separate chair increases the accountability of the CEO as well as the effectiveness and accountability of the board. Experience from Chile, Estonia, Malaysia, Peru, Romania, South Africa, Thailand, and many OECD countries encourages the separation of these two positions. An example of a chair acting as a super CEO is outlined in Box 34.

Improving SOE performance and achieving a true separation of oversight and operational functions means that responsibility for day-to-

Box 34: Chair Acting as 'Super CEO' – Peru's COFIDE (Corporación Financiera de Desarrollo)

A related problem is the practice of having a full-time chair. This chair may become a 'super CEO', effectively controlling the day-to-day management of the company while the nominal CEO acts as a deputy. The roles of board chair and CEO were separated, but COFIDE's governance reforms left the chair with functions similar to those of the general manager, effectively giving the chair operational control and undermining the benefits of separation.

Source: World Bank Group. 2014. *Corporate Governance of State-Owned Enterprises: A Toolkit.* Washington, DC: World Bank.

day management must remain with the CEO. Leading the board is the job of the chair, who should be a highly qualified and independent board member.

In some countries, the chair is a minister or a senior politician. In that case, a new set of problems arises, and the objectivity of the board is reduced. As noted above, SOE boards should generally not include senior political figures, and the chair should be subject to the same criteria as those applying to other board members.

Topic two: Develop formal (written) policies and procedures for board operations

Rationale – SOEs often lack written procedures for managing board meetings, conflicts of interest, evaluation of directors, public disclosures, or other policy areas, or the procedures may be outdated and fallen into disuse. Developing formal procedures serves to protect both the SOE and the state and to promote consistency in decision-making. For similar reasons, a growing number of countries—such as Australia, France, and Spain—guide boards on how to better manage their work, including some model documents for SOEs and their boards. Fundamental documents for most SOEs include the following:

Memorandum of Association

The Memorandum of Association (MoA) comprises all the necessary information regarding a company that is required at the time of incorporation. The MoA supersedes the articles of association. This typically includes the following clauses:

- Registered name of the company
- Location of registered office
- Capital structure
- Shareholding pattern and subscriptions (if listed)

In the case of the SOEs, the details included in the MoA would be based on the manner in which the SOE has been established (either through its own act, the SOE act, or any other legislation).

Articles of association

Articles of association may be known as the company's constitution. National laws normally prescribe the content to be addressed in these articles for privately owned companies as well as state-owned enterprises. These provisions vary from country to country, but usually address the following:

- Maximum authorized share capital
- Shareowners' rights
- Share transfers
- Alteration of capital
- General assemblies
- Shareowner votes
- Borrowing powers
- Appointment/powers/duties of directors and the CEO
- Disqualification of directors
- Board proceedings
- Appointment/powers/duties of the corporate secretary
- Issuance of dividends and company reserves
- Accounts and audit
- Special provisions associated with privatization/disinvestment

Constituting Documents – The articles of association (or articles of incorporation/organization) is a term used in common-law countries. It is a short document setting out the company's registered address, capital,

objects, and limitations on liability. In other jurisdictions it might also be referred to as follows:

- Enterprise's charter
- Enterprises bylaws/statutes
- Deed of foundation – Generally, used in civil-law jurisdictions including Luxembourg. France uses 'statutes' (company statutes), and other terms used elsewhere include constitution and charter.

The contents of such a document may also vary from country to country and may need to be tailored as per the company law requirements.

Board and committee charters and procedures

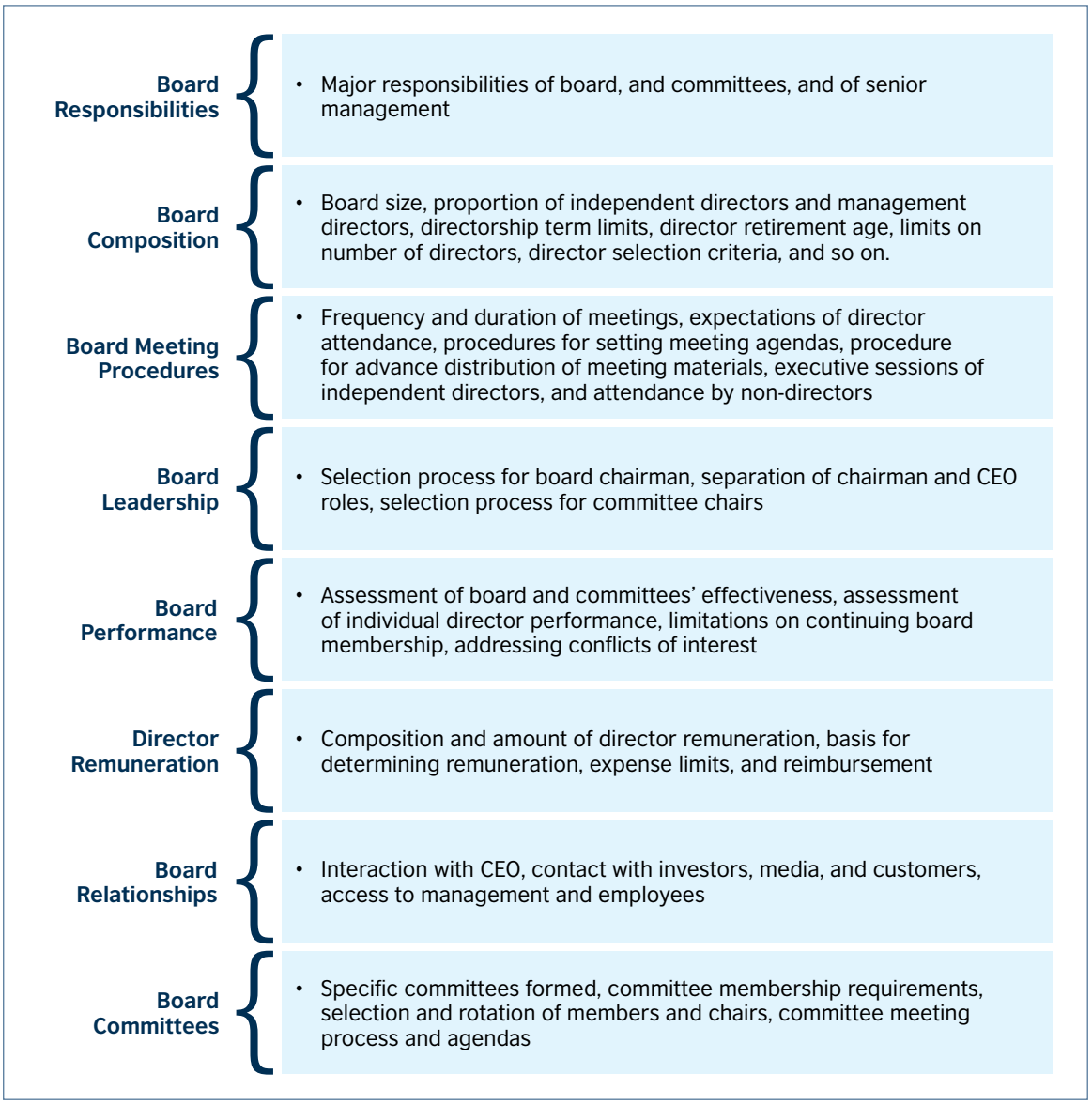
A board charter's purpose is to

- Improve and systematize the role and power of the board
- Enhance the transparency of its governance
- Demonstrate the company's commitment to good corporate governance practices

A company that plans to attract foreign investors must have a board charter that complies with international practice. A charter typically includes the following (Figure 23).

Schedule of reserved power – Many companies create a statement of reserved

Figure 23: Composition of a Board Charter



Source: Adapted from World Bank 2014.

power arising out of their board charter. A schedule clarifies the particular power in the company that the board reserves for its decision-making purposes.

These statements are regarded as evidence of good practice in corporate governance. A typical schedule would contain

- Auditor issues
- Communications to shareowners and the media
- Dividend payments
- Accounting and management control policies and practices
- Director and senior management appointments, removals, terms, conditions, and so on.
- Disposal or acquisition of major assets
- Major contracts and investments
- Authority levels
- Treasury, risk management, capital policies
- Budgets, strategies, mission, vision

Code of ethics

The purpose of a code of ethics is to

- Demonstrate the company's commitment to the highest standards of ethical behavior;
- Encourage proper ethical conduct and sanction misconduct within the company; and
- Develop an ethical culture based on such standards and conduct, led by the company's shareholders, directors, and management, and followed by all employees.

All the directors and employees should understand the standards of conduct, under which they are employed and evaluated. It is regarded as a good practice for boards to write their own code and to publish it internally and externally, as every company is different in size and industry, and each has a unique business culture and set of values. Such a code is sometimes referred to as: 'business principles', 'business philosophy', 'ethics policy', 'code of conduct', or 'conduct guidelines'. The ethics of an organization refer to the established values and principles it uses to inform and conduct its activities. Ethical business conduct provides strong organizational integrity, which should permeate its culture and drive its strategy, business goals, policies, and activities.

Codes of ethics should include guidance on procurement processes as well as specific mechanisms protecting and encouraging stakeholders, and particularly employees, to report on illegal or unethical conduct by corporate officers. In this regard, the ownership entities should ensure that SOEs under their responsibility effectively put safe harbors for employees' complaints in place, either personally or through their representative bodies, or for others outside the SOE. SOE boards could grant employees or their representatives confidential direct access to someone independent on the board or to an ombudsman within the enterprise. The codes of ethics should also comprise disciplinary measures, given the allegations be found without merit, frivolous or vexatious, and not made in good faith.

The boards should periodically monitor SOEs' compliance with codes of ethics. **In support of a code, the SOE may wish to**

- Establish an ethics training program
- Appoint an ethics officer and create an ethics office to advise and educate officers and employees, and provide guarantees for confidential counselling
- Establish a board ethics committee to oversee the company's ethics program

A code of ethics typically outlines the following:

- The company's values and ethical principles – These should be based on key principles such as honesty, integrity, fairness, and transparency. The ethical principles and standards should be based on the following:
  - Respecting the rule of law
  - Maximizing long-term value for shareholders
  - Conducting business with integrity and fairness, renouncing bribery and corruption, or similar unacceptable business practices

  - Demonstrating respect for the community the company operates in as well as for the natural environment

- Ethical standards for the company's relationship with key stakeholders:
  - Employees and officers – providing a healthy, safe, and secure environment for employees, providing equal opportunities for recruitment and advancement, non-tolerance toward discrimination, recognizing and rewarding employees for performance, and so on.
  - Customers – providing customer satisfaction, safe and quality products and services, fair pricing, and so on.
  - Relationships with business partners – good faith toward contractual negotiations and dispute resolution, high-performance standards for delivery
  - Government – paying taxes, abiding by the applicable laws and regulations, not engaging in bribery or corrupt practices, and so on.
  - Community, society, and the environment – environmentally responsible business and CSR
- Implementation of ethical standards and principles
  - Means to obtain advice – appointing ethics officers, constituting an ethics committee
  - Processes and responsibility – circulating code of ethics, monitoring ethics violations, and so on
  - Training programs – training employees on ethics code regularly

Corporate governance codes and guidelines

A corporate governance code sets out standards of good practice concerning issues such as board composition and development, remuneration, accountability and audit, and relations with shareholders. Based on this, detailed policies and procedures must be developed to guide behavior and operations within the organization. Table 29 gives a list of key in-house SOE policies.

Recommendation – Drafting a large number of policies and procedures takes considerable work, but in most cases, policies and procedures already exist. What may be required is revising and updating the documents and providing better access to them, to employees, and other stakeholders. For a code or policy issued by the ownership entity or another formal authority, ensuring access and providing awareness building are important steps.

All SOEs should begin by developing a checklist of what policies are present or missing, identifying those that need immediate attention and setting deadlines for review. The process of reviewing and updating written procedures should be assigned to a person such as a corporate secretary or chief legal counsel, who may need the assistance of lawyers or other experts. The board should check that the written policies and procedures are adequate and properly enforced.

Table 29: Key In-house SOE Policies

List of top in-house SOE policies
Policy on board diversity
Risk management policy
Investment appraisal policy
Climate risk and mitigation, adaptation and transition policy
Dividend distribution policy
Code of fair disclosure and conduct – practices and procedures for fair disclosure of unpublished price-sensitive information and prevention of insider trading
Whistle-blower policy
Policy for the training of directors
Policy on material subsidiaries
Policy on related-party transactions
Policy for the preservation of documents
Policy for determining the materiality of events/ information for disclosure to stock exchange(s)
Code of conduct for board members and senior management personnel
Corporate governance policy
CSR policy
Anti-money laundering policy
Media policy
Corporate loan policy
Website policy
Information security policy
Sexual harassment, workplace safety, and violence policy
Gifts, entertainment, gratuities policy

Source: Author's consolidation based on PwC analysis.

Topic three: Board evaluation systems

'Board evaluation' is a term that commonly refers to the assessment of the board as a whole, its committees, and its members.[13] Regular board evaluations are considered a good practice. Board evaluations help establish a comprehensive view of the board's overall functioning and identify any need that could be addressed through future nominations. It serves to assess and improve the board performance and provides the chair and ownership function with valuable information concerning possible changes to board composition.

A systematic evaluation process is a necessary tool in enhancing SOE board professionalism since it highlights the responsibilities of the board and the duties of its members. It is instrumental in identifying necessary competencies and board member profiles. It is also a useful incentive for individual board members to devote sufficient time and effort to their duties as board members. The evaluation should focus on the performance of the board as an entity. It could also include the effectiveness and contribution of individual board members. However, the evaluation of individual board members should not impede the desired and necessary collegiality of board work. Points to consider in the evaluation of the board as a whole and an individual director are given in Appendix A2.3A.

Board evaluation should be carried out under the responsibility of the chair and according to evolving the best practices. External or independent experts should be called upon as necessary. The board evaluation should provide input to the review of issues such as board size, composition, and remuneration of board members. The evaluations could also be instrumental in developing effective and appropriate induction and training programs for new and existing SOE board members. In carrying out the evaluation, SOE boards could seek advice from external and independent experts as well as the ownership entity. The suggested frequency for board evaluations is —internal evaluation can be done annually and external evaluations every three years.

The outcomes of board evaluations can also serve as a helpful source of information for future board nomination processes. However, a balance needs to be struck; board evaluations may be used to alert the ownership entity to a need to recruit future board members with specific skills that are needed in a given SOE board. However, they should generally not be used as a tool for 'deselecting' individual existent directors, which could discourage them from playing an active, and perhaps, critical role in the board's discussions.

Traditionally, SOE boards have lacked a formal process for evaluating board members, but that has begun to change. Egypt, Chile, India, Malaysia, New Zealand, South Africa, Thailand, and many if not most OECD countries now require or encourage boards to undergo regular evaluations. The aim is both to understand how members contribute to the board's tasks and to give members feedback on how to improve their performance.

An outline of the board evaluation process in Australia is provided in Box 35 on the next page.

The starting point is a self-evaluation of the board as a whole. As the board gains practice with the assessment, the performance of individual members may receive greater scrutiny. Because of the sensitivities, the results may remain confidential, although third parties could be involved in the evaluations. Evaluation of the board may also be carried out by ownership agencies, as, for example, in the case of China, where the State-owned Assets Supervision and Administration Commission of the State Council (SASAC) evaluates the boards of companies in its portfolio, focusing on both the standard operations of the board (such as operating mechanisms, board responsibilities, and institutional systems) and on the effective operation of the board (like the effectiveness

Box 35: Board Evaluation in Australia

Listed companies should disclose the process for evaluating the performance of the board, its committees and individual directors and should disclose, in relation to each reporting period, whether a performance evaluation was undertaken in the reporting period in accordance with that process. The Australian Stock Exchange (ASX) states that "it is essential that the Board has in place a formal and rigorous process for regularly reviewing the performance of the Board, its committees and individual directors and addressing any issues that may emerge from that review." The ASX recommends that the board should consider periodically using external facilitators to conduct its performance reviews. The Stock Exchange also suggests that when a listed company discloses whether a performance evaluation has been undertaken, the entity should, where appropriate, also disclose any insight it has gained from the evaluation and any governance change it has made as a result.

Source: IFC. 2015. *Board evaluation: Insights from India and Beyond.*

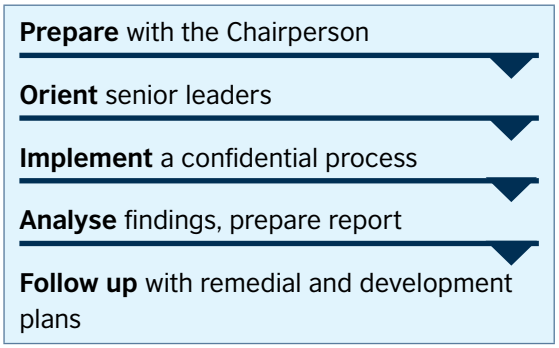
of decision-making and supervision and administration).

Results of performance evaluation fall into three categories: (a) well-performing boards that are recognized and encouraged; (b) boards in need of improvements that are given guidance and a deadline for making the needed changes; and (c) boards in need of restructuring that are required to develop and implement an improvement plan. (See Appendix A2.3A for a more detailed discussion of board evaluations and how they may be designed.) The key items usually evaluated include board performance against its objectives, board and board committee effectiveness, board relationships, board communications with management, and board processes and procedures. Experience suggests several lessons for conducting board evaluations:

- Obtaining commitment from the chairperson to carry out the evaluation
- Ensuring board agreement for self-evaluation or external evaluation
- Focusing on a limited number of defined issues
- Protecting anonymity in questionnaires
- Documenting the outcomes of the evaluation
- Reporting to the chairperson and the whole board (but not individual assessments)
- Reaching board agreements on an action plan and following up on implementation

Board evaluation typically involves the following steps:

Figure 24: Steps in Board Evaluation



Source: Adapted from World Bank 2014.

Topic four: Characteristics of a dysfunctional board

Box 36 provides guidance on the characteristics of a dysfunctional board that may be identified during a board evaluation as well as the mitigating actions that can be explored to address these challenges.

Box 36: Characteristics of a Dysfunctional Board

Wrong size and composition – If this is the case, the chairperson should consider altering the board size by

- Requesting the nominations committee to initiate selection and appointment processes
- Ensuring gender diversity in composition,
- Taking appropriate steps to remove directors, if required.

Insufficient range of expertise – If this is the case, the chairperson should consider requesting the nominations committee to initiate a study of the personal skills, knowledge, and attributes required by the board.

Inadequate information provided – If this is the case, the chairperson should ask the company secretary to remedy the situation.

Inadequate debates and few overt disagreements or differences of opinion – If this is the case, the chairperson should consider encouraging non-executive directors to be more independent, challenging, and critical in their behavior at board meetings.

Individual board member or small inner groups outside of the board make all major decisions – If this is the case, the chairperson should consider reviewing the statement of reserved powers.

Few reviews to see if the decisions were correct – If this is the case, the chairperson should consider initiating a regular review of the board's material decisions.

Fail to identify the risks facing the company – If this is the case, the chairperson should consider initiating a regular review of the company's risk profile.

Fail to keep the company's finances under review—If this is the case, the chairperson should consider initiating a regular review of the company's financial health.

Unprepared board members – If this is the case, the board size should be reviewed, committee responsibilities may be reallocated or rotated between members.

Source: IFC. 2008 *Toolkit 3: Corporate Governance Board Leadership Training Resources Kit*. World Bank Group. https://www.ifc.org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_site/ifc+cg/resources/toolkits+and+manuals/leadershiptoolkit.

Topic five: Remuneration policies for the board

Good practice calls for board remuneration to be competitive and set in a way that attracts, motivates, and retains qualified people and serves the interests of the company. It also calls for the board to determine the level of remuneration paid to directors. However, in some jurisdictions, director remuneration is directly set by the shareholder or needs the approval of the shareholder. SOE board remuneration practices differ by country, by the size and complexity of SOEs, and by listing status (listed or unlisted). They also differ between the executive and non-executive directors.

Executive remuneration – For executive directors, salaries and benefits are generally considered adequate compensation for any board-related duties they may have. Such directors typically do not receive additional compensation for sitting on boards. Excessive executive remuneration is being benchmarked against the competition and it is being linked to performance. Particular attention is being paid to the effectiveness of compensation plans in attracting and motivating CEOs and other senior executives. Remuneration is typically set by the government or by remuneration committees of the board. The approval of the government or the general assembly is usually required to ensure the transparency of remuneration and keep it from leading to excesses.

Some countries require that executive remuneration is set within the confines of broader public sector pay policy, but it is important that the policy allows board discretion and does not limit the ability of the SOE to hire competitively. For that reason, greater flexibility is being given to SOE boards in setting remuneration.

Non-executive remuneration – For non-executive directors, good practice calls for board remuneration to be competitive and set in a way that attracts, motivates, and retains qualified people and serves the interests of the company. It also calls for the board to determine the level of remuneration paid to directors.

In the case of SOEs, however, remunerations of non-executive directors give rise to special issues. One issue is the remuneration of civil servants, who serve as government nominees on the board. Contrary to good practice, many countries treat civil servants just as other board members in terms of fees, and, in some cases, director liability. In Thailand, for example, civil servants, who are heavily represented on SOE boards, are paid the same amount as other board members in addition to their regular compensation, which can be substantial in listed companies, especially for the chair (World Bank 2012). Two potential conflicts arise with the practice of paying civil servants board fees: (a) it provides government officials with an incentive to take on more directorships, which may lead them to neglect their duties as public servants or prevent them from properly preparing for board meetings and (b) it may provide a strong incentive for government officials to seek to become nominees of the companies with the highest remuneration practices rather than where they can make the most difference.

Good practice suggests that fees should not be paid to civil servants, since they are performing board duties as part of their jobs. Provision of fees may compromise their duty of loyalty to the SOE (since the civil servants are beholden to ministers or others who nominate them) and can lead to the perverse incentives as discussed above. For these reasons, countries such as Lithuania and the Philippines do not pay directors' fees to civil servants. The aim is to prevent inappropriate practices and to ensure transparency, accountability, and prudence in the spending of public funds. Where fees are paid to civil servants, they should be treated like any other board members concerning their selection, responsibilities and accountabilities, and liabilities.

Another issue is that remuneration is often set or regulated by the government rather than by the board, which is contrary to good practice. As executive directors, the compensation of civil servants and other non-executive members—such as private sector members and independent members—is also sometimes determined by the government rather than by the board. Remuneration should ideally be determined by the board or its remuneration committee and be approved by the government or by the general assembly.

The structure and level of remuneration can also be an issue.

Remuneration typically involves the following components:

- Fees per meeting, or in rarer cases, a monthly or annual cash retainer
- Fees for additional work, such as on committee assignments
- Fees for additional responsibilities, such as serving as chair of the board or a committee
- Reimbursement for legitimate travel costs and business expenses

Board fees vary by country and within countries by the size and complexity of the SOE, by the market environment in which they participate, and by their listing status. Board fees tend to be higher in large SOEs and listed SOEs—and, in a few cases, higher for SOEs than for other listed companies.

In general, SOE board remuneration tends to be below what board members might be paid by comparable companies in the private sector, making it hard to attract and retain talent. Competitive rates may be less of an issue in SOEs that are mainly concerned with the delivery of policy and social goals. In major emerging market countries with a well-functioning private sector, and especially for those SOEs that operate in a competitive environment, the compensation of private sector boards provides a benchmark for setting remuneration. In Malaysia, for example, compensation guidance for government-linked companies calls for pay to be set at the 50th percentile of an appropriate peer group. The peer group should reflect similarities in various attributes: (a) skills, experience, and time commitment required of the board members; (b) the company's current situation (for example, if it is undergoing significant change or experiencing high growth); and (c) the company's aspirations (for example, to be in the top three in market share in the country or region) (Putrajaya Committee 2006). In other cases, such as the Arab Republic of Egypt and India, remuneration levels are often significantly below what board members might be paid by comparable companies in the private sector. While government control prevents the SOE board from overpaying itself, low compensation makes it difficult to attract those who could add maximum value. It also creates incentives to hold more board meetings than are needed to obtain sitting fees and increase compensation.

Other forms of compensation such as short-term bonuses and benefits are also available, but they need to be designed properly, as they align the interests of non-executive directors closer to management and may encourage the management to take excessive short-term risks. Performance targets also need to be carefully designed so that they are not manipulated or 'gamed' to improve pay. Bonuses may also compromise the independence of directors. Thus, while bonuses can help attract and motivate directors, how much of a board member's pay can and should be tied to performance targets, needs to be carefully considered.

Many of the above problems stem from a lack of clear board remuneration policies, and a first step should, therefore, be to develop a proper policy. Given the wide range of SOEs in a given country as well as wide variations among countries themselves, it is not possible to recommend a single policy approach. Several factors will affect, including the prevailing laws and regulations, industry practices, existing company practices, the size and complexity of the companies, and the market environment in which they operate, among others. Nevertheless, the following principles are useful in developing board remuneration policies:

- SOEs should be grouped according to their characteristics so that fees may be

comparable by SOE size and industry, given the wide differences by industry, particularly in financial and nonfinancial sectors.

- Compensation practices of private sector boards provide a benchmark, although there may be a preference for applying a 'public sector discount', in recognition of the public nature of SOEs.
- Remuneration should be competitive and commensurate with the directors' responsibilities and accountabilities.
- Care must be taken to ensure that the packages are not set so high that they jeopardize the independence of directors.
- All non-executive board members should be paid the same amount.
- Remuneration structures should be kept simple, with both fixed and variable components. They should be structured in a way that provides incentives for taking on additional responsibilities, for example, the chairmanship of a committee.

Topic six: Invest in board director training

A well-run and capable board is more likely to attract competent and qualified directors. Likewise, the appointment of high-caliber directors will raise the performance of the board and vice versa. However, board members, with little or no preparation, are often appointed to their positions. Too often, it is assumed that the skills and experience they bring are enough. Board members may think they do not need training, or they find it tedious or too academic.

It takes time for a board member to become effective. Thus, there is a substantial payoff from investing in training, both specific training for individual roles and more general board training. More and more countries are undertaking training programs for directors, and many are making training mandatory—in some cases even before they are selected for the position.

Box 37 (on the next page) informs that several certification programs are now rolled out, specifically for board of directors in many jurisdictions.[14]

Experience across a range of countries suggests that training is generally one of two broad types: general board training or induction training.

General training – General board training typically covers basic corporate governance principles and practices; business ethics; board duties, responsibilities, and liabilities; strategic thinking; communication skills and techniques; and specialized skills and tools in core areas such as legal responsibilities, risk management, internal controls, corporate reporting, and compliance. Ideally, training will include interaction with board members from other enterprises and sectors through formal case studies as well as informally.

Induction training – Even when board members have received appropriate general or professional training, induction training helps prepare a new director for the circumstances of a particular SOE. Such training should cover several specific issues:

- Background, mission, and challenges faced by the SOE, including industry-specific information
- Role of the board of directors
- Role, responsibilities, and power of a director
- Role of ministers and ministries
- Role of management
- Relationship between social and commercial objectives and how to manage potential trade-offs

Box 37: Case studies on Director Certification Programs Across Countries

Companies increasingly recognize the value that board directors can provide to their organizations. In particular, some companies seek to identify current and aspiring directors, who proactively focus on improving their professionalism through certification programs that demonstrate their knowledge and understanding and suggest the willingness for continual learning in what is an increasingly demanding profession. In some markets the director training institute maintains a database of certified directors, and companies can subscribe to it. For example, the Slovenian Directors Association invites members, who hold positions on supervisory boards of listed companies to become a 'chartered supervisory board member' by passing an examination. All candidates, who successfully complete the examination, are listed in a national register of supervisory board members.

Case of Institute of Directors (IoD) in New Zealand

The IoD in New Zealand has over 6,250 members. The Chartered Director program is designed to make transition of the IoD from a membership organization to a professional body. The program will offer members meaningful recognition for their experience and expertise, and to the market, it will assure the quality of the IoD members. The program was developed after extensive consultation with members and stakeholders. The new structure of the professional body involves six categories; the three most relevant categories are

- **Associate**—Required to meet all current membership requirements and subject to the IoD Code of Practice;
- **Member**—Nominated by a sponsor (experience guidelines, currently being developed, measure the quality of minimum experience levels using the IoD's Director Competency Framework); must engage in continuing professional development;
- **Chartered Director**—nominated by a sponsor and subject to a higher level of experience guidelines; requires references and meeting with an interview panel.

Source: IFC. 2013. *Behind Directors Certification Programs: Key Points to Consider.* Global Corporate Governance Forum.

SOE boards should be encouraged to develop common lists of information that will benefit all new board members. The induction process should be included among the formal procedures that enhance the professionalism of the board of directors. Induction training should focus on a basic understanding of the director's role and on how directors can contribute early on. Serving directors consider themselves less at risk, when new appointees join the board, knowing their responsibilities.

While training of this nature helps equip directors with the knowledge required to perform their duties more effectively, the typical coverage of general and induction training does not adequately cover themes such as environmental and social issues associated with various aspects of the SOEs operations.

The coverage of such training should encompass the following aspects:

- Identifying environmental and social risks – this covers risks that affect the SOEs' operations as well as those caused by the SOEs' operations. Such risks include
  - o Climate risks on business operations and the resulting contingent liabilities
  - o Potential environmental and social risks from new capital investment projects involving physical asset creation, for example, pollution and resettlement risks
- Designing and implementing mitigating actions to address environmental and social risks; these could include the following:
  - o Developing environmental and social risk mitigation plans as part of project preparatory activities
  - o Monitoring environmental and social risks
  - o Disaster recovery and business continuity planning

These issues require a behavioral and cultural shift at all levels of the institution to be addressed. Consequently, the board of directors must be trained in identifying and managing such risks, which will help induce an institutional shift toward recognizing the

importance of these themes in the SOEs operations.

Training can be offered in different forms. One approach is through training courses: a growing number of countries employ specialized institutes to prepare classes and methodologies geared to board members, distinct from more academic and youth-oriented education. These institutes have built a brand—and sometimes a club—that board members want to be associated with. Ownership entities have encouraged these institutions through direct support (or support from donors) and by encouraging or requiring SOE board members to receive training. Some countries, including Malaysia and Thailand, have specific institutes for SOE board members.

In markets too small to have a permanent institution, workshops can be arranged with experienced trainers from other countries, or board members from larger SOEs can go abroad. While both options can be costly, workshops, if they can be arranged, are more economical than offshore training (although offshore training might be more appealing to otherwise skeptical board members).

In another approach to training, directors are exposed to training through practice and continuous programs to master and sustain learned competencies. Learning from the best practice and peers is another option. Communications with peers can take place through a community of practice in different forums, such as regional or international networks on corporate governance or through company circles. Such networks provide a useful platform for exposure to good practices. Board members and senior executives should attend periodic workshops, update their knowledge, and participate in continuous professional education programs.

Notes:

13 Larson, Mary Jo and Pierce, Chris. 2015. *Board Evaluations: Insights from India and Beyond*. International Finance Corporation, World Bank Group. https://www.ifc.org/wps/wcm/connect/4b08172d-8e28-4280-914c-c9979bdce200/IFC_Board_Evaluation_Booklet_v9-PR-Lo-Res.pdf?MOD=AJPERES&CVID=kSxr.sW.

14 IFC. 2013. *Behind Directors Certification Programs: Key Points to Consider.* Global Corporate Governance Forum. https://www.ifc.org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_site/ifc+cg/resources/lessons+learned/behind+directors+certification+programs+-+dec+2013.

Appendix A2.3A Board evaluation

Evaluation can be applied to the board as a whole, to committees, and individual board members. For the board as a whole, the evaluation should be closely linked to the SOE's performance management system. Board evaluation systems will focus attention on specific corporate governance categories, including

- Board leadership. Chairperson's approach; board culture (principled, independent-minded); inclusion in deliberations and decision-making, and so on.
- Board structure. The appropriate number and types of committees; reporting lines between the board and management, and so on.
- Board composition. Size, skill mix, relevant experience; attributes (diversity, independence); the selection process, and so on.
- Company strategy. Board's understanding, contributions, and oversight
- Financial oversight and management reporting. Right information, appropriate tools, key risk indicators
- Board practices. Board meeting frequency, agendas, efficiency, minutes, and so on.
- Board development. Evaluation of senior leaders (CEO, directors), succession planning, professional development opportunities

For individual board members, the evaluation should recognize that being a good board member involves a mix of 'hard' and 'soft' skills. Individual directors may be evaluated across broad parameters given in Figure 25.[15]

The question of how to carry out a board evaluation is a sensitive and challenging one. Few boards or board members welcome formal performance evaluations. After all, board members have been selected for their stature, their competence, and their probity. One approach to outlining an evaluation system is by responding to three basic questions: (a) should the assessment be internal or external? (b) should it be qualitative or quantitative? (c) should it be a self-assessment or a peer assessment?

Figure 25: Parameters to Consider when Evaluating Individual Directors

Critical analysis	**Engaging communicator**	**Independent judgment**	**Intuitiveness**
Vision and imagination	**Interpersonal sensitivity**	**Strategic perspective**	**Influence**
Managerial experience	**Motivation**	**Resource management**	**Conscientiousness**
Achieving results	**Banking**	**Risk management**	**Financial analysis**

Source: Adapted from IFC 2008.

15 The International Finance Corporation. 2016. *The Corporate Secretary: The Governance Professional.* https://www.ifc.org/wps/wcm/connect/4b96fc61-80da-4508-98f7-8a3641e8178c/CG_CoSec_June_2016.pdf?MOD=AJPERES&CVID=llo4tQ-.

Table 30: Advantages and Disadvantages of Different Approaches to Board Evaluation

Feature	Advantages	Disadvantages
Internal or external assessment?		
Internal. An assessment of the performance of an organization (or its members) carried out by individuals within and connected to the organization being assessed	• More knowledge about the corporation and the board • Less costly than engaging an external assessor	• Often remains a chance of limited assessment experience • May be less objective than external assessment
External. An assessment of the performance of an organization (or its members) carried out by experts, who are not connected to the organization being assessed	• More objective assessment • Advanced assessment experience and tools	• Less knowledge about the corporation and the board • More expensive
Qualitative or quantitative assessment?		
Qualitative. An analysis of subjective measures that do not lend themselves to quantitative or numerical measurement; qualitative assessment is generally in narrative form	• May provide richer and deeper answers	• Time-consuming to complete properly • Harder to compile results
Quantitative. The use of numerical and statistical techniques rather than analysis of subjective measures of behavior; quantitative measurement is generally used to obtain responses in a numerical form	• Quick to complete • Easy to compile answers Standardized questions	• Less depth to answers • May miss important information not captured by questions
Self-assessment or peer assessment?		
Self-assessment. A process of critically reviewing the quality of one's performance; reflectively examining one's work to identify strengths, and weaknesses	• Enables individual directors to reexamine board or individual performance, mandate, roles, responsibilities, and so on.	• Offers only one perspective • Individual reporting bias
Peer assessment. A process in which individuals provide feedback on the amount, quality, or success of the performance of peers of similar status	• Chance to assess peers • Multiple viewpoints	• The discomfort of assessing peers • Newer board members may lack information on peers and their roles

Source: Adapted from IFC 2008.

Table 30 summarizes the advantages and disadvantages of the different approaches.

Since no board of directors wants to run the risk of embarrassment, an internal and qualitative self-assessment could be a good place to start. It may also be quite cost effective. However, self-assessments have evident limitations. External assessors can play a role in not only analyzing the governance of the SOE but also in educating directors, catalyzing a reform process, and drafting an action plan. Some companies use a combination of self-assessment and external assessment.

Once an SOE board has decided to undertake an assessment and selected an approach, practical recommendations to initiate the process include the following:

- Should be started with the full support of the board chair and the ownership entity
- Should not be to blame and shame
- Underscore that the objective is to improve the performance of the SOE
- Assign responsibility to an individual (internal or external expert) to manage the evaluation process
- Agree on relevant criteria for the evaluation and ensure that all the board members are informed of the criteria

All the board members should be interviewed to find out whether they have experienced governance problems that they believe

have affected the performance of the SOE. Any problem uncovered, should be clearly described and alternative solutions are to be discussed. All the results of this assessment should then be reported to the full board to develop an action plan with areas for improvement. Remedial actions might include reconstituting committees or revising their terms of reference, providing relevant training, recruiting new board members to address noted skill gaps, and, when necessary, considering changes to the present membership of the board. Progress against the plan should be measured at least, once a year.

The corporate secretary also has a role to play as the primary facilitator for the board to carry out these evaluations effectively.

The corporate secretary typically would be responsible for the items listed below:

- Identifying the requirements for evaluations in the organization's jurisdiction and advising the board chairman of them
- Informing the board chairman of the requirements and agreeing on what evaluations should take place
- Assisting the board chairman in explaining to the other board members the reasons for the evaluations, the types of evaluations, and how the evaluations will be carried out

Table 31 illustrates the corporate secretary's role in the evaluation of the performance of the board and board committees, and individual board directors.

Table 31: Corporate Secretary's Role in Evaluation of Board as a Whole and Individual Director

Evaluation of the performance of the board and board committees	Individual board directors' evaluations
• Advising the board in determining whether the evaluations should be carried out in-house (usually by the corporate secretary) or through engaging external consultants • Assisting the board in developing core criteria for the evaluation, including how to report the findings and actions resulting from the evaluation • Ensuring that the questionnaires and questions to be used for the interviews are tailored to deal with company-specific issues • Analyzing the questionnaires and the interview responses • Discussing the findings and recommendations with the chairman • Developing an action plan and monitoring progress against agreed actions/timelines • Ensuring that a reference to the evaluations is included in the corporate governance statement in the organization's annual report	• Assisting the chairman by organizing the evaluation of individual members of the board • Advising the board that the evaluation will be of the board members' performance as part of a team • Reassuring individual board members, persuading the chairman that it will be impossible for the board to function as a high-performance team without demanding high performance from its members • Advising the board that it is important to assess executive directors not just on their managerial roles but also as members of the board • Assisting the chairman in deciding who should stand for re-election or retire from the board • Developing directors training programs

Source: Adapted from IFC 2016.



Handout H2.4A: Policies, procedures, and assessment

Activity

INSTRUCTIONS

A. Directors/participants are required to assess the effectiveness of implementation and compliance of the policies across the following categories:

- None (when no such policy exists in their SOE)
- Weak
- Moderate
- Strong

Table 32: List of In-house SOE Policies

List of key in-house SOE policies	None	Weak	Moderate	Strong
Institutional and Governance-Related Policies				
Code of conduct for board members and senior management personnel				
Policy of corporate governance				
Anti-money laundering policy				
Investment appraisal policy				
Risk management policy				
Climate risk and mitigation, adaptation and transition policy				
Code of fair disclosure and conduct-practices and procedures for fair disclosure of unpublished price-sensitive information and prevention of insider trading				
Bribery and anti-corruption policy				
Whistle-blower policy				
Policy on diversity of board				
Policy for the training of directors				
Policy on material subsidiaries				
Dividend distribution policy				
Policy for the preservation of documents				
Operational Policies and Guidelines				
Media policy				
Corporate loan policy				
Website policy				
Information security policy				
HR policies				
Finance related policies				
Internal audit policy				
Policy on related-party transactions				
CSR policy				
Policy for determining materiality of events/information for disclosure to stock exchange(s)				

Source: Author's consolidation.

B. ***In cases when the participants include representatives of the state*** – Participants, who are representatives of state or ownership entity, are required to assess the effectiveness of implementation and compliance of the policies across the following categories:

- None (when no such policy exists in their SOE)
- Weak
- Moderate
- Strong

Table 33: List of SOE Ownership Policies/Guidelines

List of key SOE ownership policies/ guidelines	None	Weak	Moderate	Strong
SOE ownership policy				
Competitive neutrality policy				
Vigilance policies (includes guidance on acceptance of gift by government servants, scrutiny of annual property returns of officers/executives of SOEs, and so on)				
Guidelines on corporate governance				
Guidelines on SOE board member nomination and appointment				
Guidelines on investment of surplus funds				
Guidelines on capital restructuring				
Guidelines on foreign investment				
Guidelines on privatization of SOEs				
Guidelines on preparation and disclosure of financial statements				
Guidelines on public procurement				
Guidelines on delegation of power				
Guidelines on executive remuneration				
Guidelines on CSR of SOEs				
Guidelines on gender diversity				
Guidelines on grievance redressal mechanisms				
Guidelines on compliance with SAI audit				

Source: Author's consolidation.



Handout H2.4B: Action ideas

INSTRUCTION

Complete the following three statements:

1. I plan to take the following actions upon returning to my company/ownership entity:

2. Obstacles that may prevent me from implementing these actions are:

3. Actions I can take to overcome the anticipated problems are:

4. How will I measure success? Indicators, targets, and time frame:

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The Board

Leadership Training Toolkit for SOEs

Part II
Caselets

CASE STUDY

1. Board committees at Ravells

Ravells Energy was set up in 1967 and is a state-owned electricity distributor in its operating country. The SOE's corporate governance practices took a backseat due to the state's direct involvement in its oversight, management, and operations. Moreover, there were no independent directors on the board and its committees. However, with the incoming of a new government and its agenda to reform the SOEs in the country, several SOE corporate governance assessments were conducted. This necessitated SOEs, including Ravells Energy, to adopt concrete reform measures.

Current governance situation and key governance challenges faced by Ravells

Structure

The company originally had audit, program and finance, human resources, ethics and management, and formalization committees. A non-executive, who had close family ties with the country's President, headed the audit committee. Most committees needed to improve their capabilities.

Procedures

The board met quarterly, but the committees did not meet regularly. The committee proceedings were relatively informal with no set agenda.

What did it change?

Ravells Energy conducted a corporate governance assessment in 2018. As a result of the assessment, the board of Ravells Energy decided the following:

- **Board composition** – The company added a non-executive member with an accounting background to its board to enhance the board's skills mix. Formal terms were set at three years, with a maximum of three terms.
- **Board committee structure** – The company made changes to the committees' structure by
  - Establishing a new nominations committee;
  - Enlarging the scope of the audit committee;
  - Appointing a non-executive as the head of the audit committee;
  - Appointing two advisors with appropriate skills, one each to the human resources committee and the program and finance committee;
  - Appointing to the audit committee a non-executive director, with accounting experience.
- **Procedures** – The board now meets five times a year and focuses on improving the level and quality of discussions. Committees meet one or two days before the board meetings, and their meetings have become more structured and result oriented. There are set work plans in place and formal agendas circulated before each meeting.

Tasks

What do you think has been the impact on the organization of making the corporate governance changes in the Board Structure?

- None
- Weak
- Moderate
- Strong
- Substantial

Trainer notes
Distribute the case study handout; allow 30 minutes for reading and discussion.

Key discussion points
Ravells puts a high value on its governance. Good corporate governance practices are central to its operations and help it leverage its relations with its customers, donors, and commercial lenders. During the first round of corporate governance reforms in 2017, Ravells established key board committees to enhance the board's independence and effectiveness. Ravells underwent an IFC Corporate Governance Assessment in 2018. The impact of these reforms is that the board is more visionary now and actively involved in setting strategy and guiding management. It has enhanced its oversight capabilities by improving its accounting expertise.

2. Managing conflict of interest

You are a member of a board of a state-owned infrastructure bank. The SOE provides long-term and large funding to infrastructure projects in your country.

Board of directors

The board of directors is divided into the **executive branch,** with committees comprising **risk, appraisal and audit,** and an adequate number of **independent directors**.

Situation

The government has opened a tender for a major urban railways project in the country's third-largest city. The project is expected to take five years to complete and will be conducted on a public-private partnership (PPP) basis. The Infrastructure and Economic Development Bank that you are board members of will be involved in the selection process, because the assignment will require a substantial loan from the bank. While reviewing quotes, you come across a bid of a potential service provider that employs a family member of one of your board members on an executive level.

If this activity is used, the participants within the group can be given board member roles to role-play the board meeting.

If this activity is undertaken, discussions can be held on the following lines:

- While this is at a nascent stage, can this company be fairly considered in the bid review process?
- If the board member, whose family potentially benefits from selection, is in the Appraisal Committee, should the board member recuse himself from the review process? What process should be followed in the event of this decision?
- If the board member, whose family potentially benefits from selection, is in the Audit Committee, the conflict may be identified at a stage, where the bid is accepted and due diligence is being conducted. What are the implications for the SOE? What action can be taken regarding the board member and the bidder?
- If the board member is a part of none of the mentioned committees, yet has not declared a conflict, what action can be taken upon identification during due diligence processes? (This question can be answered by the trainees playing the roles of Audit and Risk Committee members.)
- If the board member is one of the executive directors of the SOE, what action can be taken to mitigate risk?
- If the board member were one of the independent directors of the SOE, what course of action would follow?
- How must the board member, whose close family member would inevitably benefit

from this selection, act upon this? (Keeping in mind one's Duty of Loyalty to the SOE)

- Discuss the reputational risk for the SOE and the risk regarding related-party transactions.

Tasks

Trainer notes

Distribute the case study handout, allow 30 minutes for reading and discussion.

Questions to focus discussion

- What should the executive board members say and do?
- How important is the board composition in this case?
- How commonplace are such conflicts of interest in your experience?
- What effective communication strategies can be deployed to convey the significance of putting the reputational interests of the SOE above one's benefit?

Part III



Strategy, Risk, and Performance

Leadership Training Toolkit for SOEs

Introduction to Part III: Strategy, Risk, and Performance

> *"Improved governance structures and processes help ensure quality decision making, encourage effective succession planning for senior management, and enhance the long-term prosperity of companies, independent of the type of company and its sources of finance."*
> – Why Corporate Governance, International Finance Corporation (IFC)

Part III explores the development of an effective business strategy, financial planning, oversight and decision-making, and risk governance of state-owned enterprises (SOEs).

Table 34: Coverage of OECD Guidelines on board of State-Owned Enterprises in Part III

OECD Guidelines	Coverage
The rationale for state ownership	☑
The state's role as an owner	☑
SOEs in the marketplace	☑
Equitable treatment of shareholders and other investors	☑
Stakeholder relations and responsible business	☑
Disclosure and transparency	☑
The responsibilities of the boards of SOEs	☑

Figure 26: Contents of Part III

Module 1	**Developing an effective business strategy**	• This module provides an overview of the development of effective strategy in SOEs, role of board and state in developing business strategy and specific tools for developing a strategy.
Module 2	**Financial planning and budgeting for SOEs**	• This module explains the process of financial managment in SOEs including the budgeting process in SOEs. The module also describes the review of SOE investments against the publlic investment management (PIM) guidelines.
Module 3	**Financial oversight and decision-making**	• This module details the financial oversight in SOEs and the corresponding decision-making process. The module will explain assessing the financial health of the SOE and the process of disinvestment and subsidiary governance in SOEs.
Module 4	**Risk governance**	• This module will describe risk management in SOEs. This will include concepts and nature of risk and strategies to manage risks.

III

Strategy, Risk, and Performance

Leadership Training Toolkit for SOEs

Part III Module 1
Developing an effective business strategy



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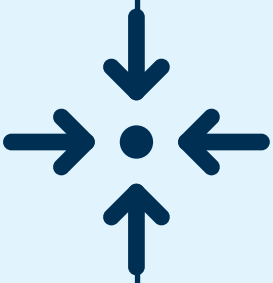
Part III Module 1: Developing an effective business strategy

This session (module) covers the following topics:

1. Elements of a good strategy
2. Board's role in the governance of a company's strategy
3. Strategic planning process
4. Tools to formulate strategy linking PMA and corporate governance code
5. Balancing SOE public service obligations with commercial obligations
6. Monitoring of strategy implementation, HR policy to support strategy

Learning objectives

By the end of this module, the participants will be able to



- **Explain balancing of commercial and public service obligations of SOEs**
- **Detail the role of HR in strategic management development and implementation**
- **Describe strategy monitoring process**
- **Define PMA and its links with corporate governance code**
- **Describe the role of board and management in strategy management**
- **Define the elements of an effective strategy and describe strategic planning process**

Agenda

Total time: 4 hours 40 min

Time	Topic
30 min	Elements of a good strategy
25 min	Board's role in the governance of a company's strategy, including governance of risk
30 min	Strategic planning process
30 min	Tools to formulate strategy linking performance management agreement and corporate governance code
30 min	Balancing SOE public service obligations with commercial obligations
30 min	Case study
30 min	Monitoring implementation of strategy by management
30 min	Exercise
45 min	HR policy to support strategy implementation

Topic one: Elements of a strategy

Strategy is how a company orients itself toward its market and its competitors. Flawed strategic thinking can lead to significant value erosion and even threaten a company's survival. Consequently, boards today are increasingly cognizant of limitations in their strategic planning and management and the need for improvement.

While there is no separate SOE strategy (SOEs like any private sector enterprise require a corporate strategy to delineate their functional approach), SOEs still differ from wholly privately owned firms in terms of their governance, attitude to risk, and access to resources. Moreover, the process owners shape strategies for their firms depending on the institutional framework under which they operate. Hence, even firms with similar types of ownership may make different strategic choices when institutional contexts vary.

For most companies, strategic planning and management processes are complex. For example, when Professor Henry Mintzberg explored strategic planning processes among large multinational companies, he was unable to identify a single process that could be called strategic planning. Instead, he identified five strategic visions for organizations—the 5 Ps of strategy. The 5Ps are plan, pattern, position, perspective, and ploy.[1] These five components allow an organization to implement a more effective strategy.

As a plan, a strategy needs to be developed in advance and with purpose. As a ploy, strategy is a means of outsmarting the competition. With strategy as a pattern, one may learn to appreciate that what was successful in the past can lead to success in the future. With position, strategy is about how the organization relates to its competitive environment, and what it can do to make its products unique in the marketplace. Perspective emphasizes the substantial influence that organizational culture and collective thinking can have on strategic decision-making within a company.

Understanding and using each element help develop a robust, practical, and achievable business strategy.

The key elements of a strategy are[2]

- **Realistic**–The vision, mission, objectives, and so on should be realistic and realizable.
- **Balanced**–It should address the concerns and requirements of all the stakeholders, including the employees, customers, minority shareholders. For an SOE, the strategy should also address the requirements of the state and the public.
- **Sustainable**–Ideally, the strategy will encompass all three pillars of the triple bottom line, that is, people, planet, and profit.
- **Actionable**–The strategic plan should be detailed enough to either specifically outline actions required to meet the goal or be able to directly lead to such actions.
- **Well deployed**–Every single part of the organization should be informed of and engaged in the strategic direction and formulate their specific plans in line with the greater goals.
- **Flexible**–The strategy should be flexible to make revisions that are in support of the overall vision and purpose and are agreed to by the board and management.
- **Monitored**–The strategy should be monitored regularly. Performance indices are built into the strategy and monitored regularly to ensure proper implementation of the strategy. Learnings from the monitoring must be integrated back into implementation.

Companies with effective strategies gain advantages over poorly planned and managed companies. A strategy can do the following:

- Predict and sometimes influence the pace and direction of changes in the business environment to their advantage

- Provide a competitive edge through easily accessible plans and dissemination of information throughout the company
- Focus on monitoring of external markets and increase awareness of internal core competencies, which can help the board and senior management to anticipate developments, develop reactions, and even preempt developments.
- Encourage the board, senior management, and employees to accept the need for continuous change and to better prepare for it, having the right attitudes and culture in place throughout the organization.
- Allocate resources rationally, meeting short- and long-term goals based on sound commercial reasons. (As a result, managers have better direction and focus, and they are more motivated, committed, and receptive.)
- Improve inter-functional relations through shared goals and clear objectives.

Clearly defining the mandate of each SOE is necessary for defining accountability, for determining the scope of public services or other special obligations, and for forming a basis for more specific targets for the company's operations. Based on its mandate, each SOE needs to develop its strategy, subject to board approval (and explicit or implicit approval of the ownership entity). A clear mission, vision, and strategic plan can provide conceptual clarity for both management and employees. Clear strategies help managers make decisions and trade-offs that are in line with the overall direction of the company. They also provide a basis for measuring their performance.

Topic two: Board's role in the governance of a company's strategy, including governance of risk

A key board role is to ensure that the company is pursuing an appropriate and effective strategy. The only way to achieve this is for the board to be constructively engaged in governing the strategy process. A well-developed strategy reduces a company's risk of failure and increases its chance of success at the expense of its rivals, who have less-developed plans or do not have any plan at all.

Questions directors should ask include

- Where should the company be in the long-term? What is the strategic direction?
- Which markets should it compete in and what kinds of products and services should it provide? What are the markets and the scope?
- How can the business perform better than the competition in those markets? What is the source of competitive advantage?
- What resources (skills, assets, finance, relationships, technical competence, and facilities) are required to compete effectively?
- What external factors within the broad business environment affect the company's ability to compete?
- What are the values and expectations of those with influence on the company, such as the stakeholders?

While strategy formulation is undertaken by the management, as discussed later, the strategy should be approved by the board of directors and reviewed at least annually. Even where the strategy does not radically change, the process of revisiting it can help to re-energize, refocus, and renew the organization. The board should ensure that the strategy seeks to meet the expectations of all categories of stakeholders without letting them override the organization's core values. Moreover, the state should also ensure that the SOE and the top management are accorded with the requisite operational autonomy to design and develop the strategy. The state's

role should be restricted to designing the overall policy priorities for the sector as a whole or the SOE, but the SOE must have the autonomy to craft the annual strategy of the company.

In evaluating the merits and demerits of the strategy, directors should also review

- The previous year's plans, budgets, and financial information;
- A summary of the current year's activities and progress;
- Information on related organizations and national or international bodies;
- Information on government policy and legislation that could affect the organization;
- Analysis of the organization's strengths and weaknesses as well as opportunities and threats; and
- Strategic recommendations

Boards of directors must make sure that their organizations 'optimize' risk by balancing risk and opportunity following risk tolerance levels approved by the board. **The decision to adopt a strategy should include discussions on the following**:

- Is this the best use of the organization's resources?
- Is the organization comfortable with the risks involved?

This risk evaluation becomes more important for an SOE given its unique responsibility toward 'indirect' stakeholders (citizens and public) and political influences.

Risk governance needs to be an integral part of the organization's culture, strategy, and day-to-day business operations. In strategy development, boards are expected to navigate organizational growth while protecting the organization from unnecessary risk so that it does not affect the business negatively. With the changing role of SOEs and the current commercial and economic climate, boards need to step up their game with an intense focus on risk management.

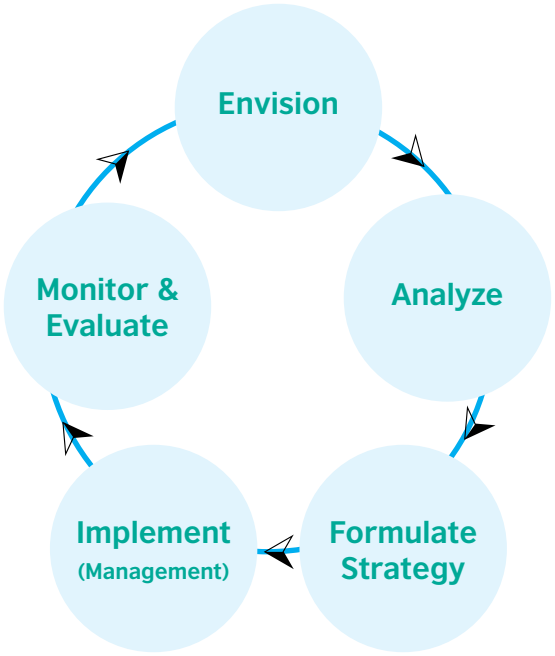
Topic three: Strategy planning process (role of the board versus management)

Strategic planning and management in SOEs are closely associated with activities by the government and its organizational units. According to Organization for Economic Cooperation and Development (OECD 2005) and EU (European Union 2010), strategy in SOE involves two main contents. The first one is the strategic management activities that normally involve identifying the mission, vision, enterprise value, internal environment, and external environment, directed toward long-term activities. Following that are activities of assessing, reporting, and overseeing for strategy implementation. Second, the budget plan for strategy implementation is identified by analyzing the interrelationship between the objects and the results achieved, and the indexes for analyzing budget performance used. A strategic plan is successfully created when the management and setting up the budget plan for the strategy are reasonable.

A typical framework for developing and articulating a company's strategic direction is illustrated in Figure 27 on the next page.

Envisioning a future state for the company: The board should develop a vision that is operationally useful, and not theoretical with limited scope in practice. Such a vision needs to be translated into corporate goals or objectives, usually through a purpose statement.

Figure 27: Framework for Developing and Articulating Strategic Direction



Source: Adapted from IFC 2008.

Strategic analysis: The board should ensure identification of

- The company's competitive advantages;
- Any gap between the company's present capabilities and capabilities needed for the desired state to fulfil the vision. This involves an analysis of the external political, social, and market environment and the company's internal resources. This analysis may lead to a redefinition of the company's purpose. Boards should be prepared to ask incisive questions, anticipating rather than reacting to major issues.

Strategy formulation: The next step is to broadly generate potential options and then make strategic decisions. This process should involve cooperation between executive management and the board, each with an understanding of their respective roles. This activity may not be necessary every year unless the company operates in a volatile business environment.

Implementation: The choice in strategy needs to be translated into detailed operational plans by executive management for sales, marketing, production, and research and development (R&D).

Monitor and evaluate: These operational plans should be disseminated throughout the organization by senior executive management and then widely discussed internally. The board should monitor the strategy's execution against milestones and call on the management to modify the strategy as necessary. It is usually not sufficient to track the strategy's implementation solely by using financial performance targets.

As defined previously, strategy is about determining the following:

- Current position of the organization
- Where and how is it expected to go from the current position into the future?

Following the framework defined above, a strategic planning process includes (Jurevicius, 2013)[3]

Initial assessment: The organization's vision and mission statements to be developed. The vision statement describes the goal of the firm and sets the direction for its employees to achieve the same. The mission describes the company's business. It informs the organization's stakeholders about the products, customers, markets, values, concern for public image, and employees of the organization.[4] Thorough mission statement acts as guidance for the managers in making appropriate daily decisions.[5]

Situation analysis: Situation analysis identifies strengths, weaknesses, opportunities, and threats (SWOT) for the organization and reveals a clear picture of the company's situation in the market. This includes evaluating an organization's external and internal environments and analyzing its competitors. During an external environment analysis, managers investigate the key external forces, that is, macro- and microenvironments and competition. Political, Economic, Socio-cultural and Technological (PEST) or Political, Economic, Socio-cultural, Technological, Environmental and Legal (PESTEL) frameworks represent all the macro environment factors that influence the organization in the global environment. The microenvironment affects the company in its industry. It is analyzed using Porter's 5 Forces Framework. The internal analysis includes the assessment of

the company's resources, core competencies and activities. When analyzing the company's activities, managers look into the value chain and the whole production process.

Strategy formulation: In an organization, strategies are chosen at three different levels:

- **Business level strategy**: This type of strategy is used when strategic business units (SBU), divisions, or small and medium enterprises (SMEs) select strategies for only one product that is sold in only one market.
- **Corporate level strategy**: At this level, executives at top parent companies choose which products to sell, which market to enter, and whether to acquire a competitor or merge with it. They select between integration, intensive, diversification, and defensive strategies.
- **Global/International strategy**: The main questions to answer; which new markets to develop and how to enter them? How far to diversify?

Strategy implementation: Only well executed strategies create a competitive advantage for a company. **Strategy implementation includes the following**:

- Setting annual objectives
- Revising policies to meet the objectives
- Allocating resources to strategically important areas
- Changing organizational structure to meet new strategy
- Managing resistance to change
- Introducing new reward systems for performance results if needed

Strategy monitoring: Implementation must be monitored to be successful. Due to constantly changing external and internal conditions, managers must continuously review both environments, as new strengths, weaknesses, opportunities, and threats arise. If new circumstances affect the company, managers must take corrective actions as soon as possible. Measuring performance is another important activity in strategy monitoring. Performance has to be measurable and comparable. Key performance indicators (KPIs) and key result areas (KRAs) are identified for the objectives developed as part of the vision and mission statements and strategies formulated. Managers compare their actual results with KPIs and KRAs to assess the accomplishment of the set objectives and goals.

Role of the board versus the management in the strategy planning process. The process of developing a strategy involves both the board and the ownership entity. The board should have ownership of the process so that it is accountable to the ownership entity for the strategy. According to good practice in corporate governance, each governance body has a role to play. The management is responsible for developing the strategy. The board is responsible for approving the strategy and monitoring its implementation. Additionally, the ownership entity is responsible for monitoring the company's performance and its adherence to its strategy and other commitments in line with the general objectives the state defines for each SOE. In practice, significant changes in strategy (especially in large and important companies) will require the approval of the government owners and stakeholders.

Essentially, the strategic planning process is an activity that involves the entire organization, right from the governing body, board, to the management, and line staff. The process also takes inputs from all interest groups and stakeholder representatives that are affected by the organization's functioning and continuity.

Table 35 (on the next page) illustrates the specific stages and indicates the possible involvement of each group at each stage.

Cross-cutting theme: climate change and resilience

SOEs are one of the largest participants in the energy sector, which also generates the largest share of greehouse gas (GHG) emissions. In such a scenario, the responsibility of SOEs to reduce their future emissions becomes very critical. However, given their various distinctive features, enlisting SOEs in the effort to address climate change might require different tools than those used for private companies. SOEs should develop a systematic climate transition and

climate risk management strategy, as part of their corporate business strategy, including a systemic assessment and mitigation of the climate risks for its large investments and assets and a gradual shift toward a low-carbon future.

Strategic corporate planning: A strategic corporate planning exercise is expected to identify how an SOE can transition its business to a low-carbon pathway, its timing and optimal technology adoption. However, for many SOEs, this type of shift gives rise to additional special challenges, as they serve various economic and social goals that extend beyond traditional corporate concerns. For example, it may lead to complex financial issues, affect employment in other sensitive sectors, reduce revenues, and raise supply and reliability concerns. Conversely, non or delayed action can cause significant financial risks and liabilities. Hence, a comprehensive and systematic approach associating all relevant stakeholders is required through the strategic corporate planning exercise.[7]

A good starting point for this planning exercise is defining a company's medium-term business strategy and assessing how it may be affected by the climate transition and climate risks. It should help the company think through its most appropriate response to climate change opportunities and risks, clearly stating what needs to be achieved. There are three policy options to reduce GHG emissions. The first is wherein the government sets a specific limit and SOEs have to abide by it. In the second option, governments may impose a carbon tax where the SOE will have to pay for the amount of CO_2 produced. SOEs that can reduce emissions will invest in cleaner options as long

Table 35: Strategic Planning Process

Planning stage/ Group	Start the planning process and ensure commitment	Purpose and target setting	Analyze and generate options	Decide and evaluate strategies	Execute and monitor results
Board					
Board members	Informed; endorse the process	Agree on the purpose and policies governing corporate conduct		Approve strategic plan	
Board chair	Be sufficiently informed, engaged, alert and able to intervene when required; provide leadership in board meetings and ensure that they run effectively				
Management					
CEO	Initiates, leads, participates and accounts to the board for formulation and execution of the strategic plan				
Planning team		Receives agreed purpose and conduct and contributes to target setting, forecasting and gap analysis. (situational analysis)	Inputs on SWOT (strengths, weaknesses, opportunities, and threats) analysis, identifies strategic issues, and suggests strategies to address them	Collects inputs from various groups and evaluates the proposed strategies; evaluates overall strategic plan for submission to board	Prepares action plans, budgets and supervises projects and receives updates and progress reports
Line managers		Receives information on targets and gaps	Provides inputs for SWOT analysis and proposed strategies		Implements action plans and report progress[6]

Source: Adapted from IFC 2008.

as it is cheaper than paying the tax. The third option involves the emission trading scheme, that is, SOEs may buy and sell the 'right to pollute' from each other or other companies. Carbon pricing may also be combined with offset credits. The SOE may choose to pay for emission reductions elsewhere rather than invest in the country of operation. For example, these funds may likely help to avoid a larger amount of carbon in emerging or developing markets where emission reduction costs are lower. Alternatively, the SOE management may employ a combination of all these measures across different jurisdictions and types of GHGs. Besides limiting or pricing emissions, there are positive incentives that reduce the cost of cleantech options. These include tax breaks, cutting tariffs for green products or renewable energy subsidies.[8] During the planning stage, the SOE management should consider all these options.

Integrated reporting: An Integrated Reporting (IR) framework will help the board focus on a strategy for dealing with climate change, as well as how climate change affects strategy and value creation. This would help in understanding how prepared and resilient the businesses is, thus, increasing the resilience of capital markets and improving financial stability. The International Integrated Reporting Council (IIRC) recommended the following on integrated reporting:

- **Embed the principle of connectivity of information** Information must flow through a business—this means ending the silo culture and putting in place cross-cutting themes to consider climate issues and how they impact the business model.
- **Start with strategy** This puts boards in control and means data and information flows from—and to—strategic decision-making.
- **Seek explanations** This forces consideration by the board. *How does climate change affect our business model in terms of physical risk and transition risk?*
- **Extend the disclosure horizon over material climate change information** *How does climate change affect our business model over the short, medium, and long term?*
- **Underpin corporate governance and stewardship codes** Signal the intention that climate-related issues should form part of the key consideration of risks by boards and investors, as they undertake their governance and stewardship obligations.

An example of integrated reporting on Corporate Governance in South Africa is provided in Box 38.

Box 38: Integrated Reporting under the King IV Report on Corporate Governance for South Africa 2016

The King Committee published the King IV Report on Corporate Governance for South Africa 2016 (King IV) on November 1, 2016. The new code is now principle based and follows an outcomes-based rather than rules-based approach and therefore moves away from a tick-box approach. Among the notable changes in the Kind IV Report, the introduction of Integrated Reporting has been a great step forward.

The concepts and principles introduced by the Integrated Reporting Framework by the IIRC (International Integrated Reporting Council) in 2013 have been reaffirmed in the King IV Code. King IV has incorporated the philosophy of integrated thinking into the code while reaffirming the governance oversight and involvement required. King IV recognizes the need for company's oversight bodies to consider their value creation and preservation story within the context of the six capitals (financial, manufactured, intellectual, human, social and relationship and natural capital). The code has reaffirmed the importance of the ability to manage and monitor performance, risk, and opportunities across the six capitals through the company's business model while taking key stakeholder consideration into account and creating long-term capital. The code makes reference to the IIRC Integrated Reporting Framework and the need for companies to embrace the principles and disclosure elements of the framework.

Sources:
Institute of Directors in Southern Africa, 2016. *King IV Report on Corporate Governance for South Africa 2016 (King IV).*

IIRC. 2013. *The Internal IR Framework.*

Topic four: Performance Management Agreement

In the case of a public entity such as a railway SOE, there is often a formal commitment put in place between the railway SOE (via the company board) and the government entity that owns and oversees the enterprise, called a Performance Management Agreement (PMA). The PMA guides the activity of the railway corporation and allows the performance of the company to be evaluated.

The exact content of the PMA varies by the type of SOE but typically includes the following:

- Corporate vision
- Overview of the company and its business
- The company's strategic objectives
- High-level business strategy
- Key initiatives
- Review of the previous year's performance, including the financial results, and the performance targets for the coming years

PMAs are commitments established between the government and the SOE. These performance agreements go by different names in different countries, often reflecting their different form or legal status. Other names of performance agreements include performance contracts, memorandums of understanding (MOUs), statements of expectations, shareholders' letters, letters of agreement and business plans. Generally, PMAs are used in New Zealand, and especially for railways and SOEs engaged in the transportation sector.

The PMA, clearly setting the enterprise objectives and performance targets as commitments to the government, enables the board and the government to maintain a transparent relationship that is transparent and at arm's-length. General shareholders meeting (GSM), the board of directors, and the company management provide governance to state enterprises. The ownership entity, for example, the Ministry of Transport or Ministry of Finance (or similar) depending on the country's SOE ownership structure, would be represented in its role as a shareholder (initially as the sole shareholder) by a unit located within the ownership entity.

The GSM is responsible for making major decisions such as the appointment of directors and approval of their plan (the PMA) and approval of major transactions. The board of directors is responsible for providing strategic direction to the enterprise (Administrative Plan or PMA) and ensuring effective management of the enterprise. It appoints the SOE management and approves their plan (Management Plan or Business Plan). SOE management provides day-to-day guidance to the enterprise and takes operational decisions.

The unit established within the owner ministry to represent the owner acts on behalf of the ministry as the shareholder of the SOE. As such, it provides general guidelines for the SOE on performance indicators, remuneration, conflict of interest, dividends, and disclosure. It works through the GSM and SOE boards to ensure compliance with relevant corporate governance codes and principles. The ownership unit monitors both compliance and 0verall performance of the SOE. The ownership unit reports to the public on the performance of the SOE portfolio.

Monitoring SOE performance is a core function of the state as the owner to ensure transparency and accountability in the use of public funds. As a shareholder, the government is required to manage its SOE investments in the best interests of the country and the taxpayers and is accountable to parliament for SOE performance. The state's ownership entities must ensure and see that each company meets its targets and objectives and takes necessary action in case of non-compliance.

A performance-monitoring framework identifies the core financial and nonfinancial

objectives of the SOE and details the government's priorities for various strategic objectives of each SOE. The framework also includes appropriate performance targets that reflect government priorities. This performance monitoring links the PMA to the company's overall strategy, which aims for accountability and supervision.

As defined above, the performance-monitoring framework aims to ensure the accountability of the SOE board and senior management in meeting financial and nonfinancial performance benchmarks. It also indirectly helps define the objectives and responsibilities of both government and SOEs. Developing such a framework requires common and clearly understood principles of accountability and governance based on several factors:

- Obtaining baseline information, to create the necessary building blocks for developing a performance-monitoring system
- Setting mandates, strategies, and objectives to reflect the overall policy goals of government in its ownership of each company
- Structuring performance agreements to facilitate periodic performance monitoring of the SOE by an ownership unit
- Identifying and developing KPIs to measure and evaluate results

An important element of performance monitoring is benchmarking against industry standards and comparators. It allows for identifying gaps and areas for improvement. This area is still underdeveloped in many emerging market countries, but ownership entities should strive to benchmark SOE performance against appropriate peers, domestic or foreign. One of the most important tools for performance monitoring is the balanced scorecard (BSC).

The BSC is essentially a list of KPIs useful for monitoring company performance. Designed as a performance measurement and management framework, it adds strategic nonfinancial performance measures to traditional financial metrics to give managers and executives a more 'balanced' view of organizational performance.

Topic five: Balancing SOE public service obligations with commercial obligations

The impact of market factors and competition on SOEs' strategy for commercial objectives does not vary significantly from their private sector counterparts (the strategy aims at maximizing profit and minimizing risk). However, the included mandate of social or economic development objectives requires a different perspective for developing the SOE's strategy. In particular, when commercial operations of the SOE are used to correct market failures or minimize situations of abuse of market power, earlier strategic options for achieving commercial objectives could be contradicted, as there was no structural separation of commercial and non-commercial activities. In such a situation, it was important for the SOE board and the state in its capacity as an owner to recognize that there might be a cost for pursuing economic or social objectives.

As a consequence of the aforementioned factors, the strategy development process must be clear in defining the priority of the commercial and social/economic development objectives of the SOE, and to identify and streamline any conflicting objective.

As noted above, SOEs face special challenges in developing clear and coherent strategies, particularly because they often have conflicting objectives that are difficult to reconcile and sometimes informal. Formalizing

objectives and incorporating them into the strategy-setting process will help identify any inherent contradiction, and thus offer scope for their timely resolution.

Objectives communicate the purpose of the SOE and the state's expectations for performance. Clarity and transparency of objectives are important. Where there are multiple objectives and trade-offs among policy, regulatory, and commercial objectives, they should be clearly identified and stated. Ownership entities often consult with sector departments, ministries of finance, and the cabinet to set the objectives and strategy for the state as a shareholder, combining optimization of shareholder value and achievement of wider socio economic objectives.

The complexity of the strategy depends on the nature of the business, the size of the company, and the depth of its competition. Large companies can benefit from engaging consulting firms that specialize in national or international strategy, provided the terms of reference are clear and well defined. Most importantly, the strategy for SOEs should be formally written, timely updated as necessary, and closely linked to the performance management process to ensure effective measurement of the SOEs' progress. It is also important for the strategies to be realistic and broadly internalized throughout the company.

The strategy is expected to include goals and specific objectives. The overriding goals are to ensure the SOE's performance and long-run financial sustainability and to meet the performance objectives set by the owner. Objectives are then measured against KPIs and targets. Objectives for SOEs should be clear and realistic. Guidance should be provided on trade-offs, and the management should have limited discretion in balancing different objectives.

Performance agreements are an important factor in supporting the SOEs to balance their commercial and public service obligations, by providing a framework, wherein such objectives are clearly stated and agreed upon. These performance agreements are an important input to the strategic planning process and help in subsequently translating strategy into action plans and the annual budgets.

Two actors play a key role to support the SOE in balancing its commercial and public service obligations. These are the state, in its capacity as an owner, and the board of the SOE.

Role of the state in setting broad mandates and objectives: The state, with the primary ownership and oversight function over the SOEs, defines the mandate for the respective SOE and sets out its' objectives. The mandate and objectives laid out by the state can be formalized through the legal framework (based on which the SOE was constituted), and the SOE's charter, among others. The overall mandate of the SOE provides an indication as to whether the SOE's operations are commercially oriented or constituted for achieving specific socioeconomic public policy objectives. While an SOE can be expected to fulfil both the commercial and public service obligations, the formal mandate set out by the state defines the SOE's primary objectives.

In addition to the overall mandate, the state also plays an important role in defining short- and medium-term objectives for the SOEs, wherein SOEs can often be instructed to prioritize public service obligations over commercial considerations. Examples of these instances can include utilizing SOEs for correcting market distortions and failures and achieving specific public policy objectives.

Role of the board setting the strategy: While the state's role broadly involves communicating specific objectives and priorities, the board plays an important part in setting the optimal strategy to achieve these objectives, considering various internal and external factors such as resources, capacity, market factors, and so on. The board is also responsible for maintaining a constructive dialogue with the state on the support required to achieve specific commercial or public policy objectives as well as to highlight any potential risk it may face in pursuing specific objectives that deviate from its primary mandate. In this regard, maintaining healthy state-board relations is paramount to help balance and achieve both commercial and public service obligations.

Topic six: Designing a performance agreement

Continuing from the previous section, performance monitoring is an integral part of the strategy, as it allows evaluating if the organization is following the direction established during strategic planning.

The strategic plan document should specify responsibility for the overall implementation of the plan, and for achieving each goal and objective. The document should also specify responsibility for monitoring the implementation of the plan and for decision-making based on achieved results. For example, the board might expect the CEO to regularly report to it on the status of implementation, including progress toward each of the overall strategic goals. In turn, the CEO might expect regular status reports from middle managers on the achievement status of assigned goals and objectives.

A fundamental challenge for the state or ownership entities in creating performance frameworks is that SOEs are usually established (and continue in government ownership) because they have both commercial and non-commercial objectives. In many cases, the nonfinancial goals will carry financial costs, thus making it difficult for the board and senior executives of the SOE to resolve their competing priorities.

A sound performance-monitoring framework explicitly identifies the core financial and nonfinancial objectives of the SOE and defines the government's priorities for various strategic objectives of each SOE. In this process, the ownership unit must develop appropriate performance targets that reflect these priorities.

Before the performance agreements (for example, PMA discussed in the previous section) are finalized, the ownership entity and the SOE must discuss it and negotiate its contents. In countries, where this process is fully developed, such as India, Malaysia, and South Africa, agreements and targets are produced annually. In many countries, the performance agreement is made public and presented to the parliament to establish the links in accountability. The government's expectations of the SOE must be formally, clearly, and publicly communicated.

Monitoring company performance against the agreed company objectives and performance targets as set out in the performance agreement is generally done on an annual basis; but for important portfolio companies, regular monitoring (biannual or quarterly) may be warranted. The key to implementing a periodic monitoring framework is establishing suitable performance indicators and targets.

In general, periodic monitoring instills a culture of accountability that serves multiple aims including the following:

- Initially, the state or ownership entity can ensure that the SOE is completing all periodic reports and actions (for example, preparation of annual financial statements and external audits) and delivering them on time.
- All variances between the actual financial and nonfinancial results and the agreed results (as set out in the relevant performance agreement) should be documented.
- SOE management can be asked to document reasons for any unexpected variances, the principals of the SOE can give explanations in face-to-face meetings with the state or ownership entity.
- Large or unjustified variances from planned results should be reported up through the system. As a result, for instance, the major issues arising from the performance review might be discussed between the chairman of the SOE, the state and the head of the government ownership unit. Depending on the national accountability structure, significant issues might be reported to the Minister of

Finance and Portfolio Minister, the Head of Government, and or a legislative oversight committee.

- Variances may give rise to consequences under the performance agreement as is notably the case in Republic of Korea where it directly affects the compensation or even tenure of the SOE management.
- Periodic public disclosure can be made of SOE performance against the agreed objectives or relevant benchmarks and can act as a strong incentive for managers and boards to improve the performance.

The feedback provided by performance indicators allows an organization to improve itself continually. While there are many ways to develop indicators and targets, each SOE's objectives and targets should align with its overall mandate and with the strategy that it has adopted to fulfil that mandate. It is also advisable that performance indicators include both financial measures (capturing sales, profit, and debt) and nonfinancial ones (either those that predict future nonfinancial performance or that are particularly important to the company's strategy). Key performance indicators need to be carefully selected to ensure that each directly drives a strategic objective. When designing indicators and targets for the broader performance agreement, the ownership entity should have the opportunity to engage the required expertise.

Indicators should

- Be linked to company strategy and objectives
- Be SMART—specific, measurable, achievable, results-oriented, and time-based
- Not distort incentives
- Be challenging but achievable, based on historical performance
- Facilitate benchmarking
- Be tracked by appropriate information systems
- Be linked to management performance
- Be audited to ensure quality and accuracy of information provided
- Be simple at the start and enhanced over time

Two categories of indicators are used to measure performance—financial and nonfinancial—as outlined in Table 36 on the next page.

The BSC is a strategic planning and management system that organizations use to[9]

- Communicate what they are trying to accomplish
- Align the day-to-day work that everyone is doing with strategy
- Prioritize projects, products and services
- Measure and monitor progress toward strategic targets

The BSC approach suggests that an organization requires to undertake evaluation from four perspectives, with further detailing of objectives, measures (KPIs), targets, and initiatives (actions) for each:

- **Financial**: Often renamed stewardship or some other appropriate name in the public sector; this perspective views organizational financial performance and the use of financial resources.
- **Customer/stakeholder**: This perspective views organizational performance from the point of view of the customer or other key stakeholders that the organization is designed to serve.
- **Internal process**: Views organizational performance through the lenses of the quality and efficiency related to products, services, or other key business processes.
- **Organizational capacity** (originally called learning and growth): Views organizational performance through the lenses of human capital, infrastructure, technology, culture, and other capacities that are the key to breakthrough performance.

Strategic objectives are the continuous improvement activities that must be undertaken to implement a strategy. This breaks down more abstract concepts like mission and vision into actionable steps. Actions are steps that the organization should undertake to achieve the strategic objectives.

Therefore, strategies describe the 'what' and action plans describe the 'how'. Examples of actions might include increasing the revenue, improving the customer or stakeholder experience or the cost-effectiveness of programs.

Subsequently, a strategy map should be created. A strategy map is a simple graphic that shows a logical, cause-and-effect connection between each of the strategic objectives.

For each objective on the strategy map, at least one measure or KPI should be identified and tracked over time. KPIs indicate progress toward a desirable outcome. Strategic KPIs monitor the implementation and effectiveness of an organization's strategies, determine the gap between actual and targeted performance, and determine organization effectiveness and operational efficiency.

Table 36: Financial and Nonfinancial Indicators

Financial indicators	Nonfinancial indicators
Profitability indicators • Revenues • Profits (net income) • Return on equity • Return on assets • Return on invested capital • Economic value added	**Customer service** • Customer satisfaction • Delivery performance, customer service • Product or process quality • Service quality
Efficiency indicators • Measure how well the firm utilizes its resources • Return on assets or equity • Ratio of the costs of production to sales	**Market performance** • Marketing effectiveness • Market growth • Market share
Solvency indicators • Debt-equity ratio • Liquidity ratio • Asset-liability ratio • Changes in net borrowing • Changes in net borrowing from private and public sources • Investments (equity, loans) • Nonperforming loans • Capital adequacy ratio • Interest covered by earnings	**Goal achievement** • Productivity • Environmental compliance • Strategic achievement
Budgetary appropriations indicators • New government investments • Government credit injections or support • Subsidies	**Innovation** • New product development • Manufacturing flexibility • Technological capability • R&D productivity • Innovation
	Employee involvement • Employee satisfaction • Employee turnover • Education and training • Core competencies • Internal recognition • Morale

Source: Adapted from World Bank 2014.

Topic seven: HR policy to support strategy delivery

Defining HR policies

HR policies are continuing guidelines that dictate how people are managed in organizations. They essentially define the values of the organization, particularly concerning the treatment of staff. Well-structured HR policies also are one of the key elements in ensuring the competitiveness of SOEs in relation to the private sector.

HR policies of SOEs principally follow the ensuing overarching principles:

- Policies written for the SOE are adhered to by all the employees.
- HR policies, by definition, make it possible for the SOE ownership to set ground rules for employee behaviors, ethics, and professionalism to ensure consistency in the workplace.
- The policies are expected to be designed to address as many permutations of eventualities as possible for fair and standardized redressal of issues and situations.
- A fundamental feature of HR policies is the element of clarity. Each element of the HR policy must have clear mandates and procedures to reduce liabilities of the SOE.

Key elements of HR policies in SOEs are described below:
The function of HR is to ensure the presence and utilization of appropriately qualified individuals to effectively carry out and execute the goals of the SOE in addition to ensuring employee satisfaction. The key elements in developing HR policies are:

Strategy development and management

The design of an organizational strategy involves the leadership of the SOE to comply and adhere to the goals of the organization. (*Also, see Key stakeholders in SOEs.*) This means to engaging with the management of the SOE as a strategic partner, as opposed to approaching HR as a body, focused solely on administrative functions. More importantly, the organization's overall strategy for success drives the HR management's policy development and implementation.

Compliance

Complying with the country's labor and employment laws is a very significant element in HR policy development. For instance, the policy should ensure adherence to Fair Labor Standards legislation, minimum wage provisions, and overtime pay guidelines that apply to the state. Compliance with gender inclusion principles is also imperative.

Recruitment and selection

Improving the value of its human capital rests on the organization's recruitment and selection procedures. This is as true for SOEs, as it is for any other organization. The philosophy of all recruitment policies is offering equal opportunity irrespective of race, color, religion, national origin, gender, physical or mental disability, but more specific recruiting procedures include HR communication with department leaders about their staffing needs, job postings and interview steps, and hiring managers' decision-making authority. Recruitment and selection policies are based on the compensation strategy.

Individual and team development

Policy frameworks in most SOEs in the developing world do not pay adequate attention to the need for individual skill development in the organization. Identifying needs for employee skill development, training, and development are significant pillars in ensuring the SOE meets its goals. Succession planning, determining performance criteria that encompass role identification and description are a few other key elements.

Compensation

Compensation and benefits policies and procedures begin with developing a compensation strategy, which in turn is a part of the overarching corporate strategy. To be competitive, SOEs need to attract the best-qualified workers; hence, they must develop compensation policies that provide a distinct advantage over private players. Below-market compensation strategy puts the company at risk for high employee turnover and less-qualified workers.

Relationship between business strategy and HR policies and practices

People-centric focus is an essential enabling factor for achieving the business strategy successfully. It is concerned with aligning the elements of business strategy in a way that stimulates and reinforces different employee role behaviors. The primary impact of an effective HR strategy is on employees and in turn on what they do. A dedicated and well-rounded HR strategy means better performance on core tasks, more going beyond the call of duty, greater willingness to share knowledge, and generally lower quit rates or turnover (Sun et al. 2007). It has a significantly positive effect on the operations of the entity in terms of labor productivity and quality. Moreover, in various academic research, it has been proved that HR strategies have a direct bearing on financial performance as well as stock price performance in some economies. Given this integral linkage between HR operational strategy and the corporate business strategy, it warrants higher oversight from the board and top management of an SOE.

The board of directors is responsible for the approval of HR policies and periodic review of the HR performance. They are responsible to oversee key strategic HR issues such as succession planning, talent management, and especially executive compensation. Traditionally, this function was limited to the compensation committee but now HR finds a mention on the agenda of all other board committees including governance, nominations and even audit, though its scope may vary.

HR planning and recruitment

Workforce planning has become increasingly significant in all agencies, including SOEs. Designing a well-defined recruitment strategy ensures that SOEs can attract the best-in-class talents among various age demographics and adequately anticipate changes to the workforce, identify trends, and navigate the demands of the organization's goals.

Traditionally, the public sector is typically characterized by being unable to attract as many new hires as its corporate counterparts. The perception that SOEs are hierarchical and bureaucratic, where job promotions are based more on personal connections and seniority rather than performance may discourage talented people to join their ranks. Therefore, performance-based competitive salary and benefits packages must be designed to attract talented people. However, recent trends indicate that in many developing economies, SOE jobs are relatively more attractive than other government jobs, as SOE jobs are more remunerative for similar job security as in other public sector jobs. Despite the relative attractiveness of SOE jobs, the recruitment of the right skillset continues to remain a challenge in SOEs.

There are numerous reasons for this. Lack of strategic staffing and limited flexibility in adjusting the skills mix due to the general top-down hierarchical decision-making, interference in appointments, and relative lack of delegation to the line and HR managers to decide on the best fit for a particular position, is a major reason. The public sector does not reach out to students and graduates in the way that most commercial companies do. Other reasons include lack of market competition, factor reallocation, and strong unionization in many countries. In some cases, SOEs often look for temporary workers to fill immediate needs or reduce the burden on their existing employees. Temporary hires lack the benefits available to permanent employees, which is a factor contributing to the continuing challenge among SOEs to attract the best talent. Finally, the issue of culture fit also acts as a potential issue since the bureaucratic, government-focused nature of operations is not always conducive to the interests of customer

centricity and requires a radical mindset change in potential candidates to be able to cope with the operating realities.

In developing HR plans, input is required from a variety of different leaders across the SOE. The key idea is that the entire agency must buy into the strategy and the process behind the same. Although the HR department is the major player in the development and implementation of workforce planning, all levels of the organization are responsible too for overall successful HR planning.

The responsibility matrix below (refer Table 37) illustrates the activities that complement and are necessary for the SOE's workforce planning to be successful. The idea behind this is to illustrate the process of workplace planning and its dependency on various levels of the organization to render efficient of Human Resource Management (HRM) processes and make the organization capable of attracting the best in market diverse talent.

Box 39 (on the next page) provides a country case study on evaluation and monitoring in Poland.

To meet the growing HR needs of the SOEs, both internal and external markets should be used for recruitment. However, especially in developing economies, SOEs generally go in for tapping the external markets through either print media advertising or government recruitment websites. On the other hand, the private sector has largely upgraded its recruitment processes through outsourcing,

Table 37: HR Planning Activities Against Responsibilities

Activities	SOE leadership	Line managers	HR specific
Conduct strategic planning	✓		✓
Conduct workforce planning	✓	✓	✓
Develop HR strategies	✓	✓	✓
Align employee expectation with HR strategies	✓	✓	✓
Identify business functions		✓	
Assess and forecast capacity demand			✓
Assess and forecast capacity supply			✓
Analyze the competency gap or surplus			✓
Analyze workload gap or surplus		✓	✓
Create staffing plans		✓	✓
Identify competencies	✓	✓	✓
Create development plans		✓	✓
Implement development plans		✓	✓
Envision the desired workforce	✓	✓	✓
Measure results			✓
Conduct succession planning			✓
Develop capabilities	✓	✓	✓
Train effective managers	✓	✓	✓
Evaluate performance	✓	✓	✓
Share success related to communications	✓	✓	✓
Develop retention strategies			✓
Achieve diversity	✓	✓	✓
Assess budget implications	✓		✓

Source: Adapted from IFC 2008.

Box 39: Evaluation and Monitoring in Poland

In Poland, the fundamental assumption is that all strategies and programs will be subject to evaluation and monitoring of their results. Hence, in the area of recruitment and selection, the following actions are planned:

- Constant monitoring of vacancies against incoming applications;
- Comparative studies concerning the employment of candidates with a special focus on prevention of biases with respect to gender, age, and similar negative attitudes;
- Fine-tuning of the recruitment monitoring and evaluation tools;
- Evaluating competition for high-level positions within the civil service corps.

Source: Aijadll, Kirsi. 2002. *Public Sector, an Employer of Choice Report on the Competitive Public Employer Project.* OECD.

recruitment agencies, networking sites, and so on, which attract a wider range of well-qualified candidates. Hence, to recruit from improved demography of candidates, SOEs should expand their sources in tapping the external market for human capital by way of job fairs, college fairs, and campus recruitments. In general, for higher levels in SOEs, there is a heavy reliance on government officials to be deployed for various leadership functions in SOEs. This too is to be updated, particularly concerning hiring independent board members.

Training and development

Training and development have become key issues for organizations worldwide, issues that continue to gain center stage, being as relevant for the public sector enterprises as for the private. The strategies and policies articulated by the SOE indicate the degree of importance they give to the provision of HR training and development. Normally, such strategies aim to upgrade employees' knowledge and raise the level of their performance. Establishing a sound training strategy and training policy must also involve all the stakeholders of the organization. It is very important to recognize that training and development are strategic priorities rather than simply tactical or knee-jerk responses. Moreover, training and development policies and corresponding implementing strategies must be conceptualized as primarily a means of assessing and addressing skill deficiencies in the organization.

Talent management priorities in emerging economies need to be tailored specifically to the context. Improving workforce diversity, particularly with regard to gender is a key element in laying the groundwork for HR policies in these countries. Further, these economies are also largely characterized by their fast-moving pace of changing demography. The development of policies in HRM, therefore, need to strike a balance between the need for diversity inclusion and the pace of demographic change.

Once the need for a training policy and strategy has been accepted, the policy must be fully documented and shared across the organization. In a large organization, a written policy also helps to communicate key concerns to the whole workforce, integrating them into its efforts and empowering them in its implementation. The training policy also emphasizes the goals and objectives of the training rather than the methods and procedures.

It is commonly observed that SOEs fail to properly evaluate the real effects of their training programs. Often, simply conducting the training is seen as a success, with limited focus on measuring the achievement of learning objectives, skills and knowledge transfer, and impact on job performance.

It is imperative that in addition to ensuring continued incentives of undergoing training among staff, SOEs also need to consider the cost-effectiveness of training programs. It is, therefore, critical for the SOE to always

ensure alignment of the programs with the organization's larger business strategy and goals. This translates to the necessity of a strongly defined organizational strategy, articulated in a clear HR policy.

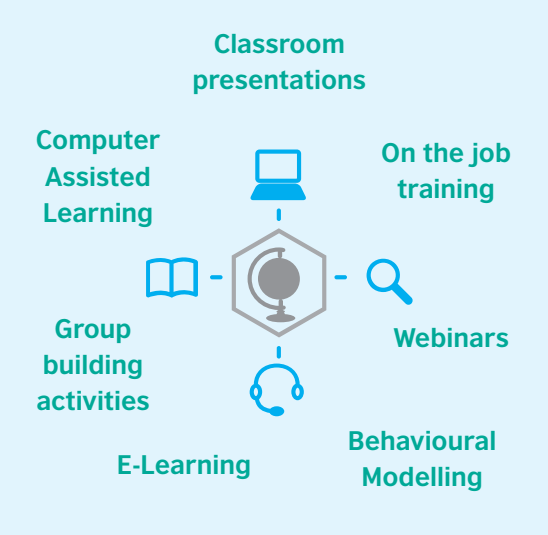
The planning of training activities requires a cogent understanding of the SOE goals as well as a detailed assessment of the existing skills and capacities of the employees. Further, it is essential that organizations prioritize their training programs and adopt training agendas for a specific period, rather than have a piecemeal and ad hoc training plan. In general, annual training plans based on competency analyses can avoid such ad hoc training.

It is essential to make the goals and objectives of the training program clear. Employees can then visualize their career goals and gain interest in the training offered. If, however, they are forced to attend a training program where they see no added value, the effect may be counterproductive. Organizational policies, which force uninterested employees to attend training courses, may lead to negative attitudes and seriously limit the effectiveness of the training. There have been multiple cases of this occurrence among SOEs and public sector organizations.

Another critical element for the training and development of SOE staff is the need for the induction of new employees. This should be included in the organization's overall training plan. Such training serves to make new employees more quickly aware of the organization's culture, mission, philosophy, and work expectations. Effective induction training usually emphasizes the basic skills and knowledge that new employees need to settle in and start doing their jobs effectively. These should be created per SOE's development plans and can be used to assess the skill sets brought by new employees in designing further training if required.

Evaluation of training is the final step in the training process in any organization. Its function is to help in identifying and rectifying any error made in the implementation of the training strategy. The success of the entire training process thus depends upon the development of the right kind of metrics and tools for measuring its effectiveness. Various training and development tools can be employed to ensure the competitiveness of SOE staff as outlined in the Figure 28.

Figure 28: Training and Development Tools



Source: Author's consolidation.

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Strategy, Risk, and Performance

Leadership Training Toolkit for SOEs

Part III Module 2
Financial planning and budgeting for SOEs



Photo: ©Pexels.com

Part III Module 2: Financial planning and budgeting for SOEs

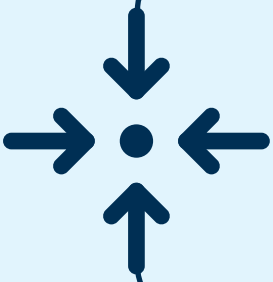
This session (module) covers the following topics:

1 Budgeting process and management in SOEs

2 Financing options for SOE service obligations

Learning objectives

By the end of this module, the participants will be able to



- **Understand the budgeting process for SOEs**
- **Understand the pros and cons of the various financing options available**

Agenda

Total time: 1 hour 15 min

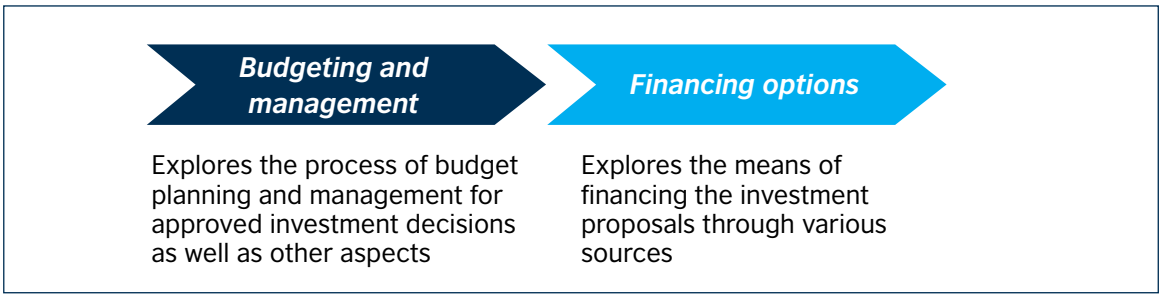
Time	Topic
15 min	Introduction to the module
30 min	Budgeting process and management in SOEs
30 min	Financing options for service obligations, advantages, and disadvantages

Introduction to the module

World Bank's Toolkit on Corporate Governance of State-Owned Enterprises and the OECD's guidelines on corporate governance of SOEs stress on the importance of equitable treatment of SOEs in the marketplace, to ensure a level playing field and fair competition in the marketplace.

With the SOEs often having both commercial and social objectives without distinct financing sources, there is a greater need for prudent financial planning to fulfil the SOEs' service obligations. Financial planning encompasses the budgeting process (including appraisals of SOE investment proposals) as well as finding the optimal financing mix, which enables the SOEs' financial sustainability. These themes are explored in this module as outlined in Figure 29.

Figure 29: Coverage of the Module



Source: Adapted from World Bank 2014.

Topic one: Budgeting process and management in SOEs

The budgeting process helps translate a company's long-term vision and strategic plans into operational plans with resources allocated to help achieve annual/medium-term targets. While this process is not always adopted in the private sector, for SOEs in particular, the budgeting process is important, as their budgets are often published as part of the state budgets (at a consolidated level). Additionally, there is a relationship between the state budget and the SOEs budget, given the direct and indirect financial support provided by the state to SOEs (budget transfers, capital infusions, loans, subsidies, preferential tax treatment, treasury guarantees, and so on) as well as the revenues received by the state from SOEs in the form of dividends, loan repayments, and any other transfer to the state.

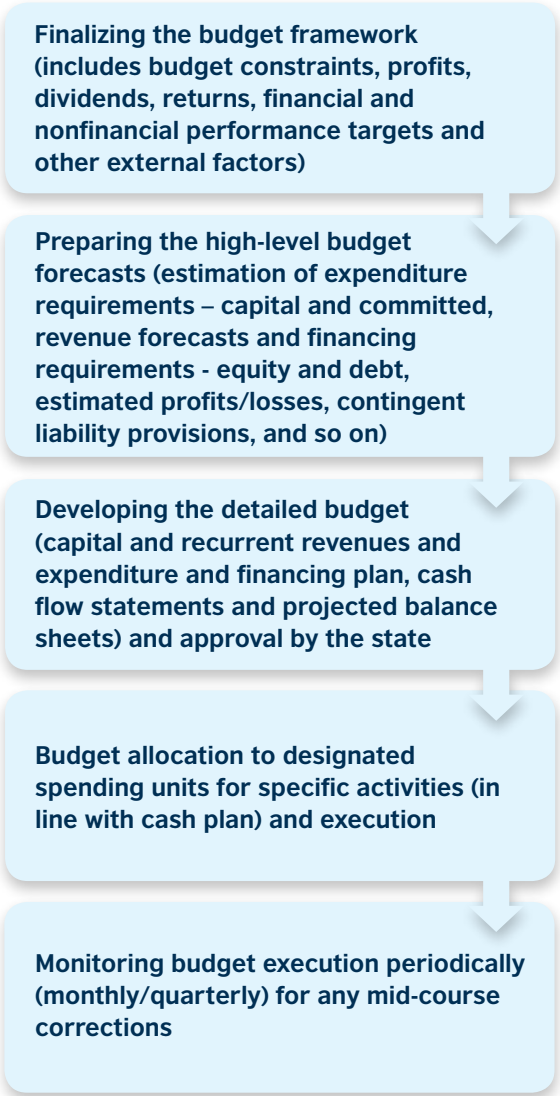
Figure 30 illustrates the high-level steps toward developing and managing the annual budget.

Finalizing the budget framework: As a first step to translating strategy into an operational plan, it is important to understand the framework, in which budget decisions are made annually. This framework is primarily based on the annual targets to be achieved, which can include and are defined for both commercial and non-commercial (social and economic development) indicators. These targets are finalized and negotiated between the state and the SOE board (refer balancing commercial and public service obligations and performance agreements). Performance agreements are used as a tool to guide such negotiations and develop the framework for budget preparation.

The state plays a key role here in defining any soft/hard budget constraints, the quantum of any budget transfers, and providing guidelines for the budget preparation process. SOEs are often subject to the state's budget laws because of their ownership and mandates, which merit public disclosure and transparency. Sometimes this can restrict the board's autonomy due to the SOEs' dependence on public finance.

The framework for budget decisions should also factor various internal and external factors that can have an impact on SOEs operations. The external factors include market outlooks and risks, access and cost of equity and debt financing, the budgetary priorities of the state and the resources allocated toward SOE financing. Internal factors can include any profit expectation/loss

Figure 30: Overview of Budget Preparation and Management Process



Source: Author's consolidation

from previous years, committed and recurrent expenditure on tax liabilities, debt servicing, dividends, investor exits, capital investment plans, maintenance/sale of assets, among others. SOEs also need to factor in the risk of realization of contingent liabilities, which may have an impact on the budget implementation/ execution and may need to be provisioned for in the annual budget.

Preparing the high-level budget forecasts: Following the deliberations and finalization of the budget framework, the next step is to prepare the budget forecasts with realistic projections of revenues and expenditure in line with the budget framework.

For SOEs with commercial objectives, the forecasting of revenues through their commercial activities requires a strong understanding of the market outlook and the sector in which the SOE operates, particularly concerning any competitor they may have from private sector counterparts. Other sources of revenues would include budget transfers and other direct forms of support from the state to ideally fulfil any public service obligation or to finance the SOEs' operations when the overall mandate is non-commercial. The state typically communicates the overall ceiling of these budget transfers to the SOE, and any additional assistance, if needed, can be negotiated between the SOE board and the state.

Expenditure forecasts predominantly include committed/recurrent expenditure on payroll, pensions (if any), operation and maintenance of capital assets, tax obligations, debt servicing costs, and committed project expenditure, among others. These typically have to be adjusted for inflationary effects and any other such parameter, which may have a bearing on the overall expenditure requirements for these components. Expenditure forecasts should also include the estimates of planned capital investments for the year, selected from the pipeline of appraised projects during the budget preparation phase. The decisions regarding planned capital investments are typically based on the resource availability and the priority of these investments (often discussed in consultation with the state).

As mentioned above, the budget should include projections of realistic revenues and expenditure, both recurrent and capital, for aforementioned external and internal factors that have a bearing on the SOEs' operations. A critical activity in this stage is to subsequently develop the financing plan for fulfilling commercial and public service obligations, to balance the SOEs budget, and identify any financing gap to be bridged. This exercise helps identify the quantum of debt to be availed by the SOE if its expenditure requirements cannot be met by its revenues and any transfer from the state. This will further help the SOE to define the optimal sources, cost, and other terms of debt, based on its risk appetite. This is further outlined in Part I, Module 2 Topic 3 (Financing options for service obligations).

While preparing the budget forecasts, it is also important to take the timing of the receipts and disbursements throughout the year into account. Consequently, the financial plan plays an important role in outlining these inflows and outflows to identify any cash flow mismatches that may impact the SOEs financial operations. The SOE should adequately invest in projecting the cash flows for the year to guide the budget execution process.

Developing a detailed budget: Translating these forecasts into a detailed budget is the next stage of the budgeting process. The form and contents of the budgets should synchronize with the format in which the annual accounts are presented and conform to any guideline prescribed by the state.

The budget should include the following:

- Budgeted income and expenditure statement for the year
- Budgeted balance sheet at the end of the year
- Cash flow statement for the year
- Budgeted capital expenditure together with an action plan

The formats for the budget preparation are typically prescribed by the state, along with the chart of accounts, which outline unique codes for various components of the budget estimates. Conformance with the chart of

accounts is a key requirement to allow the state to aggregate and analyze budget estimates from the various SOEs.

In addition to the above, good practice dictates that medium-term estimates of the income, expenditure, and financing plan should be prepared for the budget year as well as the following three years. The respective state's budget laws and guidelines often mandate this practice.

The preparation of the detailed budget often involves the submission of revenue and expenditure estimates from any of the subunits of the SOE, which are reviewed by the central unit and subsequently aggregated to develop the final budget estimates. Alternatively, the estimates can also be prepared centrally based on the institutional structure of the SOE and the availability of information. Information Technology (IT) systems for financial management play a key role in facilitating the budget preparation process by recording information on payroll, debt, and capital expenditure, among others.

After the budget is prepared and finalized by the SOE, it is formally submitted for approval to the state (depending on the prevailing legislation). The budget is then negotiated with the ownership entity (optional based on prevailing legislation) and more importantly, with the Treasury/Ministry of Finance (varies based on country context). The finalized budget then becomes the basis for the SOEs' financial operations during the year.

Budget allocation and execution: Following the finalization of the budget estimates, the SOE can commence its financial operations for the year, which begin with the process of allocating the budget among any spending unit (based on the organizational structure of the SOE), based on which expenditure can be incurred. The allocation of the budget should take the spending needs of the concerned sub-unit (categories and quantum of expenditure) into consideration. This is followed by the cash allocation of the budget to the spending units, which should consider the timing of the expenditure needs. The efficient allocation of cash can help in better management of the SOEs' finances by reducing the possibility of idle cash balances (which can be invested in short-term instruments) or cash flow deficits (that would require additional in-year short-term borrowings to manage).

Following the allocation of the budget and cash to the subunits of the SOE, the respective units can subsequently incur expenditure with the necessary documentation (invoices/bills) in place for maintaining the audit trail. Budget allocation and execution can also be conducted in a centralized manner, where the spending units of the SOE can submit expenditure requests to a central unit with the required documentation, and subsequently, the requested funds are transferred post mandated budget and proprietary checks.

Monitoring budget execution: In parallel to the budget execution progress throughout the year, it is also important to establish effective reporting mechanisms to monitor this progress and make any mid-course corrections per requirement. Periodic reporting to the SOE's management and board on a monthly/quarterly basis will help identify any component of the budget estimates, which need to be revised. Examples of the same can include any shortfall or surplus in revenue, which can be used to increase the planned expenditure for the year/or reduce the amount of debt to be availed by the SOE for the year. The state also requires periodic progress reports of the budget execution in its capacity as an owner to allow for effective fiscal oversight.

Topic two: Financing options for service obligations (including advantages and disadvantages)

SOEs, while benefiting from different types of direct or indirect financial or fiscal support from the state, still require exploring alternate sources of finance to fulfil their commercial objectives.

This topic explores various sources of financing available to SOEs to fulfil both their commercial and non-commercial service obligations. It covers various financing sources and instruments, financing mechanisms, and their various advantages and disadvantages. Additionally, it includes different forms of financial and fiscal support extended to SOEs by the state (direct—such as budget transfers, loans, and so on; indirect—preferential tax treatment, access to credit, treasury guarantees, and so on).

For non-state sources, SOEs can generate financing through two channels – internal and external financing. Alternatively, public-private partnerships (PPPs) may also be explored for large-scale project financing. Internal financing can be generated through the sale of assets, reinvestment of business profits, and reducing the working capital. However, in most developing countries, SOEs often face difficulties in raising internal finance, owing to low profitability and over-reliance on state funding.

In contrast to the above, SOEs often explore external financing that can be raised through various financial instruments and mechanisms from various financial institutions/ service providers that expect to receive a return based on the nature of the financial instrument. These sources include public and private equity, bank loans from state and private financial institutions, bond issuances, and grants/budgetary transfers from the state. The following describes various types of financial instruments typically availed by SOEs:

Equity: Equity investment is a financing tool provided to the recipient by an investor in exchange for partial ownership of the SOE (since the majority equity is held by the state in its capacity as an owner), typically in the form of the acquisition of share. An investor, based on an agreed-upon valuation, acquires shares in the company. The provider (called a shareholder after acquiring the shares) can at a later stage either sell these shares to another investor or sell them back to the recipient to realize the gains if any. In some cases, the recipient may also reward the shareholder by paying periodic cash payments called dividends, but this is usually the case only with large and established corporations.

This type of financing can take the form of either private or public equity. Private equity is provided through privately negotiated transactions between the provider and the recipient. Public equity, on the contrary, refers to financing raised from retail investors (or the public) and institutional investors by offering the shares for sale on a stock market (also referred to as 'listing' the entity) in an initial public offering (IPO). Larger companies mostly do this.

These companies, called public listed companies after the IPO, can subsequently approach the general public or private-equity providers for additional financing (refer Box 40 on the next page for case studies).

Loans from financial institutions: Bank loans are a type of debt instrument, in which the amount (principal) borrowed from a bank must be repaid by the recipient with interest. Bank loans have a fixed period for repayment, along with a fixed or variable rate of interest that are payable periodically. Usually, repayment starts immediately after a recipient takes out the loan. However, in some cases, a grace period (also known as moratorium period) is offered, during which no repayment is required, but interest nevertheless continues to accrue. Loans can be secured (which means the recipient's assets are provided as security or collateral) or unsecured (in which case no security is provided). Such loans are availed by SOEs from both commercial banks and state-owned banks, often with preferred access to

financing. This includes loans at below-market interest rates with favorable terms. SOEs often receive preferential treatment in private financial markets with an implicit or explicit guarantee by the state against default of the SOE debt.

Bond issuances: Bonds, also known as fixed-income instruments, are a type of debt instrument, in which the bond issuer (that is, the finance recipient) borrows a sum from the bond purchaser (that is, the finance provider) and returns that sum to the purchaser (or current bondholder) upon the maturity of the bond, while additionally paying periodic sums of interest. **There are two key differences between bonds and bank loans**:

- Bonds typically have a longer duration than loans
- There is a market where bonds can be bought and sold among investors

Grants/budgetary transfers from the state: Grants are financial transfers, typically provided by the state in its capacity as an owner. The money does not have to be repaid and is usually exempt from tax. Grants can fill financing gaps when other sources of capital are not easily available or accessible and are often used to finance SOEs fulfilling specific public policy objectives/public service obligations. They can also be used in structures such as results-based financing or blended finance. The state, as a grant provider, does not expect any financial return. However, it also closely monitors the development impact of programs it has financed.

Although such support is usually justified because SOEs fulfil special public functions or provide non-commercial services, direct funding can create market distortions, particularly when funds are used to cross-subsidize commercial services or products. Budget funding may also exceed company needs, in which case SOEs may pursue business strategies that affect the market structure in which they operate, strategies they would not have pursued otherwise. For example, easy access to financing may allow very rapid SOE growth, enabling these enterprises to secure a dominant position over their competitors or to adopt aggressive acquisition strategies that may lead to

Box 40: Listing of SOEs on the Stock Exchange

Many countries are subjecting large SOEs to capital market discipline by listing shares of corporatized SOEs on the stock markets and applying the more stringent governance requirements under securities laws. Such laws contain stronger requirements for independent directors on the board, treat minority shareholders fairly, and mandate comprehensive and timely financial and nonfinancial reporting. Listing also exposes SOEs to capital market scrutiny through oversight of expert analysts, rating agencies, and the financial media.

Major emerging market countries such as Brazil, China, India, Indonesia, Malaysia, and the Russian Federation have listed large SOEs on both domestic and international capital markets. Large SOEs have also been listed on stock exchanges in such diverse countries as Colombia, Kenya, Pakistan, Peru, South Africa, and Vietnam. Indeed, several successful listed SOEs are recognized as world leaders, such as Petrobras, Ecopetrol, Sabesp, and ISAGEN in Latin America.

Listing large SOEs on the stock exchange gives SOEs access to alternative sources of financing and provides greater flexibility for adjusting their capital structure, while contributing to the development of the capital markets. Listing also exposes SOEs to market dynamics and provides a measure of market valuation of net worth.

It is also a powerful starting point for strengthening SOE commitment to corporate governance. Listed SOEs come under the same regulation and scrutiny as other listed companies, including the oversight of the securities regulator, the stock exchange, and for financial institutions, the central bank or supervisory authority. Exercising regulatory oversight over very large and prominent SOEs can be difficult and requires support and capacity from the relevant parts of the government. Through a stock listing, minority shareholders may also apply pressure and monitor the firm in ways that complement monitoring by lenders.

Source: World Bank Group. 2014. *Corporate Governance of State-Owned Enterprises: A Toolkit.* Washington, DC: World Bank.

excessive market concentration. For these reasons, many countries have chosen to reduce direct support to SOEs, especially to those that operate in competitive markets.

Financial instruments vary significantly on aspects such as their effect on ownership, level of operational influence, costs, risks, degree of liquidity, and tenure (the typical time the investment is held, or before repayment is due). Determining the suitability of a specific financing instrument thus entails an evaluation of the SOEs characteristics, needs, and limitations.

Table 38 presents a comparison of the aforementioned financing instruments.

These instruments traditionally involve a finance provider making capital available to the SOE for an acceptable level of risk and collecting the associated reward. Different finance providers have different risk appetites and return expectations. As a consequence, they provide financing via different financial instruments that reflect these differences. Also, depending on the type of financing provided and the nature of the provider's operations, approaching different providers

Table 38: Comparison of Financing Instruments

Parameter	Equity	Debt (Loans)	Bonds	Grants/Budget transfers
Acquisition of ownership	Yes	No	No	No
Board representation	Sometimes	No	No	Sometimes
Strategic support	Sometimes	No	No	Sometimes
Risk share of the finance provider	High	Low	Low	—
Form of returns for the finance provider	Gains/losses following resale of shares (based on increase/decrease in share prices); dividends	Interest payments as an annual percentage of the principal	Fixed interest payments, possible market-based sale of bonds to other investors (with gains based on changes in the market price of bonds)	No monetary returns expected
Cost of capital	High	Medium	Low	—
Tenure	Usually 5–7 years	Depends on the purpose (can be as low as a few months, and as high as 15 years or longer)	Mostly long-term, but bonds with shorter tenures also exist	—
Use of funds	Mostly unrestricted subject to memorandum/articles for a company or charter for a non-corporate entity	Often restricted	Sometimes restricted (for example, for green bonds, only certain uses of proceeds are eligible)	Usually restricted
Repayment / Exit	The finance provider realizes returns by selling equity shares acquired as part of the investment (exit strategy); buy back.	A principal must be repaid according to an agreed repayment schedule along with interest	A principal must be repaid along with interest according to an agreed repayment schedule. Periodic payments may include no more than interest, with principal repaid all at once upon bond maturity.	—

Source: Adapted from Deutsche Gesellschaft für Internationale Zusammenarbeit (GiZ) 2018.

entails different processes of assessing the viability of the financing, signing, and closing the financing, and exiting.

Table 39 provides an overview of finance providers and the instruments they typically use to provide funding.

These financing instruments have evolved into financing mechanisms, which are innovative structures that modify the traditional risk-return relationship by sharing and distributing risk among the participating actors by combining two or more financing mechanisms.

These financing mechanisms include PPPs, value-chain financing, blended financing, project financing, results-based financing, and thematic bonds (impact bonds/green bonds, and so on), among others. Detailed explanations of these financing mechanisms, the flow of funds, and the advantages and disadvantages of each mechanism are provided in Appendix 1B.

SOEs can benefit from availing such financing mechanisms, which can be tailored to suit specific financing needs based on the economic sector in which they operate.

While a range of financial instruments and mechanisms are available to SOEs with their relative advantages and disadvantages, it is imperative to find the optimal mix of these financing instruments and mechanisms to be used to finance the SOEs service obligations, which is referred to as capital structuring.

The state, in its capacity as an owner, often defines specific guidelines/rules regarding the SOEs' capital structure. **This is an important consideration because it concerns**

- How and at what cost SOEs finance their operations (mix of equity and debt financing) and
- How SOEs use these capital resources (including grants) to create value for their investors and the public (refer balancing commercial and public service obligations in the previous module).

These financing decisions have an impact on the SOEs' capital structure throughout the SOEs from the establishment of the company (based on planned capital investment needs and relative cost of debt and equity) and throughout the corporate life cycle, based on the interplay between company profits (or losses), the financial returns required by investors, including the state (in the form of dividends or rate-of-return expectations), and decisions to infuse fresh funds. Raising equity, in particular, may require state approval, given the potential impact of diluting the state's majority shareholding. Consequently, the SOE boards need to understand various financing options and their advantages/disadvantages (particularly for the cost of capital, financing tenure, and investor/finance provider exit process), within the context of the capital structuring decisions and the need to balance commercial and social objectives of the SOE.

Table 39: Finance Providers and Typical Financing Instruments

Finance provider	Equity	Loans	Bonds	Grants
State (as an owner)	☑	☑		☑
Private equity funds	☑			
Commercial banks		☑		
Development finance institutions (DFI)	☑	☑	☑	☑
Pension and sovereign funds	☑		☑	
Corporates (ventures)	☑	☑	☑	☑

Source: Adapted from GiZ 2018.

Appendix A3.2A Detailed description of financing mechanisms[10]

Public-private partnerships (PPPs)

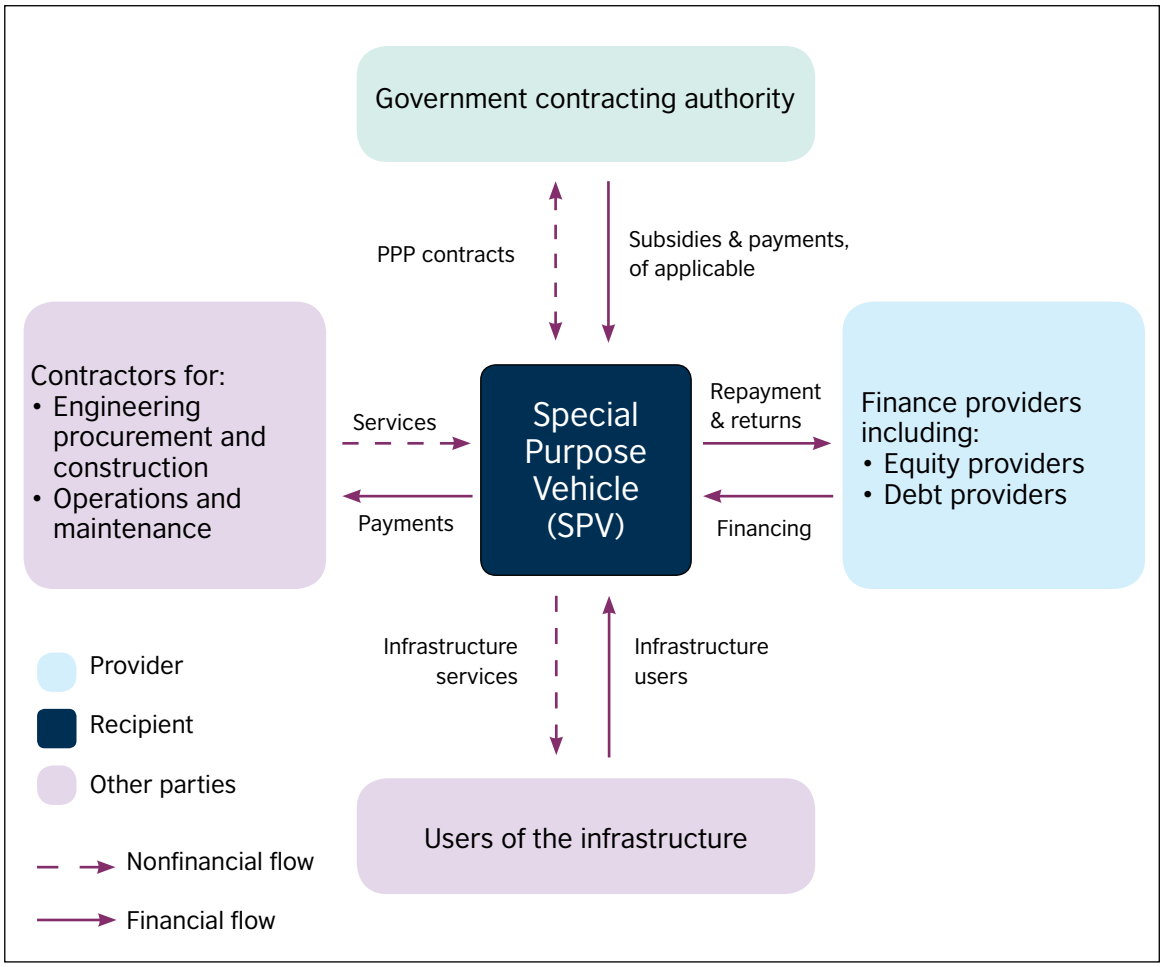
In a PPP arrangement, a government authority enters into a contract with a special purpose vehicle (SPV), a private project company formed by the private sector project developer specifically to finance, build, and operate the infrastructure project for a period of up to 30 years. This is typically a cash-flow-based arrangement, in which anticipated cash flows from the project are a key consideration in the provision of financing.

A generalized schematic of various financial flows taking place under a PPP structure is presented in Figure 31.

The finance recipient in a PPP is the SPV. The private party that has been awarded the contract is responsible for identifying the finance providers. This may include equity investments provided by the SPV's shareholders, loans provided by banks, proceeds from the sale of bonds, or other financial instruments (for example, mezzanine finance).

The underlying revenue model provides SPVs with the opportunity to generate cash flows sufficient to recover their costs and pay the finance providers. The SPV can generate revenues through one of three primary modalities used alone or in combination:

Figure 31: Flow of Funds in PPP Arrangement



Source: Adapted from GiZ 2018.

- *Payment by public authorities:* This modality applies to sectors and/or large projects that are very capital intensive and in which covering costs solely through user payments would be nearly impossible. It could also be applied to areas in which future project cash flows are uncertain (Annuity Model).
- *User fees or tariffs:* In these cases, the private party is paid directly by the users of the infrastructure asset. A typical example would be large renewable energy projects that are paid by the local power company based on a feed-in tariff set by the local regulator.
- *Shadow fees/tolls:* An intermediate way of allowing the private-sector partner to share in the financial benefits of the project is to base the public payment on shadow fees or tolls. While in this case, the actual users do not directly pay anything for using the infrastructure asset, public authorities pay the private partners based on the number of users benefiting from the asset. This mechanism is often used for road projects.

Funding for PPP projects can include both equity and debt capital providers. Equity investors may include the owners of the SPV (typically the project's developers, the engineering or construction companies involved, and any relevant infrastructure-management company) and external private equity funds.

Unlike other infrastructure financing mechanisms, PPPs typically have a large debt component that may be as high as 70 percent to 90 percent of the total project cost. A higher proportion of debt in the overall funding structure means that the equity providers have a higher potential for return since debt is cheaper than equity and interest is an allowable expenditure for tax purposes. The lenders to PPP projects in developing countries may include commercial banks, development finance institutions (DFIs), multilateral institutions, or institutional investors such as pension and sovereign funds. In assessing the project's financial viability, lenders assess whether expected revenues (as ascertained by the project's payment modality, as explained above) will be enough to cover the interest and loan-repayment amounts. If the project is expected to generate robust and certain future revenues, lenders tend to be more willing to provide financing.

Blended finance

Blended finance, aimed at catalyzing private sector activity, can take numerous forms, including tools that facilitate financing flows by providing support mechanisms (grants, guarantees) or as complementary financing (grants, equity, debt). All of these helps to create stronger incentives for private entities to invest in strategic sectors. Examples of such instruments include the following:

- Guarantees from DFIs that help reduce the risk inherent in projects
- Grants that can be used to defray the costs of setting up an investment vehicle
- Concessional finance with below-market terms or rates for the borrower, which can help lower overall project costs and/or enhance potential risk-adjusted returns
- A junior equity position in a co-financing structure that absorbs a higher level of risk than what other investors are willing to assume

The objectives of blending are often achieved in combination with nonfinancial instruments. These could include a range of technical-assistance interventions such as facilitating access to information and data; supporting financial-product development and feasibility studies; providing technical assistance to recipients, fund managers, governments and other market players; and facilitating networking and policy dialogue.

One of the commonly used mechanisms within blended finance involves different loss tranches. In this model, equity or debt-capital investments are divided into different tranches to attract investors with different risk appetites.

In so-called waterfall structures (as illustrated in Figure 32 on the next page), higher or 'senior' tiers receive repayment deriving from lending or investing activities first, and are

thus safer investments, while lower or 'junior' tiers receive payment only after the higher-tiered finance providers are paid in full.

In the case of losses, the lowest tranche—the equity/first-loss tranche (C shares as illustrated in Figure 32, often bought by the government or philanthropic organization)—absorbs the initial losses, followed by the mezzanine tranches (commonly bought by DFIs), again followed by more senior tranches. The senior tranches are attractive for risk-averse investors such as pension funds or insurers, as finance providers with a more senior position are expected to be insulated from default risk through the absorption of losses by the junior tranches.

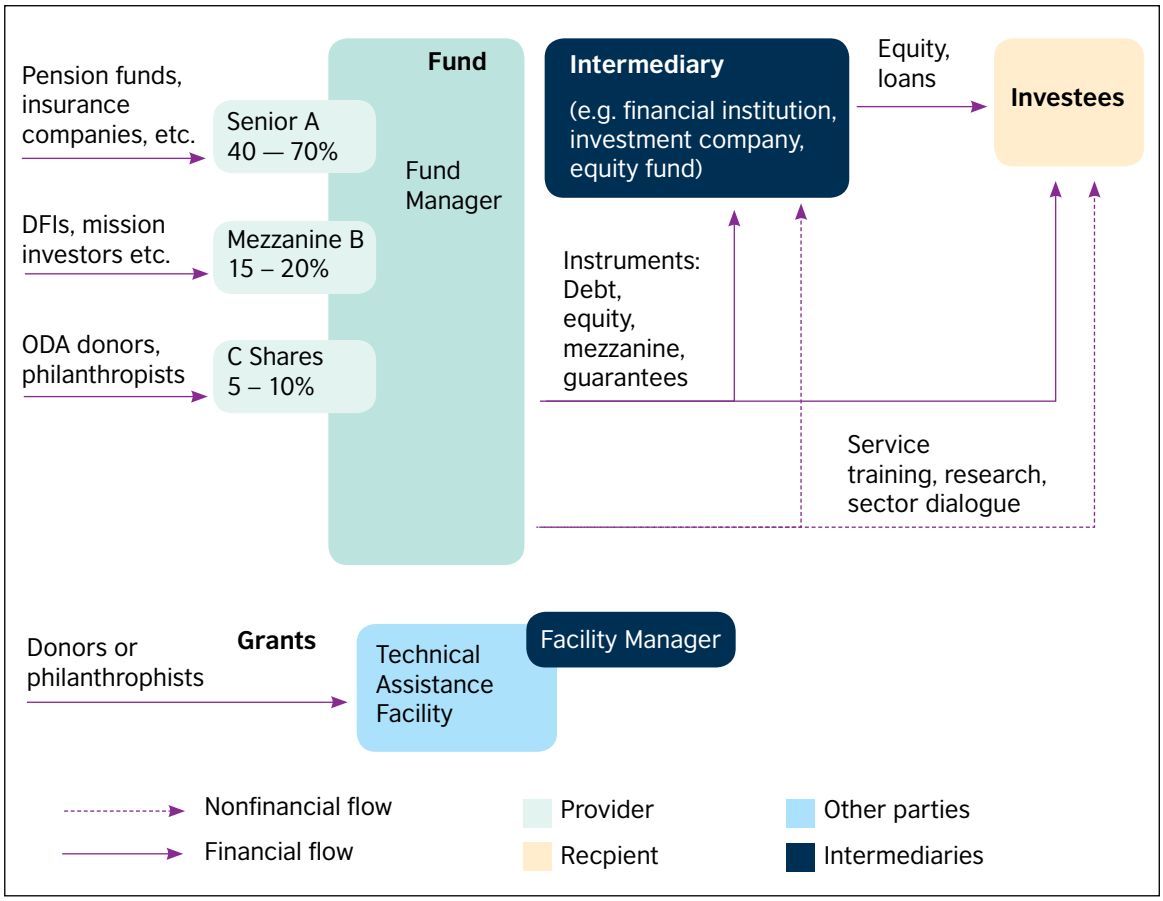
Project finance

Project finance differs from traditional corporate financing arrangements, in which financing is based on the assets, liabilities, and business reputation of the project developer. Project finance allows for what is known as ring-fencing, by decoupling the project's financing from the project developer's assets, liabilities, and cash flows. Thus, it is also called off-balance-sheet finance. In corporate finance, if a project fails, the finance providers do not necessarily suffer if the company owning the project remains financially viable.

In project finance, if the project fails or the SPV fails to meet its obligations, the finance providers can expect significant losses. In such cases, finance providers seeking to recover their investments have recourse only to the assets of the SPV. This is called non-recourse finance. More common, however, is limited-recourse finance, in which the providers have some (limited) recourse to the sponsor's assets beyond the assets of the SPV.

Project finance ensures the opportunity to provide long-term financing as long as the project in question is well structured and economically viable, even if the developer's resources are insufficient to carry out the project. With various contracts, insurance products and complex financing and risk-mitigation structures, it allows for the

Figure 32: Flow of Funds in Blended Finance



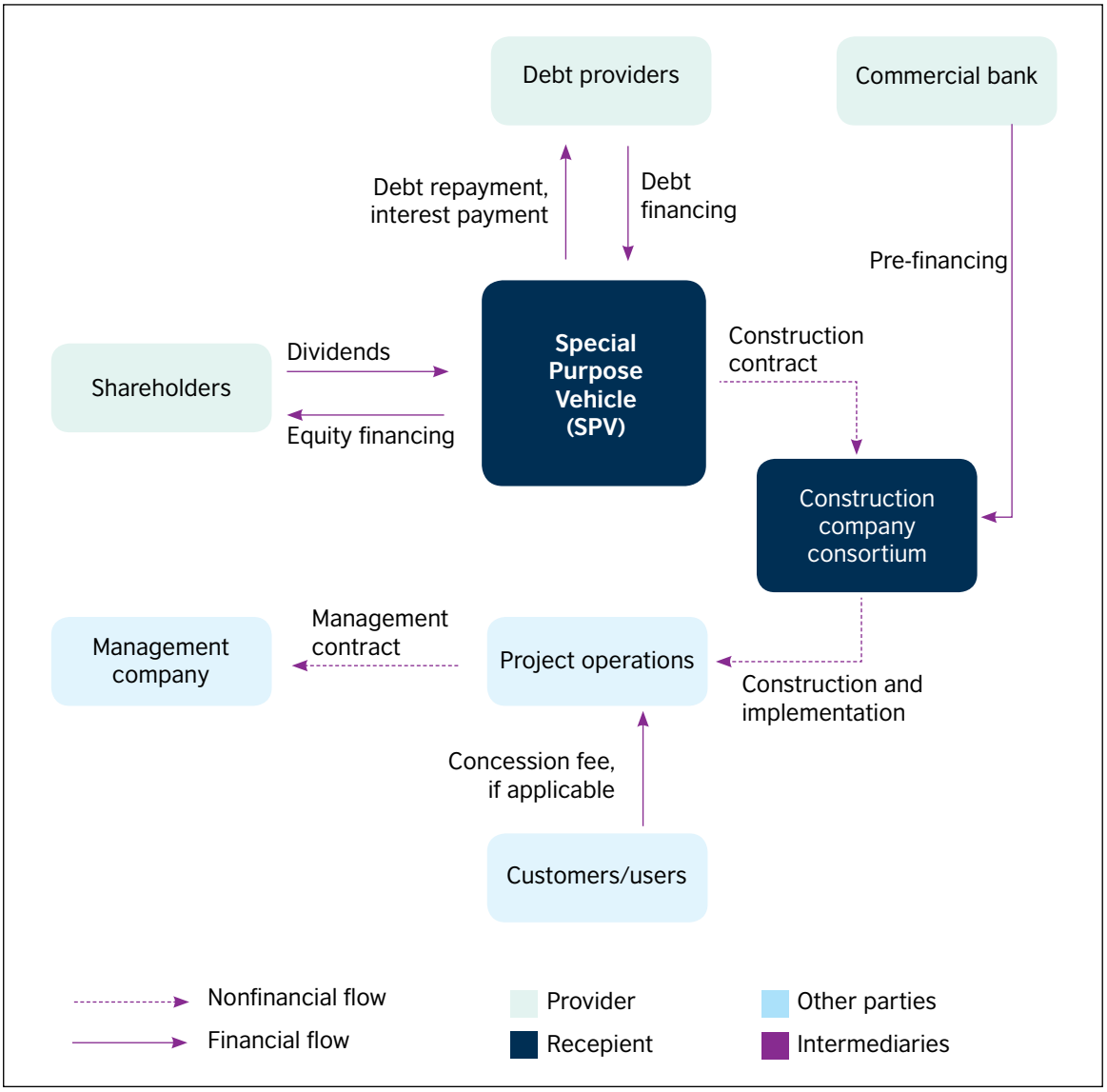
Source: Adapted from GiZ 2018.

allocation of project risk, among those who are the best able to manage and control that exposure.

Project finance usually includes a large up-front investment, a long utilization term, and a long repayment term. The financing is usually provided in the form of long-term loans to the SPV. It is secured by the project's assets and repaid from the project's cash flows. The flow of funds is illustrated in Figure 33.

For project finance, the finance recipient is the SPV set up to implement a task, such as a large infrastructure development project. The project-owning company thus has no asset other than the project itself. Once constructed, the project is typically managed by a professional management company and is expected to generate enough cash flow to pay back the loan principal and interest to the banks as well as to generate a dividend for the shareholders. The cash flows come from the income generated by the project operations, for instance in the form of concession fees in the case of a road, airport or port, or from the sales of electricity from a hydropower plant. Due to its complex structure and long-term commitment, project financing requires sound financial modeling. Risk identification and allocation are key components of project finance. Projects may be subject to several technical, environmental, economic, and political risks, particularly in developing countries.

Figure 33: Flow of Funds in Project Finance



Source: Adapted from GiZ 2018.

Results-based financing (RBF) – Impact bonds

RBF seeks to mobilize additional financing from investors that would not normally consider investing in the social sector due to low expected returns. Despite the variety of models, RBF mechanisms are based on a few common principles, identified below.

- Disbursement of funds is contingent on the delivery of predetermined outcomes.
- The private sector (and non-profit sector) has discretion over how results are achieved, thus allowing for product and service innovation.
- Independent verification acts as the trigger for disbursement.

Impact bonds combine impact investing, RBF, and PPP concepts. In an impact bond, private investors provide up-front capital for social services that are repaid by an outcome funder if the agreed-upon outcomes have been achieved.

The flow of funds under this model depends on the exact nature of the RBF mechanism. For illustration purposes, this section describes impact bonds, which are increasing in importance in both the social and development sectors. Most impact bonds involve three types of actors:

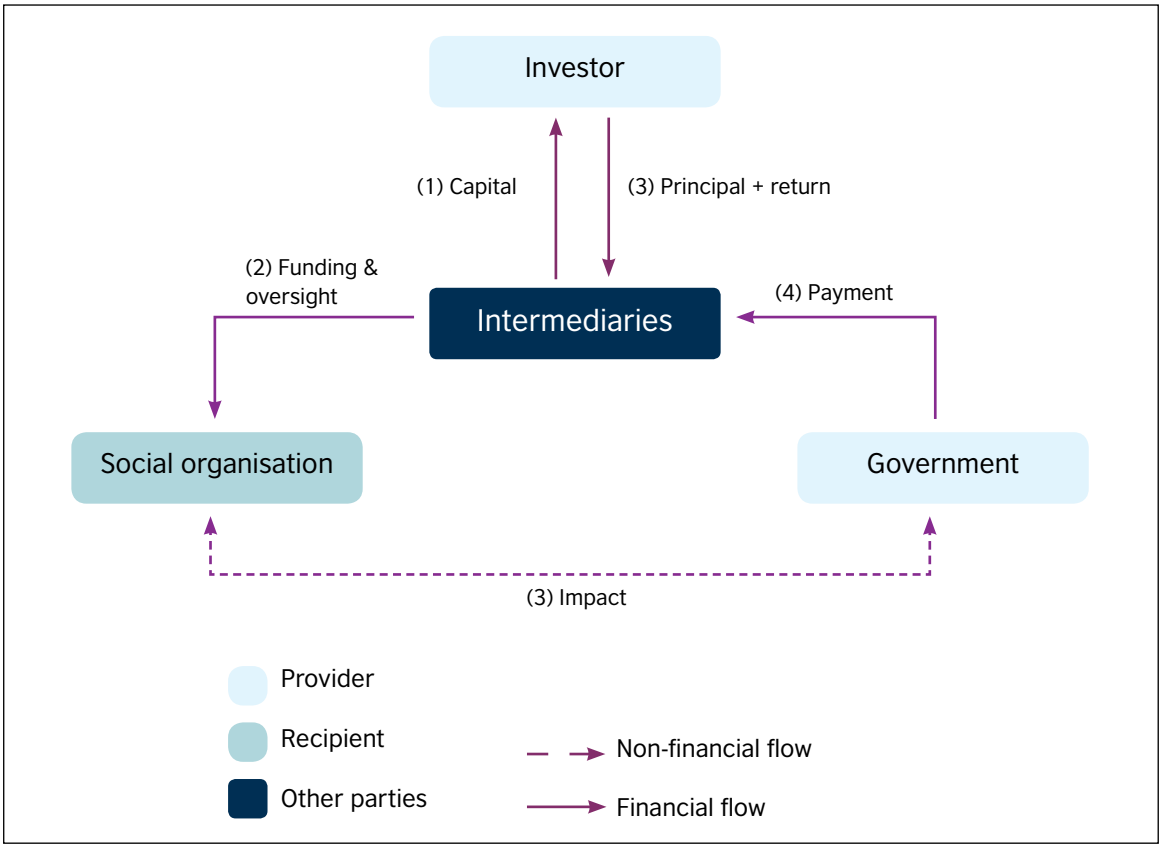
- The investors, who are typically return-seeking, impact investors or venture philanthropists that provide up-front capital to social organizations
- A non-profit organization or social enterprise often called a service provider that delivers products and services to the target group
- The outcome funder, usually a government, development agency or philanthropic organization that promises to repay the investors if the agreed outcome is achieved with the addition of a predetermined bonus representing the return on investment.

Other actors in this model include evaluators that verify whether agreed-upon outcomes have been achieved and intermediaries that perform tasks such as designing the bond, helping to raise capital, and arranging negotiations among the participants. In many cases, external legal and technical know-how is required from lawyers and sector or impact experts, sometimes called technical-assistance providers or simply experts.

Figure 34 on the next page explains the process and the flow of funds using the structure and process of the first social-impact bonds in the United Kingdom as an example.

- An intermediary issues a bond to a (social) investor and receives the capital (step 1).
- The intermediary transfers the money to one or several social organizations (step 2).
- Social organizations use the funds as working capital to scale and improve the outcome of a preventive program. The work can be coordinated and monitored by an intermediary (step 3).
- At the end of the contract period (3–10 years), an independent evaluator determines whether the agreed-upon outcomes have been achieved based on the government contract. If a positive evaluation is provided, the intermediary is paid a previously agreed amount. This may take the form of a percentage of the government savings created through the achievement of the outcomes, for example. If the evaluation is negative, the government (that is, the outcome payer) funder does not owe anything (step 4).
- Only in the case of success would the intermediary repay the original (social) investor, the equivalent of the principal and a return on investment, the size of which may vary depending upon the service providers' performance (step 5).

Figure 34: Flow of funds in impact bonds



Source: Adapted from GiZ 2018.

Appendix A3.2B Business Case and Investment Plan Review

The Business Case and Investment Plan model sets out the structure for preparing investment proposals for projects initiated by SOEs. It puts into practice the project cycle and is prepared in line with a model, which takes into account six interdependent dimensions shown in Table 40 and outlined further below.

The SOE needs to establish the business case for the investment proposals across the following dimensions:

Strategic dimension

The strategic element should provide the background to the proposal and describe

Table 40: Six Interdependent Dimensions for Project Cycle

Dimensions	Description
Strategic dimension	What is the rationale for this intervention? How does it relate to the company's business plan and development objectives of the government?
Economic dimension	How does the proposed business case or the investment optimize the public value and how this is achieved?
Commercial dimension	Is this intervention commercially feasible? Could a realistic and commercial deal be developed?
Financial dimension	Is this project affordable? How much will this project cost? How would this project be funded?
Social, environmental, and climate dimension	What are the social and environmental implications of this project? What are the climate risks and adaptation needs?
Implementation dimension	How would this project be delivered effectively?

Source: Adapted from HM Treasury 2013.

the objectives to be achieved. Accordingly, the strategic policy context and how this intervention fits with the broad sectoral or national policy and the SOEs business plan should be explained. As such, the strategic element should aim to address the following aspects:

- Set out the rationale for intervention describing the current situation and desired outcome and gaps between the current situation the intervention aims to achieve;
- Identify a clear need, specify outputs, and ascertain the extent of current and future demand for the intervention;
- Demonstrate the strategic alignment for the proposed program to government's development agenda/sectoral agenda, the vision and the mission of the SOE and its core values;
- Establish the SMART investment objectives, existing arrangements, and business needs in line with the business plan;
- Consider the potential business scope and key service and public service requirements; and
- Identify potential strengths, weaknesses, opportunities, and threats (SWOT analysis)

Economic dimension

The economic element comprises key analytical components of a business case and investment plan and evaluates the economic costs and benefits of the proposed intervention to the society. This section elaborates how the proposed business case or the investment plan would optimize the public value and how this is achieved by identifying and evaluating different achievable and realistic alternatives, in terms of how well they meet the spending objectives by subjecting a selected number of options, known as 'the shortlist', to cost-benefit analysis. Accordingly, the economic element should aim to address the following:

- A long list of alternative options and initial options analysis (refer Figure 35 for a sample)
- A shortlist of at least four alternative options and economic assessment of these options including market analysis, cost-benefit analysis, assessment of non-monetary benefits, and risks and uncertainties (refer Figure 36 for the process of conducting a cost-benefit analysis)
- The rationale for selecting the preferred option

Commercial dimension

The commercial element will look at the commercial feasibility of the proposed intervention and assess if a realistic and commercial deal could be developed. This section will analyze the planning and management of procurement, commercial strategy of the business case, service requirements contract management including

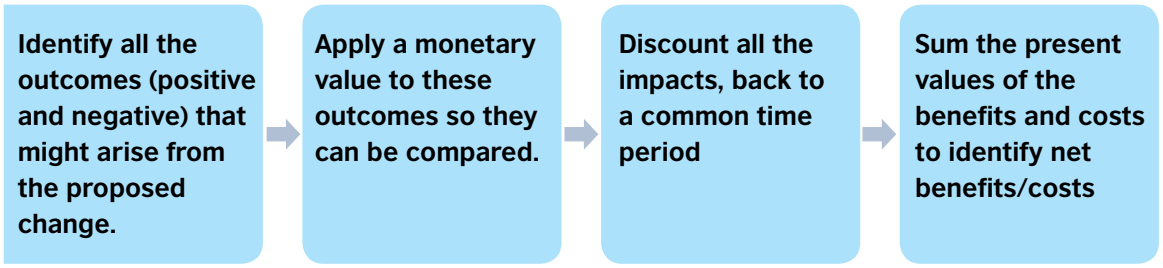
Figure 35: Sample Options Analysis

***Project objective:* Deliver a better Public Transport Solution in the Western Province**

Do Nothing	• The current public transportation system remains as it is
Use Better	• Conduct a network review to optimize use of routes • Conduct a time-table review to manage demand and resoueces
Improve Existing	• Integrate bus and rail transport systems to provide an integrated public transportation solution
Introduce New	• Light Rail System • Hybrid Buses

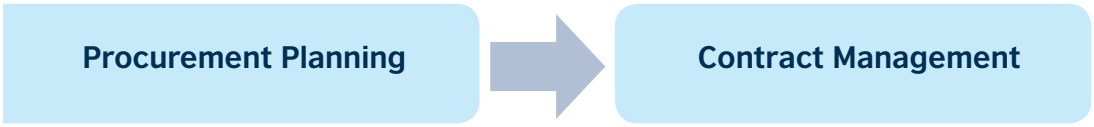
Source: Adapted from World Bank, 2014

Figure 36: Process of Conducting a Cost-Benefit Analysis



Source: Adapted from World Bank 2014.

Figure 37: Key Elements of Commercial Dimension



Source: Adapted from World Bank 2014.

contractual milestones and delivery dates, and identification of risks related to different contracts/tenders, as outlined in Figure 37.

Financial dimension

Financial element aims to identify the affordability and budget implications of the preferred business case or investment option. This section of the business case and investment plan proposal requires the SOE to set out the capital and revenue requirements over the expected life span of the project, together with an assessment of what impacts the project would have on the SOEs balance sheet, income and expenditure statements, and the overall financial position. Under this section, the SOE will be expected to demonstrate the financing of the business case—self-financing, private sector financing/ PPPs or budget funded, and provisions for dealing with the financing of any time or cost overruns. Accordingly, this element aims to address the following:

- A description of the model and the costing methodology used;
- All key assumptions in the model including how these assumptions were derived and agreed upon (for example, discount rates, inflation, taxation, depreciation, cost savings);
- A description of the proposed funding arrangements;
- A sensitivity analysis to identify the impact of changes in any assumption used on the cash flow;
- Contingencies for risks and uncertainties, including scenario testing on key assumptions;
- Capital and operating impacts on the SOE's finances; and
- Fiscal impacts on the SOE's baseline.

Social and environmental dimension

This element aims to identify social and environmental implications potentially resulting from a proposed project and steps that can be taken to avoid negative environmental impacts or reduce them to acceptable levels before they occur. New or major infrastructure development projects will be expected to undertake a comprehensive social and environmental impact assessment, whereas medium- and small-scale projects would require providing an outline of the social and environmental impact of the project.

The contents of the environmental and social dimensions of a project are outlined in Figure 38 on the next page.

Implementation dimension

This element primarily evaluates the deliverability of the business case. This should include a delivery plan with comprehensive milestones, a timeline and KPIs. The purpose of this dimension is to demonstrate that robust arrangements

Figure 38: Contents of Social and Environmental Dimensions

Social dimension

- Resettlement of communities
- Key social and cultural issues in the project's area of influence
- Gender implications of the project including contribution to women empowerment and reducing risk of gender-based violence (where applicable)
- Differently-abled friendly

Environment dimension

- Identification of environmental consideration, and exposure of the proposed business case to environmental hazards and climate change vulnerabilities
- Climate resilience and adoption plan (disaster risk reduction)



Source: Adapted from World Bank 2014.

are in place for the delivery, monitoring and evaluation of the scheme, including feedback into the organization's strategic planning cycle (as outlined in Figure 39).

Figure 39: Components of Implementation Dimension



Source: Adapted from World Bank 2014.

Demonstrating that the preferred option can be successfully delivered requires evidencing that the scheme is being managed following the best practice, subjected to independent assurance and that the necessary arrangements are in place for change and contract management, benefits realization, and risk management. Accordingly, this section should aim to answer the following:

- Is this proposal practically deliverable and what is the sequencing of steps?
- Who is the implementing agency?
- When is the deadline?

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Strategy, Risk, and Performance

Leadership Training Toolkit for SOEs

Part III Module 3
Financial oversight and decision-making

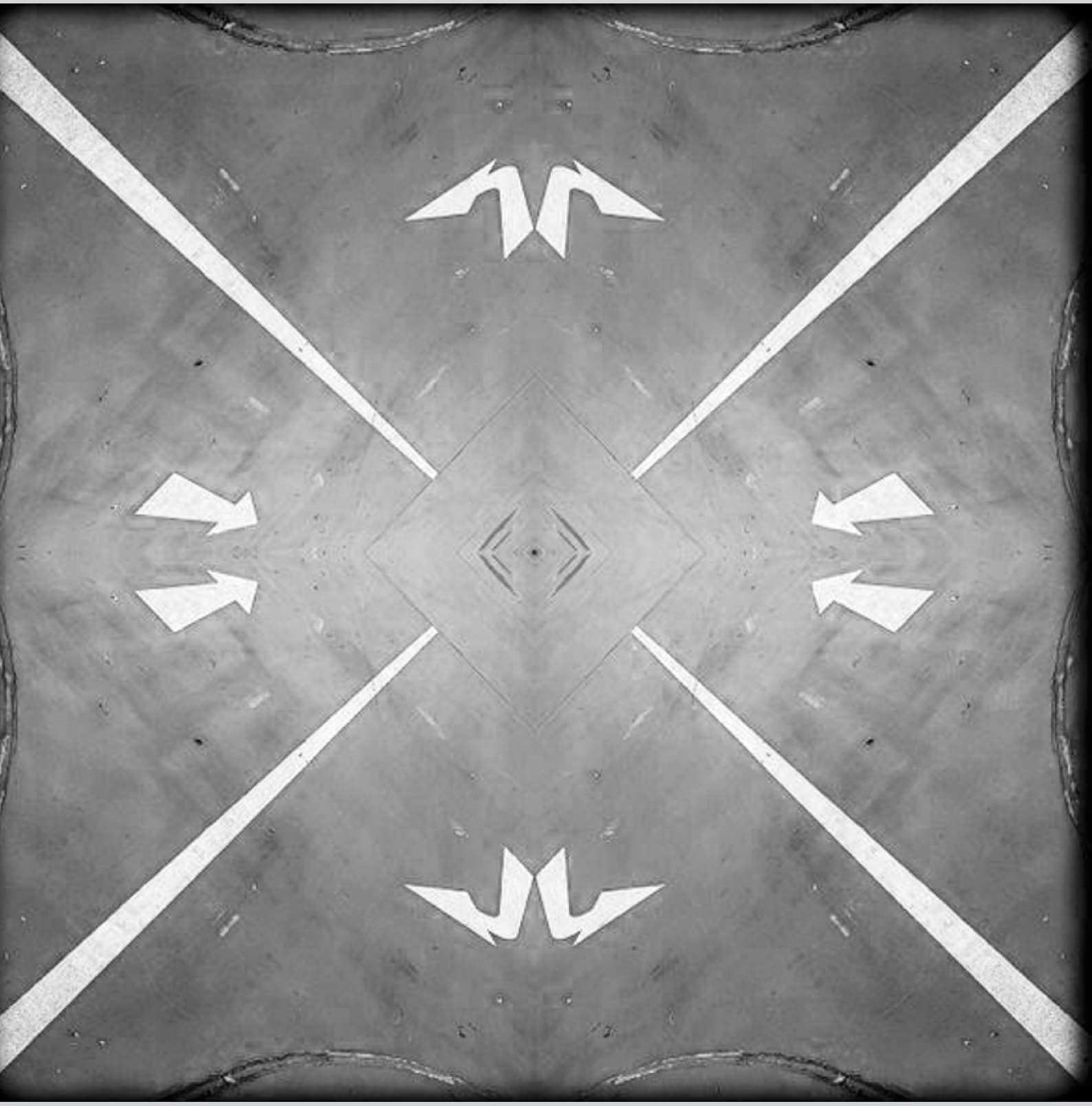


Photo: ©Cyrill Bellier

Part III Module 3: Financial oversight and decision-making

This session (module) covers the following topics:

1 Financial oversight arrangements in SOEs – Board level

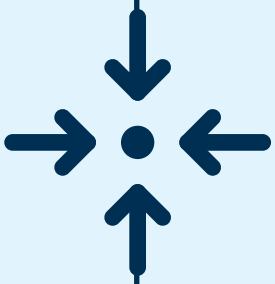
2 Assessing financial performance and health of SOEs

3 Company's capital gearing, dividend policy, and valuation

4 Subsidiary governance

Learning objectives

By the end of this module, the participants will be able to



- **Describe the board's role in financial oversight of SOEs**
- **Discuss various indicators to assess financial performance and health of SOEs through case studies**
- **Describe the issues related to SOEs capital gearing, dividend policy, and valuation**
- **Discuss the role of subsidiary board, board composition, and related-party transactions**

Agenda

Total time: 2 hours 50 min

Time	Topic
30 min	Financial oversight arrangements in SOEs – Board level
45 min	Assessing financial performance and health of SOEs
30 min	Case study on the performance monitoring report
45 min	Company's capital gearing, dividend policy, and valuation
20 min	Subsidiary governance

Topic one: Financial oversight arrangements in SOEs – Board level

Financial stewardship

The SOE is required to keep appropriate accounting records and to issue financial statements to ensure accountability to capital providers and proper use of assets. Such financial stewardship aims to make available historical financial information at a level of detail that enables the entity's performance to be assessed in its own right and to provide information about the entity's positioning for the future.

The International Accounting Standards Board (IASB) describes the role of stewardship in financial reporting as providing information useful in assessing how the management has fulfilled its stewardship responsibility as that is part of the overall objective of providing information useful in making resource allocation decisions.

Role of the board and audit committee in financial oversight

The board's financial oversight of the SOE's activities is required to ensure financial stewardship and provide users with the appropriate information to make decisions. In most countries, company law or its equivalent, and other statutory and reporting requirements hold directors responsible for a broad range of matters, including

- Maintenance of proper accounting records, including the review, approval, and monitoring of capital and management budgets and performance.
- Disclosure of the company's financial position, changes in that position and performance, and the publication of financial statements on at least an annual basis and more often if required (see Part IV, Module 2, 'Financial Reporting of SOEs').
- Establishing and monitoring proper internal controls (see Part IV, Module 1, 'Understanding the Control Environment including internal and external controls').
- Assurance that appropriate external controls and audit are in place and operating (see Part IV, Module 1, 'Understanding the Control Environment including internal and external controls').

The directors' role is to ensure conformance and compliance with state's expectations when the state is the sole shareholder or all shareholders including minority shareholders when the state is not the sole shareholder, and regulatory requirements. In many countries, an audit committee (see Part II, Module 1) of the board will be mandated by regulation and delegated to reviewing the company's financial statements and other financial information.

In general, despite the existence of an audit committee, it is still every director's role to ensure that financial information is understood and sufficient to make informed judgments and decisions. A director must act in the SOE's and the shareowners' best interests. In particular, they include a duty of care and diligence and the fiduciary duty of all directors to act honestly and in good faith for a proper purpose. The board will exercise its power based on the information provided by the management. Its duties include overseeing and monitoring management, especially the SOE's financial management and the proper use of its assets.

To ensure that these responsibilities are carried out, a director must have a broad range of skills and business experience, and in particular, understand the financial consequences of board decisions. A director is not expected to be a qualified accountant. Financial skill and knowledge may come from other business experience. However, most boards are likely to have someone with finance background or one with proven financial acumen and literacy. All directors should have sufficient, relevant, and current financial skills and experience so that each director can

- Have a broad understanding of the accounting environment, understand accounting terminology and accounting standards, policies, and procedures, and when accounting judgments may have been applied by management;
- Know how a set of financial statements is developed, what they represent, and be able to review them;
- Know the relevant questions to ask and understand the answers given;
- Ensure the SOE is liquid/solvent, profitable, and performing.

Directors and the accounting function

The finance director, finance department, or management accountant provides a service and support function to the company. They must provide information that is helpful to the directors and managers. Directors have the right, within reason, to stipulate the nature of their information requirement, timelines, and its presentation format. Directors should also ensure that proper accounting policies and recordkeeping processes are in place for the provision of relevant and reliable financial information.

Topic two: Assessing financial performance and health of SOEs

Governments need to oversee the financial operations of SOEs to ensure accountability for their performance and manage fiscal risks. Governments should focus their surveillance on SOEs that are significantly large, pose high fiscal risks, are not profitable, are unstable financially, or are heavily dependent on government subsidies or guarantees. Appropriate legal, institutional, and procedural arrangements need to be in place to facilitate the state's oversight of SOEs as discussed in Part I, Module 2 Role of the state as an owner.

Financial management practices

Financial management "is the operational activity of a business that is responsible for obtaining and effectively utilizing the funds necessary for efficient operations." – Joseph and Massie (as cited in Classification of Finance by Paramasivan and Subramanian 2009)

In the case of an SOE, the following key elements make up a robust set of financial management practices.

- **Finance organization** – This is the finance department within the SOE's organization structure. There should be a well-documented finance organization structure showing roles and functions of each position within the organization structure and the reporting relationships or interrelationships between the positions, that has been approved by the SOE's board or the state. Each position should have a detailed job description and associated KRAs that indicates the HR requirement in terms of desired skills and qualification.
- **Standard Operating Procedures (SOPs) and Manuals** – There should be comprehensive and the board-approved SOPs that standardize the functioning of finance operations. It should also talk about the delegation of financial powers showing approval limits and ceilings at various levels of authority for different business transactions.
- **Availability and quality of financial information** – There should be a structured framework that enables the availability of timely and quality financial information for daily monitoring by the management of the SOE and periodic monitoring by the board of directors and state. For example, a comprehensive cost accounting system that identifies, records, and analyses costs in terms of their nature (fixed or variable), allows rational allocation of overheads to products and operating centers, and allows suitable

decision-making for cost control, will significantly enhance the quality of decision-making.

- **Cash management and forecasting** – An SOE should have a credible cash forecasting system on a rolling basis that is fully aligned with the strategic vision and the annual operating plans and budgets with regular monitoring of variances.
- **Budgeting** – A well-defined budget manual lays down the standard contours for budgeting periodically. It is also important to ensure that budgets get approved in time so that all business units within an SOE have clearly assigned budget ceilings. The SOE budgeting process was described in detail in Part III, Module 2 Financial planning for SOE service obligations.

Ratio Analysis

Ratio analysis is one of several tools used when analyzing a company's strengths and weaknesses as revealed in the financial statements. Ratio analysis explores important relationships among key pieces of data in the statements, such as

- Liquidity/solvency
- Profitability
- Management of working capital
- Investment attractiveness

Lack of accounting method consistency reduces the capacity to compare a given ratio between periods. The use of ratio analysis is most valuable when the boundaries of a reasonable range of ratios are well-established for the SOE in the industry and the economic environment.

Table 41 provides an overview of the ratios that can be used to analyze the financial performance of an SOE. Refer to the IFRS taxonomy for guidance on globally accepted definitions of above financial items.[11]

Table 41: List of Ratios

Ratio	Formula	Interpretation
ANALYSIS OF LIQUIDITY - A company is liquid and a 'going concern', when it can pay its debts, as they become due. This means that it can pay its suppliers because it has enough cash flow and working capital.		
Current ratio	Current assets/ Current liabilities	The current ratio looks at the relationship between current assets and liabilities. Interpretation of the health of the results should carefully consider the company's particular circumstances, its activities, and the economic environment. For example, the quality and the salability of the stock and the collectability of the debtors are important when considering the current ratio. A business may look healthy using the current ratio but may be carrying too much inventory or stock. A healthy level of current assets may hide the fact that a large proportion of the current assets were stock. Stock can be turned into cash, but only given a reasonable amount of time to do so.
Quick ratio or Liquidity ratio	Current assets less Stock/ Current liabilities	The quick ratio or liquidity ratio (also known as the 'acid test') is useful, as it measures liquidity more precisely than the current ratio. Turning stock into cash takes time as cash from any sale will only be received under the company's trading terms. Quick ratio ignores the value of stock within current assets. Historically, a 1.5-to-1 ratio may also be looked at as satisfactory, but, again, companies have tended to work with lower ratios. Even when reviewing the results of a quick ratio, an analyst should consider the marketability of securities and the collectability of debtors.
ANALYSIS OF PROFITABILITY - One can determine if a company is profitable by analyzing the income statement, but one needs to put that profit into perspective. Consider if the • Profit is growing in proportion to the size of the business; • Profit is growing or falling in relative terms, that is, the company is making as much profit on new/extra sales, as it was on existing sales; • Business is as profitable as other companies are in the same sector.		
Gross profit margin	Gross Profit/ Revenue × 100	It indicates the profit earned after the cost of production for every US$1 of sales. Small negative changes in this percentage can indicate that production costs are creeping up, prompting consideration to increase prices or look for cheaper suppliers. A gross profit margin is not the same as 'mark-up', which is calculated as follows: Mark-up = Gross Profit/Cost of Sales × 100

Net profit margin	Net Profit % = Net Profit/ Revenue × 100	The ratio provides a good measure of performance. However, if the percentage is declining over time and it is subject to many variable elements, further investigation will be needed to determine the root cause of the decline. In such circumstances, ratio analysis may be supported by other review techniques and investigations. Net profit is calculated after taking all costs into account. It may be affected by a declining gross profit (see above) or by increased business costs. It is probably worth looking at individual costs to see which have proportionately increased the most. Consideration must then be given to reducing these costs.
Return on assets	Net Profit/Net Assets × 100	The level of profit compared to the value of net assets invested can be measured for a company. The assets are the major items that need to be in place to do business, including fixed assets (for example, buildings, plant, vehicles, and computers) and current assets (for example, stock, debtors, and cash). The net asset/net capital is total assets less total liabilities. This represents the net amount of capital invested in the business. One can, therefore, look at net profit as a percentage of net capital/assets employed. The return that a business can expect differs by business sector and also may differ over time—depending on the economic cycle. However, it remains a good measure of business efficiency. Similarly, the return on equity can also be calculated as net profit/equity.
ANALYSIS OF PERFORMANCE - Here, the performance of individual aspects of the business is evaluated.		
Borrowing ratio (gearing ratio)	Total borrowings/ net worth (net assets − net liabilities)	It shows the level of security there is for borrowings. For example, if borrowings totaled US$30 million and the business net worth (as shown in the balance sheet) was US$9 million, the borrowing ratio would be '1:3'. A '1:3' gearing ratio would normally be considered conservative and low. A '1:2' gearing ratio is an average level of gearing. To determine if the gearing ratio is seen as adequate, consideration of the general economic environment and the availability of funds is important. The level of gearing that may be acceptable should be considered in the light of the number, size, and strength of financial institutions in the market and the maturity of bank facilities and the level of market confidence at the time. Financial institutions may significantly reduce their lending in difficult times.
Average collection period (debtor days)	Debtors/ Revenue × 365	This ratio is used widely within businesses to measure the effectiveness of their debt collection routines. It sets out the relationship between debtors and the sales that have been made on credit. It shows how quickly customers are paying their invoices. If this ratio starts to increase, directors should look carefully at debtor collection routines and take appropriate action. They must check if the company is effective in collecting debts quickly and/or if a customer is building up a large debt that could cause concern.
Average credit period creditor days	Creditor days = creditors/ purchases × 365	This ratio sets out the number of days the company takes to pay suppliers. This is less important than the debtor day statistics since the control overpayment to suppliers is in the company's hands. However, it may be an indicator of a cash flow problem within the company. When assessing another business, for example, one that is asking to increase its credit, this ratio can give a useful pointer as to whether the business is taking longer to pay people. Outside credit, reference agencies use the calculations to give a profile of the business to potential suppliers.
Stock turnover	Cost of goods sold/stock value	This ratio looks at how quickly a company turns its stock (or inventory) into sales. The quicker that stock is turned over, the better. A quick turnover suggests that the company is efficient in holding the minimum stock used within the business. Again, the trend over time is very important and should be related to the company's history, competitor comparisons, and the economic cycle. Consider the reasons, for which the company is turning over its stock more slowly. For example, consider if some stock is not easily sold and if the company has appropriate discount strategies in place.
Overheads as a % of revenue	Overheads/ Revenue × 100	A useful tool in assessing whether the business is growing too rapidly and in a manner not matched by revenue. The calculation means little on its own, but when reviewed over several periods, can provide useful trend information. As the company grows, this percentage should fall. If it does not, the overhead costs should be reviewed carefully to understand why this is happening and to see if they can be corrected.

Source: Adapted from World Bank 2014.

Therefore, an analysis of the financial performance of SOEs should include a range of indicators of profitability, risks, and financial relations with the government. The choice of specific indicators depends on country circumstances, including the type of industry an SOE is representing, the level of risk, and comparability with the private sector. However, financial surveillance by the government typically focuses on the following indicators:

- *Financial performance* as measured by indicators such as the profit margin (earnings/revenue), the return on equity (earnings/equity), and the return on assets (earnings/assets).
- *Financial risk* as measured by indicators such as liquidity (current assets/current liabilities), leverage (assets/equity), solvency (liabilities/revenue), or the probability of default.[12]
- *Transactions with the government* in the form of dividends, taxes, grants, compensation for quasi-fiscal activities, and other subsidies.
- *Foreign linkages* as measured by indicators such as the relative weight of debt to foreign creditors, the currency composition of debt, or the hedging of currency risk.

Figure 40 provides examples of the specific indicators monitored by the Australian government.

Box 41 (on the next page) outlines a country case study on assessing the financial performance and health of SOEs in Indonesia.

Given that SOEs may expose the government to a range of fiscal risks, particularly if their

Figure 40: Australia: Financial Performance Indicators for Government Enterprises

Financial performance (indication of the commercial viability of the enterprise	Financial risk (information on the risk of an enterprise not being able to meet the financial obligations	Transactions with government (impact of the transactions wit the government in the enterprise's finances)
Profit before tax = Revenue – Total expenses (excluding income tax)	***Debt to equity*** = $\frac{\text{Debt}}{\text{Equity based on operating assets and liabilities}} \times 100$	***Dividend to equity*** = $\frac{\text{Dividend paid or provided for}}{\text{Average equity based on operating assets and liabilities}} \times 100$
Operating profit margin = $\frac{\text{Earnings before interest and tax from operation}}{\text{Operating revenue}}$	***Debt to operating assets*** = $\frac{\text{Debt}}{\text{Average operating assets}} \times 100$	***Dividend payout ratio*** = $\frac{\text{Dividends paid or provided for}}{\text{Operating profit after tax}} \times 100$
Cost Recovery = $\frac{\text{Operating revenue}}{\text{Operating expenses}} \times 100$	***Total liabilities to equity*** = $\frac{\text{Total liabilities}}{\text{Total equity}} \times 100$	***Income tax expense*** = the value of income tax or income tax-equivalent expenses payable to government
Return on operating assets = $\frac{\text{Earnings before interest and tax}}{\text{Average operating assets}} \times 100$	***Operating liabilities to equity*** = $\frac{\text{Operating liabilities}}{\text{Equity based on operating assets and liabilities}} \times 100$	***Grants revenue ratio*** = $\frac{\text{Grants to cover deficits in operations}}{\text{Revenue}} \times 100$
Return on total equity = $\frac{\text{Operating profit after tax}}{\text{Average total equity}} \times 100$	***Interest Coverage*** = $\frac{\text{Earnings before interest and tax}}{\text{Gross interest expense}}$	***Public service obligations*** = the sum of payments by governments to public corporations for the specific noncommercial activities that they direct public corporations to undertake
Return on equity based on operating assets and liabilities = $\frac{\text{Operating profit after tax}}{\text{Average equity based on operating assets and liabilities}} \times 100$	***Current ratio*** = $\frac{\text{Current operating assets}}{\text{Current operating liabilities}} \times 100$	
Operating cash flow to sales = $\frac{\text{Operating cash flow}}{\text{Operating revenue}} \times 100$	***Leverage ratio*** = $\frac{\text{Total operating assets}}{\text{Equity based on operating assets and liabilities}} \times 100$	
	Short term debt coverage = $\frac{\text{Operating cash flow}}{\text{Current liabilities}} \times 100$	

Source: Australian Government, Productivity Commission, 2008.

Box 41: Assessing Financial Performance and Health of SOEs in Indonesia

In Indonesia, the ownership entity uses eight financial indicators to assess the financial health of nonfinancial public enterprises. These indicators include the return on equity, the return on investment, the ratio of current assets to current liabilities, inventory turnover, total asset turnover, and the equity to total asset ratio. A weighted average of the indicators is also constructed in order to classify enterprises as 'healthy', 'less than healthy', and 'not healthy'.

Source: World Bank Group. 2014. *Corporate Governance of State-Owned Enterprises: A Toolkit.* Washington, DC: World Bank.

debts are implicitly or explicitly guaranteed by the government, the SOE needs to disclose the following, in particular, to facilitate a stress test analysis on the fiscal risk, undertaken by the state:[13]

- **Taxes and royalties paid by SOEs (including tax arrears).** Because of their size and the opportunities for corruption and irregularities, there is often particular public interest in the transparency of tax and royalty payments made by government-owned natural resource companies;
- Dividends paid by SOEs to the government and profit transfers from the central bank;
- Capital transfers or injections to SOEs, write-offs of debt, and pension liabilities that exceed the pension scheme's assets;
- Operating subsidies paid by the government for the costs of specific activities conducted by SOE or to compensate for operating losses;
- Payments by the government for services provided by SOEs or the central bank;
- Loans or on-lending by the government to SOEs;
- Government guarantees of SOE borrowing;
- Any reduced rate of tax, customs duties, or royalties imposed on SOE compared to the rates and allowances that apply to private sector companies;
- Interest rate subsidies;
- Any departure from normal economy-wide regulatory requirements for SOEs;
- Any preferential treatment accorded in public procurement; and
- Any implicit guarantees provided by the government to SOEs, which may reduce their borrowing costs.

Public corporation monitoring Reports

Monitoring reports on SOEs/public corporations should summarize the overall financial performance of the sector as well as provide information on individual companies. Well-designed reports usually encompass five main sections:

- An overview of the sector and highlights of public corporation activities during the year, including information on policy decisions or transactions that had a material impact on the financial position of the sector.
- A full list of the companies owned by the government, broken down by industry, size, and type of ownership (for example, the majority- or minority-owned companies, strategic companies, or candidates for privatization).
- An overview of how the government has exercised its ownership policy, including the appointment of board members, dividend policy, organizational and governance arrangements, and the announcement of financial and public policy targets.
- Special topics, including a more thorough explanation of issues related to the government's ownership policy: for example, changes in the policy framework for public corporations, remuneration policy, the valuation of companies, issues of organization and management, and the impact of public corporations on government finances and the economy.
- Information on individual companies, comprising a summary of their operations, abridged financial statements, and indicators of financial performance for the current year and previous years. The

report should also provide a list of board members, key personnel and auditors, as well as information on the government's shareholding and financial targets, if applicable, together with data on KPIs. This information could draw on a central database of public corporations at the national and sub-national levels.

Topic three: Company's capital gearing, dividend policy, and valuation

Suitable dividend policy for SOEs

Clear SOE dividend guidelines should be developed. Dividends paid to the government usually reflect the profitability of the enterprise and the need to retain profits for investment in capital assets. Higher dividends may not always be desirable, as they may reflect monopoly profits or deprive SOEs of funds they may require for investment in new capital assets. As an alternative to dividends, governments may establish a policy of retaining funds in the enterprise to increase shareholder value. Dividend policy may be defined in the shareholder's agreement.

A dividend policy for an SOE group would divide its after-tax profit into two parts: retained earnings to finance investment in the group and dividends to finance public spending (consumption or investment in other enterprises and projects) by the government. As such, the rationale for a sound dividend policy is twofold. First, it has the potential to enhance the efficiency of investments financed by retained earnings of SOEs and second, it would improve the overall allocation of public financial resources.

Large-scale financing of investment through retained earnings may facilitate SOE expansion because of the readily accessible source of finance. However, this pattern of financing has disadvantages that grow more prominent as the economy develops and becomes more sophisticated. The critical disadvantage is that within-firm allocation of capital does not receive the same scrutiny as financing from the financial sector. If the firm's prospects for growth and profitability are good and corporate governance is strong, within-firm allocation of at least some of the profits can be optimal. However, if the prospects for growth and profitability decline and if corporate governance is weak, the likelihood of inefficient within-firm allocation increases and pay out of at least some profits to shareholders is probably warranted.

Box 42 outlines some of the dividend policies of SOEs in OECD countries.

Box 42: Dividend Policy in SOEs in OECD Countries

Actual SOE dividend policies vary among OECD countries. In New Zealand, SOE boards set dividend policies, in consultation with the shareholding ministries, based on such factors as the SOE's capital structure, proposed capital investments and profitability. SOE boards in Denmark, Finland, Norway, and Sweden set multiyear pay-out targets—for example, 33 percent, 50 percent, or 67 percent of earnings projected over an entire business cycle (Table 8). In Singapore, SOE pay-outs are based on cash flow (that is, pre-depreciation earnings). In Sweden and Norway, SOEs have occasionally returned capital to the state in the form of a special (one-time) dividend to reduce SOE capital (equity) and achieve a higher rate of return on capital invested (equity).

Source: World Bank. 2005. *SOE Dividends: How Much and to Whom?* http://siteresources.worldbank.org/INTCHINA/Resources/318862-1121421293578/SOE_En_bill.pdf.?

In most countries, the general practice is for SOE dividends to be paid to the Ministry of Finance for public uses, regardless of which government department acts as the state shareholder, as dividends are considered public financial revenues and treated accordingly. Countries with separate ownership agencies or holding companies may receive SOE dividends and retain a portion for reinvestments in SOEs, but even so, a share of dividend payments is usually made to the Ministry of Finance. In Singapore, for example, Temasek's returns are generally retained for reinvestment, but payments to the Ministry of Finance have averaged 7 percent of the market value of Temasek's shareholdings over the past 30 years. In some cases, dividend payments from the ownership entity to the Ministry of Finance may be based on a fixed percentage that the entity itself receives from SOEs in its portfolio, or on a percentage of the capital employed by the SOEs in the ownership entity's portfolio, or some combination of the two.

In some SOEs, the state as the owner tends to exercise its influence over the SOEs dividend policy. Sometimes the extent of influence varies between wholly owned SOEs and SOEs that are listed on the stock exchange. For example, New Zealand confines its interventions in wholly owned SOEs to four areas, one of which is dividend policy. In all listed SOEs, where ownership is shared with outside minority investors, such as Air New Zealand, the government will not intervene except through voting its shares at shareholder meetings.

Most researchers point out that enterprises with higher state ownership tend to pay higher dividends. Wang et al. (2011) proved that enterprises with a higher share of state ownership are more likely to pay dividends. This is consistent with the state's needs for cash flows. Additionally, Bradford et al. (2013) came to a similar conclusion that SOEs pay more dividends than non SOEs. This is because non-SOEs have greater constraints in accessing external financing and the pressure on financing the enterprise's growth by internal capital is higher for them. Bremberger et al. (2016) also concluded that SOEs pay larger dividends. Authors explained it by the fact that paying dividends is more of a concealed way to enforce political preferences than more direct actions like smoothing tax regulations. On the other hand, Al-Najjar and Kilincarslan (2016) found that SOEs are less likely to pay dividends. Other factors that may influence the state's preference for the extent of dividend from a particular SOE includes the financial performance of the entire portfolio of SOEs, the state's financial position; and the current appetite for cash.

Strengthening corporate governance and dividend policy should lead to greater scrutiny of capital allocation, making it more difficult for the managers to invest in bad projects and enhancing shareholder wealth while minimizing the financial and fiscal risks of SOEs. Profitable SOEs should provide funds for public spending to improve the equity of key public services, such as education and health.

Capital gearing

Capital gearing is the degree to which a company acquires assets or to which it funds its ongoing operations with long- or short-term debt. **Two basic questions that all boards must consider regularly are**

- How much of the SOE's finance should be in debt?
- How much of the company's finance should be in equity?

If the company has an unpredictable income stream, it may not be able to pay the required interest or repay the principal in a poor year. If the SOE defaults, the lender or debt holder would have recourse to compel the SOE to sell business assets and possibly even force liquidation. This situation contrasts with shareholder payments. In a poor year, no payment needs to be made to shareholders. However, just as debt gears up returns to equity holders in good years, debt gears up losses in bad years. The level of financial gearing should, therefore, be directly linked with the level of financial risk carried by the business. This dilemma is illustrated in Table 42 on the next page,

Gearing is the ratio of debt to equity. A gearing ratio of one to four implies one-part debt to four parts equity. This is commonly translated

Table 42: Features of Debt and Equity

	Features for the company	Features for the investor
Debt	• The lender does not have any ownership rights associated with controlling the SOE. The state, therefore, retains ownership and control. • The lender does not have any right to the SOE's future profits. • The lender may have the right to repossess assets. • The SOE must ensure that it has sufficient cash flow to pay interest and repay the loan. The interest and the loan must be paid, no matter what the SOE's performance is. • Interest paid on the loan is normally tax-deductible. • Too much debt can impair credit rating.	• Interest and principal are guaranteed to the lender. • Inability to pay interest or repay principal may attract a penal interest charge. • The lender may have the right to repossess assets. • The higher the loan's risk, the higher the interest charged. • In the case of insolvency, the lender has a higher priority in being repaid than the shareowners. • Shareholders are considered to have the last or residual claim on assets after all the creditors have been paid.
Equity	• The shareholders have ownership rights associated with controlling the SOE. • Dividends are paid at the SOE's discretion. • Dividend payments are not normally tax-deductible. • The company must comply with reporting requirements to the shareholders.	• Dividends are neither fixed nor guaranteed. • The shareowner may exercise ownership rights associated with controlling the company. • Shareowner's equity contribution does not have to be repaid even if the company goes bankrupt.

Source: Adapted from IFC 2008.

into a percentage by recognizing that there is one unit of debt to five units of total finance or 20 percent. Utilizing gearing amplifies the potential gain from an investment or project, but also increases the potential loss.

The formula for this is as follows: Debt/ (Equity + Debt) × 100 = Gearing (%)

The higher the company's degree of leverage, the more the company is considered risky. An acceptable level is determined by its comparison to ratios of companies in the same industry.

Establishing SOE debt management policies

Monitoring the SOE's debt should be integrated into the government's general fiscal policy analysis as a source of fiscal risk, wherever appropriate. Governments should implement measures to oversee, limit, or monitor the debt accumulated by SOEs when the amount of overall public sector debt is a concern. The International Monetary Fund (IMF 2007) suggests that legislation on public debt covers all debt transactions and government guarantees, including those arising out of SOEs.

Analysis of debt sustainability is commonly conducted for the sovereign debt of developing countries, usually as part of IMF and World Bank programs. However, this analysis generally does not cover SOEs' debt. Analytical tools that project SOEs' profitability concerning debt levels can help determine the sustainability of SOEs' debt. The IMF has developed such tools, sometimes termed as 'stress tests'—they are particularly well developed for assessing the financial soundness of SOE financial institutions. The authority responsible for surveillance of the banking system may conduct these tests.

A public debt law (or other primary legislation) should clearly define all SOE debt limits and monitoring arrangements. These may include three important elements: (a) restrictions on the type of instrument that can be used for debt management, risk parameters, and the content of a medium-term debt management strategy; (b) methods of analyzing contingent liabilities and the risk that government guarantees will be called; and (c) the accounting standards and reporting and audit requirements. Regulations should also define the responsibilities of the debt management unit. Any limit, ceiling, or other direct control, should, as a general rule, be reserved for

Table 43: Examples of Controls over SOE Indebtedness

Country	Control
Brazil	Ex ante approval is required for foreign borrowing by SOEs.
Canada	The Treasury Board reviews all SOE corporate borrowing plans.
Chile	All borrowing and debt issued by SOEs require authorization by the Ministry of Finance.
France	Indebtedness is one of three key SOE performance indicators monitored by the ownership entity.
India	There is a three-tiered system for SOEs, which links SOE performance to higher levels of autonomy, including greater autonomy to raise debt.
Spain	SOEs come under the state holding company, Sociedad Estatal de Participaciones Industriales (SEPI), which has financial autonomy but whose borrowing capacity is limited by the budget law. SEPI exercises fiscal oversight over SOEs through the review of the annual operating plan and the four-year multiyear business plan. Debt operations outside the annual operating plan must be submitted to SEPI for prior approval. Large SOEs (more than US$1.6, billion in assets) are required to submit a five-year financial management plan, including a debt management plan, to the Minister of Finance. SOE debt will be included in the new national debt management plan required by the Finance Act. This includes improving SOE financial results and position, considering asset sales, and limiting interest costs as a proportion of total costs, which, in effect, would set debt ceilings for SOEs.

Source: Adapted from World Bank 2014.

sectors or specific SOEs, where risk is deemed high. Examples of controls over SOE indebtedness is outlined in Table 43.

Box 43 provides an overview of good practices for monitoring and reporting on SOE debt.

Weighted average cost of capital

The effective costs of equity and debt differ because

- The risk levels inherent in the two sources of finance vary.
- There are different tax treatments for the costs associated with equity and debt.

When estimating the present-day value of projects expected to produce future cash returns, one needs to know the effective cost of capital for a company so that future cash streams can be discounted. The relevant discount rate for use in specific situations is the weighted average cost of capital that accommodates the relative mix of debt and equity and the effective relative costs.

The weighted average cost of capital is derived from the formula:

$$\frac{[\text{debt} \times (r)] + [\text{equity} \times R]}{\text{debt} + \text{equity}}$$

Where '**r**' is the rate of interest and '**R**' is the cost of equity.

Box 43: Good Practices for Institutional Arrangements and Reporting Mechanisms for SOE Debt

- Clearly defined and legally backed institutional arrangements for SOE debt monitoring are critical.
- Legislation and government regulations need to define the primary data sources and specific indicators are to be used for monitoring contingent liabilities originating from SOEs.
- Coordination mechanisms and information flows need to be transparent and streamlined to ensure efficiency and confidentiality of information, as appropriate. Care should be taken to avoid duplicate lines of reporting to reduce the overall administrative burden for SOEs and government agencies.
- Laws and regulations should stipulate which government agency is responsible for primary data collection and analysis of SOE debt. Alternatively, one unit (for example, within the Ministry of Finance) can be responsible for data collection, consolidation, and analysis.
- Financial monitoring should be seen as a proactive process (as opposed to data gathering for its own sake) and supported by appropriate financial monitoring tools.

Source: World Bank Group. 2014. *Corporate Governance of State-Owned Enterprises: A Toolkit.* Washington, DC: World Bank.

This simple formula provides the answer to one of the most difficult questions in project appraisal, that is, what is the appropriate rate to discount future cash streams? Unfortunately, the formula has limited applicability due to several reasons: 'r' is the rate of interest, but which rate of interest? In a large, established company, there will be several types of debt, bearing different rates of interest. Some debt will have floating or variable rates linked to various base rates that move according to general economic conditions and the economic policy of the government or central bank. Additionally, some debts may have fixed rates that reflected money market conditions, when the debt was incurred and certainly could not be replaced at those rates when the debt needs renewing.

'R' is the cost of equity that comprises partly dividends and partly capital appreciation.

Company valuation

Accurate business valuation is one of the most important aspects of merger, acquisition, and divestment since valuations have a major impact on a company's sale price. Most often, valuation information produced by a professional valuer is expressed in a Letter of Opinion of Value (LOV). There are essentially two main ways to value a company:

- The 'net asset' basis – focuses on the value of the assets owned by the company after subtracting liabilities.
- An 'earnings' based valuation – concentrates on the net present value of income and earnings generated by a company both historically and its potential to earn future income.

Certain companies may strongly favor a net-asset-based valuation while other companies will more obviously prefer an earnings-based valuation. Professionals, who value businesses, do not use a single method, but rather a combination to obtain a more accurate value.

In addition to the above, market sentiment also plays a key role in driving the valuation of a company. It refers to the irrational component of investor expectations. Since sentiment-induced mispricing arises as a result of irrational investor demand, the degree to which the valuation is affected purely by market sentiment is not ex ante clear. Such sentiment-induced mispricing results from illiquidity, information asymmetries, and limited visibility on pricing. As a result, it may play a more persistent role in pushing asset prices away from their fundamental values.

Most SOEs tend to undertake a valuation before privatization or going for an IPO. External advisors with expertise in corporate finance and the sector in which the SOE in question operates may be roped in for undertaking the valuation. The process for appointing external advisors is established, in almost all cases, by national procurement rules. For example, in Argentina, the following valuation methods have been employed in the past: (a) stock market valuation estimated through metrics such as Price to Equity and price/cash flow relative to comparable companies; (b) sale value of assets net of liabilities; (c) discounted flow of funds. In Kazakhstan, the valuation of each SOE is at first done by the company itself, based on an analysis of its balance sheet. During the privatization process, the Ministry of Finance, and where applicable sub-national executive bodies, make their assessment based on which the initial price is set. In the case of particularly large transactions, the authorities retain the services of an external advisor to help conduct the valuation. External advisors are also employed in other countries such as the Czech Republic, Israel, Italy, the Netherlands, and so on.[15]

Topic four: Subsidiary governance

For effective governance of subsidiary companies, the group structure must be transparent and understandable to all the stakeholders of the group. The board and senior management of the parent of a corporate group need to exercise adequate oversight and control throughout the group. Subsidiary companies in a group operate under the influence of the parent company with the majority ownership. Subsidiary boards are, generally, subject to the directions of the parent company. Nonetheless, the company law normally stipulates that a subsidiary company is a separate entity and that its board members have the duty of loyalty to act in the best interest of the company and the shareholders as a whole, not of the majority shareholder. In the case of conflicts of interest between the parent and minority shareholders, the subsidiary board must adequately handle them to treat all shareholders equitably.

Creating subsidiaries can be a form of empire building and can be used to shield the subsidiary from government oversight, accountability, and transparency. A key policy decision is whether the state/ ownership entity should execute ownership rights over the subsidiary even if shares are formally held by somebody else, that is, the SOE holding company.

Role of subsidiary boards in a group

The board of a wholly owned corporation may be reduced to only rubber-stamping decisions. However, where a subsidiary is given a high degree of autonomy and managed like a stand-alone entity, the role of the subsidiary board is not much different from that of an independent company's board as discussed in Part II of the curriculum. Given that functions related to strategy setting may be normally conducted centrally by the parent boards to manage the group effectively and efficiently as a whole, the primary function of the subsidiary boards is management monitoring.

Subsidiary board composition

Concerning subsidiary board composition, directors of subsidiary boards can fall into three categories: parent-related, local (when the subsidiary is located in any other territory), and independent. The parent-related directors are board directors, executives, and senior staff of the parent (or another member) companies sitting at the subsidiary boards. The local directors are of importance, where the business of the subsidiary should be operated carefully in the local context. Well informed about local rules and practices, they can not only exercise effective oversight and management but also contribute to the local compliance. The independent directors can play a pivotal role in the accountability of subsidiary companies. The directors independent of the parent are of particular importance when the company has minority shareholders. By bringing objective, unbiased perspectives in the board discussion and decision-making, such directors can contribute to the board in ensuring the equitable treatment of shareholders and safeguarding the minority interests against abusive related-party transactions.

Related-party transactions

The governance concern for a subsidiary company comes up typically when it is required to enter into a transaction with other member entities in the group, which serve the interest of its parent or group to the detriment of the company. The conflicts of interest between the subsidiary and its belonging group/state may also arise when the subsidiary is demanded, for example, to pay management fees or dividends to the parent/ state; to employ particular individuals; to give up a new business to allow another member entity to launch it; or to provide financial assistance for a distressed member.

The more coordinated or centralized the management of member companies in a

group, the more interdependent are these companies, and the more often boards of subsidiaries face such conflicts. Various measures are taken to address the conflicts of interest in related-party transactions, including intra-group transactions. These cover disclosure, board approval, shareholder approval (when the state is not the sole shareholder), and prohibition.

Different jurisdictions have different ways to define what constitutes a related party and therefore qualifies to be a related-party transaction. Where International Accounting Standard (IAS) 24 has been adopted, there is consistency in ascertaining which transactions fall under the ambit of related-party transactions. The following measures govern related-party transactions:

- Several jurisdictions over the world have adopted the financial reporting standards, such as, IAS 24 (Related Party Disclosure), which require disclosure of related-party transactions annually in the financial statements. Though there are certain exemptions for disclosure of related-party transactions for SOEs especially fully state-owned SOEs under IAS 24, it is not a blanket exemption and will require them to still report on certain significant transactions with government or government-related entities.[16]
- The requirement of board approval is an in-built mechanism to protect minority shareholders and other stakeholders against abusive related-party transactions.
- When a board member is interested in transactions, the one is required to disclose the same before the start of the meeting and must excuse oneself when discussion on this matter takes place in the board meeting.
- Some jurisdictions require shareholder approval to screen potentially abusive related-party transactions. As shareholder approval is a cumbersome and costly process, it is normally limited only to important transactions.
- The ultimate way to prevent abusive related-party transactions is to prohibit such transactions. A certain type of transaction is banned in various jurisdictions.

Handout H3.3A: Performance monitoring report of SOEs

Case study from Sweden: Annual report for SOEs

Sweden's state company portfolio contains 47 wholly and partially owned companies, of which two are listed. The state has a substantial responsibility to be an active and professional owner. The government's overall objective is for the companies to create value and, where applicable, to ensure that specifically adopted public policy assignments are performed well. To this effect, the state publishes an annual report on the performance of SOEs, which is made available in the public domain.

Table 44 gives an overview of the contents of Sweden's 2017 Annual Report of state-owned companies.

Question:

How does Sweden's 2017 Annual Report of State-Owned Companies differ from a traditional annual report, apart from an aggregation of financial statements?

Table 44: Overview of the Contents of Sweden's 2017 Annual Report

Content of Sweden's 2017 Annual Report of State-Owned Companies
1. Overview of significant events in 2017 a. Financial performance b. Value performance c. Case studies on multidimensional value creation
2. Strategy and targets a. Active ownership b. Financial targets c. Public policy assignments d. Public policy targets e. Tracking targets f. Strategic targets for sustainable business – 2030 Agenda g. Gender balance h. Sustainable pay levels and terms of employment
3. Financial statements a. Financial results in 2017 b. Dividends and appropriations c. Divestments and dividends d. Risk management
4. Company overview a. Individual SOE financial statement b. Companies wound up, if any
5. Additional information a. State's ownership in modern times b. Accounting principles and definitions c. Company reporting dates d. List of government bills e. States ownership policy in 2017

Source: Government Offices of Sweden 2017.

Notes:

11 IFRS. 2020. *IFRS Taxnomy 2020*. https://www.ifrs.org/issued-standards/ifrs-taxonomy/ifrs-taxonomy-2020/#entry-points.

12 There is a broad range of indicators of firm default risk, such as Altman (1968) Z-Score measures, Ohlson (1980) O-Score measures, and Black-Scholes-Merton (1973) default probabilities, which take into account broader firm characteristics such as profitability and size. In the case of public corporations, for which an implicit bailout guarantee often exists, this probability of default can be used to measure the implicit risk.

13 IMF. 2018. *Fiscal Transparency Handbook*. Fiscal Affairs Department. https://www.elibrary.imf.org/view/IMF069/24788-9781484331859/24788-9781484331859/ch04.xml?language=es&redirect=true.

14 OECD. 2018. *Privatisation and the Broadening of Ownership of State-Owned Enterprises, Stocktaking of National Practices*. https://www.oecd.org/daf/ca/Privatisation-and-the-Broadening-of-Ownership-of-SOEs-Stocktaking-of-National-Practices.pdf

15 IAS 24 requires government-related entities to provide certain information about individually or collectively significant transactions with the government or government-related entities. In addition, such entities still are required to provide full related-party disclosures in respect of transactions arising from any other related-party relationship (for example, Key Management Personnel).

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Other resources and relevant websites

Canadian Institute of Chartered Accountants www.cica.ca The accounting professional member body also overseeing the development of accounting standards in Canada.

CFA Institute www.cfainstitute.org The professional organization for investment professionals gives a view of the needs of investors from financial statements.

Deloitte www.deloitte.com An accounting and advisory firm which also provides the IASPlus website covering IFRS developments www.iasplus.com.

Ernst and Young www.ey.com An accounting and advisory firm.

International Accounting Standards Board www.iasb.org.uk Located in London, the IASB, located in London is committed to developing, in the public interest, a single set of high quality, global accounting standards.

International Federation of Accountants www.ifac.org A global organization for professional accountants' member bodies.

KPMG www.kpmg.com An accounting and advisory firm.

PwC www.pwc.com; an accounting and advisory firm. Its particular IFRS Website is accessible at www.pwc.com/ifrs.



Strategy, Risk, and Performance

Leadership Training Toolkit for SOEs

Part III Module 4
Risk governance



Photo: ©Kelly Sikkema/Unsplash.com

Part III Module 4: Risk governance

This session (module) covers the following topics:

1 Concepts and nature of risk management



2 Risk appetite, strategy, and management



3 Risks arising out of climate change and social factors

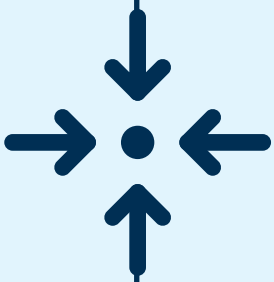


4 Disaster recovery and business continuity planning



Learning objectives

By the end of this module, the participants will be able to



- **Describe the nature of risk and board role in risk management**
- **Apply risk assessment and decision-making frameworks**
- **Identify risks arising out of environmental, climate change, and social factors**
- **Outline priorities for disaster recovery and business continuity planning**

Agenda

Total time: 2 hours 15 min

Time	Topic
30 min	Concepts and nature of risk management
30 min	Risk appetite, strategy, and management
45 min	Risks arising out of environmental, climate change, and social factors
30 min	Disaster recovery and business continuity planning

Topic one: Concepts and nature of risk management

Risk management should be a feature of all businesses. Companies take risks to generate returns. The board is responsible for ensuring that all business risks are identified, evaluated, and suitably managed. In a world of increasing complexity and uncertainty, directors must manage risk more assiduously than ever before.

Enterprise risk management (ERM) is a structured, consistent, and continuous process across the entire SOE (usually large companies) for identifying, assessing, responding to, and reporting on opportunities and threats that may affect the achievement of the SOE's objectives. Table 45 provides an overview of the types of business risks.

Table 45: Types of Business Risks

Type	Internal	External
Financial risks	Liquidity Cash flow	Interest rate Exchange rate Credit
Strategic risks	Research and Development Merger and Acquisition	Intellectual capital Competition Customer changes Industry changes
Operational risks	IT systems Accounting controls Supply chain	Regulations
Hazard risks	Employees Properties	Natural events Suppliers Contracts
Climate risks	Lack of climate change adaptation and transition plan	Physical risks related to extreme weather events

Source: Adapted from IFC 2008.

Risk management process

The steps in developing a risk management plan usually involve the board (Figure 41):

1. **Step 1**: **Methods of identifying risks**

A list of events or subjects that have an impact on the company needs to be developed. The following methods can be used in this regard:

- Brainstorming
- Using existing pro forma checklists
- SWOT analysis
- Expert guidance

Once an exhaustive list has been developed, potential downsides of each item need to be explored.

2. **Step 2**: **Understanding the nature of the risk and evaluating its potential**

(a) **Likelihood** – Identifying the probability of occurrence. A typical probability framework used by companies is

- *High*
  - Likely to occur each year
  - More than 25 percent chance of occurrence
- *Medium*
  - Likely to occur in 10 years
  - Less than 25 percent chance of occurrence
- *Low*
  - Not likely to occur in 10 years
  - Less than 2 percent chance of occurrence

Figure 41: Steps in Developing a Risk-Management Plan



Source: Adapted from IFC 2008.

(b) **Impact** – The severity of the loss. A typical severity framework used by companies is

- *High*
  - o The financial impact on the organization is likely to exceed a set high threshold
  - o Significant impact on the strategy or operational activities
  - o Significant stakeholder concern
- *Medium*
  - o The financial impact on the organization is between the low and high threshold
  - o Moderate impact on the strategy or operational activities
  - o Moderate stakeholder concern
- *Low*
  - o The financial impact on the organization is likely to be less than a set low threshold
  - o Low impact on the strategy or operational activities
  - o Low stakeholder concern
  - o These two factors are subsequently mapped against one another in a risk assessment matrix

3. **Step 3**: **Deciding on appropriate action**

- The board and senior management usually have a variety of options concerning their response to the risk that has been identified and analyzed. These options typically include
  - o Avoidance
  - o Reduction (mitigation)
  - o Transfer
  - o Acceptance (retention)
- All decisions before implementation should involve an assessment of the potential response and consequences of taking action. A cost-benefit analysis is normally required when assessing the options.

4. **Step 4**: **Risk monitoring**

Risk monitoring is usually carried out by focusing upon KPIs. These KPIs are used to provide red flags, usually via dashboards or balanced scorecards. An example of a risk framework for Swedish SOEs is provided in Box 44.

Role of the state

The state/ownership entities are responsible for setting the overall risk tolerance level for SOEs. Most countries do not have a sector-wide, explicit risk tolerance level for their overall stake in the SOE sector. It can be determined via sector-wide explicit law, regulation, or policy document; on an ad-hoc basis, according to each SOE's risk

Box 44: Risk Framework for Swedish SOEs

Applicable legal framework for listed companies and SOEs in Sweden:

Companies' Act: Sets out that the board of directors is responsible for the company's organization and management. While not explicit on risk management, the Act requires the board to evaluate the SOE's financial position to ensure that its bookkeeping, asset management, and financial situation is satisfactorily controlled.

Act on Annual Reports: Companies must include in their annual report, a management report that should outline the SOE's material risks and the main components of the SOE's system for internal control and risk management.

Swedish State Ownership Policy: Says that the Swedish Code on Corporate Governance should be applied to all SOEs in which the state has a controlling interest. This means that SOEs are required to present a corporate governance report and a statement of internal control in accordance with the Code. The Code also states that the board must ensure that there are efficient systems for monitoring and controlling the business of the SOE and associated risks.

Example of risk management reporting by a Swedish SOE: Vattenfall is fully owned by the Swedish state and is one of Europe's largest generator of electricity. Vattenfall includes in its annual and sustainability reports, a specific report on risk and risk management. Vattenfall explains in the report that its ERM system, which is based on Committee of Sponsoring Organizations of the Treadway Commission standards, categorizes its exposure to three main categories of risk and how they are mitigated: strategic risk, operational risk, and financial risk.

Source: OECD. 2018. *Risk Management by State-Owned Enterprises and their Ownership.*

profile; in the context of overall strategic planning, and so on. In the Philippines, parameters are defined for the state's risk tolerance level in the Government Owned and Controlled Corporations Governance Act. In Poland, for example, the state's risk tolerance level is determined in government resolutions concerning management control at the Ministry of Treasury. In Denmark, the government established a specific level of risk exposure toward one SOE's activities in foreign markets—no single contract could exceed DKK 0.5, billion (US$72 million) and the total amount of contracts could not exceed more than 15 percent of the company's equity.

Governments may communicate their risk tolerance level in individual SOEs in some ways as given below:

- Participating in decisions made by the board through the state representative
- Direct communication between the state/ ownership entity and SOE
- Providing risk-taking guidelines
- Conditionalities imposed while giving guarantees
- Specification of terms and conditions for major transactions

States must also undertake a review of SOE's internal risk management system. The state audit institution has a primary role in this. Such audits may be either financial or performance audits or both. Supreme Audit Institution's role is further discussed in Part IV, Module 1. In Brazil, all SOEs are audited by two specialized public institutions: the Corregedoria Geral da União (CGU) and the Federal Court of Accounts. The CGU provides SOEs' internal audit functions with a risk matrix to guide audit planning. This audit planning is approved by the board with a summary description of the risks attached to each audited item. The risk matrix evaluates the probability and impact of risks on SOE's objectives. In Switzerland, according to the Federal Audit Act, all SOEs are subject to financial oversight by the Federal Audit Office (except listed SOEs as they are subject to the Stock Exchange Market Act). The Federal Audit Office audit jurisdiction also includes an audit of SOE ownership entities to assess their management systems for dealing with the risks associated with state enterprise ownership. On the other hand, in Finland, the state audit agency may now and then survey and evaluate risks and risk management by SOEs especially in case of mismanagement.[16]

Role of the board

The board upholds a critical function in ensuring the effective execution of an SOE's day-to-day activities. From a risk management perspective, it should fulfil certain key functions including ensuring the integrity of the corporation's accounting and financial reporting systems, comprising independent audit, and that appropriate systems of control are in place, particularly systems for risk management, financial and operational control, and compliance with the law and relevant standards.

Directors must decide, acting on the management's advice, how much risk the SOE can accept—this is called risk appetite. Risk appetite may vary over time and will be influenced by the SOE's financial condition and market position.

To manage risks, the SOE needs to know what risks it faces and to evaluate them. Identifying risks is the first step in building the SOE's risk profile. There is no single right way to document an SOE's risk profile, but the documentation is critical to the effective management of risk.

The identification of risk can be separated into two distinct phases:

- **Initial risk identification** for an SOE, which has not previously identified its risks in a structured way, or for a newly instituted SOE, or perhaps for a new project or activity within the SOE.
- **Continuous risk identification,** which is necessary to identify new risks that did not arise previously, changes in existing risks, or risks, which did exist, ceasing to be relevant to the SOE (this should be a routine element of the conduct of business within the SOE).

In either of the cases, risks should be related to the overall SOE objectives. Risks can only be assessed and prioritized concerning objectives (and this can be done at any level

of objective from personal objectives to organizational objectives). Care should be taken to identify generic risks, which will affect business objectives but might not always be immediately apparent in thinking about the particular business objective. When a risk is identified, it may be relevant to more than one of the SOE's objectives, its potential impact may vary with different objectives, and the best way of addressing the risk may be different in relation to different objectives (although it is also possible that a single treatment may adequately address the risk of more than one objective). In stating risks, care should be taken to avoid stating impacts and to avoid stating risks that do not have an impact on objectives; equal care should be taken to avoid defining risks with statements that are simply the converse of the objectives. A statement of risk should encompass the cause of the risk and its impact on the objective (cause and consequence).

Duties of the board

- All directors must understand the SOE's business in its entirety
- The directors must know about the following:
  - SOE's most significant risks
  - How the SOE will manage a crisis
  - The importance of stakeholder confidence
  - How to manage communications with the shareowners and the investment community
- They should ensure appropriate levels of awareness throughout the SOE
- They must be assured that the risk management process is working effectively
- They should publish a clear risk management philosophy and responsibilities of senior management as well as any perceived new risk or failure of existing control measures
- They should ensure that sufficient time is devoted to discussing risk management strategy
- Effective risk management requires directors to understand their business intimately and to ask the following questions:
  - How do different operations and processes interact?
  - What if certain people and or facilities were unavailable?

Reporting of risk

The board in any SOE must consider the cultural and economic context it is situated in, in executing its functions about reporting of risk. The board must follow the enlisted key principles in its risk management framework to ensure effective risk reporting.

The following are the key principles in a risk management framework.

a. Risk reporting must not be the primary objective in drafting an effective framework. It should extend to the management of critical risks, including the identification of emerging risks for all staff.
b. Risks of a critical nature and emergent risks must attain prime importance in the reporting framework and warrant the most attention from the board's risk oversight process.
c. Every business has a myriad of operational, financial, and compliance risks. If any of these risks is a critical enterprise risk, it warrants the full board's attention with ongoing oversight by either the full board or a designated board committee. If not, risk reporting should focus on communicating these risk exposures to the board through periodic status reports on lines of business, product, geography, functional or program performance as well as escalate unusual matters requiring the board's immediate attention.
d. The relevancy of risk reporting is more firmly established with directors when it is closely tied to the SOE's business plans and the critical objectives and initiatives management has been communicated to them. Some risks may affect multiple objectives, whereas others may require specific actions to address changing conditions to ensure the achievement of objectives. In effect, risk reporting should be integrated with strategy, business objectives,

business plans, and performance management. It is less effective when it is an afterthought to strategy and an appendage to performance management.

e. Risk reporting is to be used to advance the SOE management's risk appetite dialogue with the board. It should disclose when conditions change and the agreed-upon parameters are approached or breached. The risk appetite statement within the SOE should serve as a guidepost when a new market opportunity or significant risk emerges. Ideally, risk reporting should call attention to the level of risk the SOE is undertaking in the pursuit of creating value and achieving key objectives and whether risk levels are consistent with risk appetite.

f. The board's risk reporting should focus on more than performance. It should provide insights as to whether executive management's assumptions about markets, customers, competition, technology, regulations, commodity prices, and other external factors continue to remain valid. Reporting should focus on whether changes in these factors in the external environment have occurred that could alter the fundamentals underlying the SOE's business model.

g. The reporting framework must provide clarity on who is responsible for risk management.

h. The framework must also ensure that the SOE's communication channels are effective. Communication channels need to be open and free-flowing, where personnel identify relevant risks in business decision-making and discuss them with the people to whom they have a direct reporting line.

Topic two: Risk appetite, strategy, and management

Risk appetite

Risk appetite translates risk metrics and methods into business decisions, reporting, and day-to-day business discussions. It sets the boundaries, which form a dynamic link between strategy, target setting, and risk management.[17]

The concept of a 'risk appetite' is the key to achieving effective risk management and it must be considered before moving on addressing risks. Determining the SOE's risk appetite begins by assessing its risk capacity. This entails the SOE's ability to withstand risk when it materializes into actuality and avoiding unwanted impacts. These impacts range from execution delays to postponed maintenance, to damage to the SOE's reputation and insolvency. Once the risk capacity is identified, the SOE board will be equipped to determine how much risk can be assumed by the SOE in expanding its scope and operations.

When considering threats, the concept of risk appetite embraces the level of exposure that is considered tolerable and justifiable, given it is realized. In this sense, it is about comparing the cost (financial or otherwise) of constraining the risk with the cost of the exposure, given the exposure become a reality, and therefore, finding an acceptable balance.

While considering opportunities, the concept embraces consideration of how much one is prepared to actively put at risk to obtain the benefits of the opportunity. In this sense, it is about comparing the value (financial or otherwise) of potential benefits with the losses that might be incurred (some losses may be incurred with or without realizing the benefits).

It should be noted that some risks are unavoidable and it is not within the ability of the SOE to completely manage them and restrict them to a tolerable level. SOEs must accept that there is a risk arising out of climate-related factors which they cannot

control. In these cases, the SOE needs to make contingency plans.

In either of the cases, the risk appetite will be best expressed as a series of boundaries, appropriately authorized by the management, which gives each level of the SOE clear guidance on the limits of risk that they can take, whether their consideration is of a threat and the cost of control or of an opportunity and the costs of trying to exploit it. This means that risk appetite will be expressed in the same terms as those used in assessing risk. The SOE's risk appetite is not necessarily static; in particular, the board will have the freedom to vary the amount of risk that it is prepared to take depending on the circumstances at the time. Box 45 provides an overview of practices for defining risk tolerance levels by SOEs in Asian countries.

Linking risk appetite to strategy and management of risks

Linking risk appetite and strategy clarifies the level of risk associated with the SOE. It also enables discussions of whether alternative strategies would present more attractive risk/return trade-offs, given the SOE's risk appetite.

Many SOEs and even private sector firms struggle to articulate risks rigorously enough for their own needs, let alone those of external parties, and many fail to link risk appetite specifically to strategy, yet doing so does not need to be complicated. The initial step for most boards is simply to have in-depth discussions with the management regarding strategy, risk, risk capacity, appetite, and tolerance.

SOE boards can benefit from having members with broad experience, who are thoughtful, ask good questions, and can challenge the management. They can also benefit from the expertise of external risk professionals, who can bring industry knowledge to conversations and act as devil's advocate regarding risks and underlying assumptions. These discussions should encompass a holistic view of the SOE's purpose and mission, business model, past and projected performance, and opportunities to create value. This enables the board to advise the management in developing the risk appetite, as opposed to simply signing on it.

The following measures can be adopted to develop a risk management strategy linked to an SOE's risk appetite:

- Establishing a risk awareness culture: A strong risk awareness culture starts at the top, by making the leadership team accountable. Although many organizations today have a dedicated chief risk officer (CRO); it is also important to view each member of the executive management board as a risk officer and hold each other accountable to that standard.
- Clearly defining and articulating measures of risk: Risk-aware boards have asked the management to define risk capacity, appetite, tolerances, and profile. This usually requires adopting a framework for developing those concepts and values and sets the stage for discussions of risks that fit into the framework and those that do not.
- In many organizations, the internal audit function periodically reports on point-

Box 45: Defining Risk Tolerance Levels in Asian Countries

In most countries, risk tolerance levels are determined by line ministries (Korea, Pakistan, Thailand, and Vietnam), and often communicated to SOEs through the ministries' board representatives. In one country (India), the determination and communication of the state's risk tolerance levels are not subject to a standard approach, but risk management is one of the parameters used in the annual performance-monitoring system. For comparison, in about two-thirds of the 33 countries examined in the OECD survey of SOE risk management practices, the determination of the state's risk tolerance levels is either undertaken on an ad hoc basis according to SOEs' risk profiles or is otherwise not subject to a standard approach (OECD 2016). In two countries (Bhutan and the Philippines), the determination of risk tolerance levels appears to be generally delegated to SOE boards of directors, subject to general guidelines by the state.

Source: OECD. 2018. *Managing Risk in the State-Owned Enterprise Sector in Asia.*

specific issues or failures deemed to be of importance to the board. These arise in diverse areas, such as finance, procurement, logistics, health and safety, and IT, leaving directors without a clear view of the larger picture. Those presenting to boards must provide context and answer questions about exposures, significance, needs, remediation costs, and likely outcomes.

- Reviewing the strategic planning and management of risks are essential. A strategic planning review might cover data used and sources, internal and external parties consulted, assumptions, and model integrity to ensure effective risk management.

The critical link between risk management and strategy in tandem with the SOE's risk appetite is detailed in the model below.

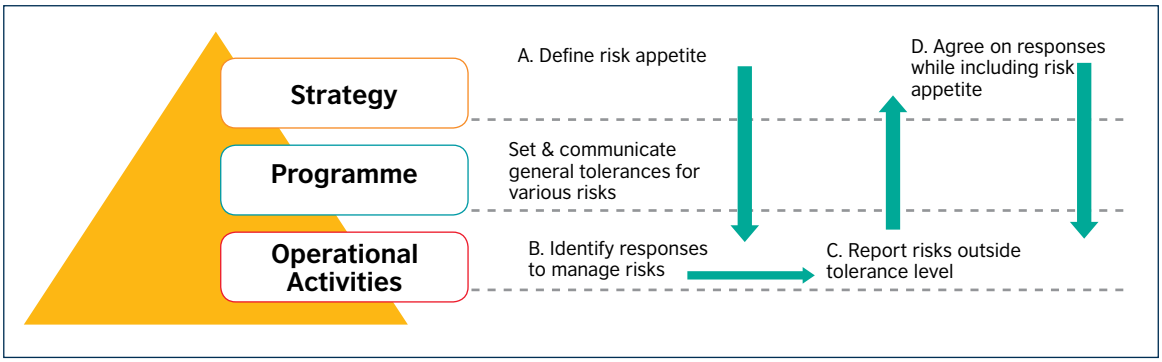
This provides a three-pronged approach to risk management. On a strategic level, the risk appetite of the SOE is defined. This is programed into the SOE, wherein levels of tolerances are established for various identifiable risks. On an operational level, responses to risks are to be identified, which will in turn produce identification of risks outside the tolerance level of the SOE. These are communicated to define a strategy on how to mitigate the same and include them within the risk appetite of the SOE.

Cross-cutting theme: integrity and anti-corruption

A risk management system is considered integral to managing corruption-related risks. Good practice as laid out by international standard setters, such as the Committee of Sponsoring Organizations of the Treadway Commission (COSO 2017), promotes the integration of risk management into strategic and operational processes of the company. Yet too often risks, let alone corruption risks, are treated separately from decision-making processes. Those companies that do explicitly treat corruption risks do so as part of the compliance risks and fewer as strategic, operational, or financial risks. Risk assessments aimed specifically at identifying, analyzing, and prioritizing corruption risks are done infrequently.

SOE boards could use risk assessment results to better insulate the company from the identified risks. Sound risk assessments should underpin internal controls and integrity mechanisms or programs that are proportionate to risks. They should be used to improve continuously thereafter. There should be a segregation of duties between those that take ownership of and manage risks, those that oversee risks and those that provide independent assurance within the SOE. SOEs, wherever possible, should publicly disclose information about material integrity-related risks, the risk management system, and measures taken to mitigate risks.

Figure 42: Link between Risk Management and Strategy in Tandem with the SOE's Risk Appetite



Source: Author's consolidation

Topic three: Risk arising from climate change and social factors

Cross-cutting theme: environmental and climate-related risks

Climate change risk relates to the effects of climate change directly on SOEs, as well as the impact on their customers, clients, and communities within which they operate. Climate risk can be broken down into two simple concepts:

- **Physical risk**: This arises from the direct effect of weather events and longer-term shifts in the climate, for example, floods, droughts, wildfires, and rising sea levels.
- **Transition risk**: This arises from the process and effects of shifting toward a low-carbon economy, for example, policy, technology and consumer sentiment. A carbon tax on emissions, repricing of securities, and client attrition due to changing consumer preferences are all examples of transition risk.

Table 46 (on the next page) illustrates some of the risks that SOEs may identify under the two categories.

The past decade has shown that financial institutions are the most effective when they address material risks across the company and are clear on the roles of the three lines of defense in addressing those risk.[18] Climate change risk is no different. An effective three-lines-of-defense model to climate change exhibits the following features:

- **First-line business ownership.** When climate change is viewed through the lens of physical and transition risks, it becomes immediately apparent that the first line—notably the lines of business—have to own climate change risk. The lines of business must be aware of the opportunities that climate change presents as they engage with their customers and clients. They also need to identify the range of associated risks and mitigate them to acceptable levels (including potential conduct-related risks that could result in misleading the customer or mis-selling products and services). The first line manages the company's operations and relations with most third parties and they own the customers and clients. They also own corporate communications and investor relations.

  On the operational side, the first line has to manage how the company copes with short-term extreme weather events and long-term physical impacts on their company's locations and third parties. On the commercial side, the first line has to determine how climate risks will affect customers and clients, and alter products and services offered—and portfolios—accordingly, as well as pricing strategies and underwriting standards. They have to make sure climate-related disclosures are comprehensive, robust, and accurate. Given the companywide nature of climate change, it is not surprising that the key executive in charge of climate change generally sits within the first line.
- **Second-line risk management.** The CRO is tasked with embedding climate change risk into the company's ERM framework. Climate change has to be woven into core capabilities, such as risk identification, risk taxonomies, risk appetite and risk reporting, scenario modelling, limit structures and underwriting standards. Novel concepts, such as climate value-at-risk (VaR), likely become a staple of risk management over time, especially as companywide 'stress tests' are conducted.

  The finance function has a second-line role in climate change risk. Capital and liquidity management and methodologies will have to be enhanced to fully capture the impact of climate change risk on the company's equity, debt holdings, and composition of capital and liquidity buffers. As the effects of climate change increase, finance groups will need to factor it into independent price verification, including hard-to-value assets and the identification of so-called 'stranded assets' (that is,

Table 46: Climate-Related Risks that May Be Identified by SOEs

Sub-type	Climate-related risks	Potential financial impacts
Transition Risks		
Policy and legal	• Increased pricing of GHG emissions • Enhanced emissions-reporting obligations • Mandates on and regulation of existing products and services • Exposure to litigation	• Increased operating costs (for example, higher compliance costs, increased insurance premiums) • Write-offs, asset impairment, and early retirement of existing assets due to policy changes • Increased costs and/or reduced demand for products and services resulting from fines and judgments
Technology	• Substitution of existing products and services with lower emissions options • Unsuccessful investment in new technologies • Costs to transition to lower emissions technology	• Write-offs and early retirement of existing assets • Reduced demand for products and services • R&D expenditure in new and alternative technologies • Capital investments in technology development • Costs to adopt/deploy new practices and processes
Market	• Changing customer behavior • Uncertainty in the market signals • Increased cost of raw materials	• Reduced demand for goods and services due to a shift in consumer preferences • Increased production costs due to changing input prices (for example, energy, water) and output requirements (for example, waste treatment) • Abrupt and unexpected shifts in energy costs • Change in revenue mix and sources, resulting in decreased revenues • Repricing of assets (for example, fossil fuel reserves, land valuations, securities valuations)
Reputation	• Shifts in consumer preferences • Stigmatization of sector • Increased stakeholder concern or negative stakeholder feedback	• Reduced revenue from decreased demand for goods/services • Reduced revenue from decreased production capacity (for example, delayed planning approvals, supply chain interruptions) • Reduced revenue from negative impacts on the workforce management and planning (for example, employee attraction and retention) • Reduction in capital availability
Physical Risks		
Acute	• Increased severity of extreme weather events such as cyclones and floods	• Reduced revenue from decreased production capacity (for example, transport difficulties, supply chain interruptions) • Reduced revenue and higher costs from negative impacts on workforce (for example, health, safety, absenteeism) • Write-off and early retirement of existing assets (for example, damage to property and assets in "high-risk" locations)
Chronic	• Changes in precipitation patterns and extreme variability in weather patterns • Rising mean temperature • Rising sea levels	• Reduced revenue from the decreased production capacity (for example, transport difficulties, supply chain interruptions) • Reduced revenue and higher costs from negative impacts on the workforce (for example, health, safety, absenteeism) • Write-offs and early retirement of existing assets (for example, damage to property and assets in "high-risk" locations) • Increased operating costs (for example, inadequate water supply for hydroelectric plants or to cool nuclear and fossil fuel plants) • Increased capital costs (for example, damage to facilities) • Reduced revenues from lower sales/output • Increased insurance premiums and potential for reduced availability of insurance on assets in "high-risk" locations

Source: Task Force on Climate-related Financial Disclosures (TFCD) 2017.

assets that become redundant in a low-carbon economy or due to environmental change). Planning over a business cycle—say a 5- or 10-year horizon—will have to assess how climate change affects long-term profitability.

- **Third-line (that is, internal audit) oversight.** Thus far, internal audit has had a limited role in assessing the impact of climate change on a company's risk governance. This will surely change as the company adopts companywide strategies, policies and governance models, risk management and pricing, and underwriting practices, and discloses more on the impact of climate change. As with other company risks, an internal audit will need to evaluate the degree to which the company is adhering to new processes and controls established by the policies and practices, how the company aligns with the evolving regulatory or industry practices, and the quality and consistency of disclosures.

Climate change must be built into the company's risk management framework. This necessitates embedding it into

- **Risk identification.** Beyond simply scanning for climate risks, this requires granular analysis of customers and clients by region and sector, as noted above. Bifurcating between physical and transition risks makes the analysis more precise and actionable. Understanding the direct impacts of physical risks on the company's operations and third parties is essential. Beyond these risks, as noted above, associated risks, like conduct and compliance risks, have to be identified. SOEs that prepare Statements of Corporate Intent or performance contracts with the state, need to clearly identify the climate risks and proposed mitigation measures in their agreements. Box 46 provides an overview of the World Bank's Climate Risk Screening Tools.
- **Risk taxonomies.** To capture climate risk within existing processes and standards, companies need to re-evaluate their risk taxonomies to determine whether climate risk is material. When ESG risks surface in a company's heat map or risk register, the board needs to consider whether these issues have a material impact. Given the growing findings that relevant ESG topics can be financially material to a corporation, boards need to ask management to run materiality analyses that include both traditional financial factors and financial impacts from ESG-related risks (refer Box 47).
- **Risk reporting.** Financial institutions must develop and maintain a set of risk metrics that capture their own and their customers' climate change risks. They must also be able to aggregate those metrics to enable the board and senior

Box 46: World Bank's Climate Risk Screening Tools

Risk assessment: SOEs should assess risks in their projects as well as operations through the use of sector-specific risk screening tools. Risk screening tools such as the **World Bank Climate and Disaster Risk Screening tools** assess physical risk across sectors and also at the policy level. The tools link to climate projections, country adaptation profiles, and disaster risk data sources from the World Bank's 'Climate Change Knowledge Portal'. The data, combined with the user's understanding of the subject matter and country context, generate a characterization of risks to help inform dialogue, consultation, and planning processes at the project and program level. The tools apply an Exposure–Impact–Adaptive-capacity framework to assess risks.

The framework incorporates elements of the risk analysis framework adopted by the Intergovernmental Panel on Climate Change (IPCC) and the framework for vulnerability assessment used by the United States Agency for International Development (USAID), with some modifications. These tools can be applied to a range of development sectors in support of project-level investments. The tools provide a self-paced, structured, and systematic process for understanding climate and disaster risks to programs and investments. It is essential that risk screening for projects are carried out at an early stage of project design.

Source: World Bank Group. 2020. *World Bank Climate and Disaster Risk Screening Tools.* World Bank.

Box 47: Case Study – Use of a Materiality Lens

Nestle conducts a materiality assessment every two years to identify the economic, social, and environmental issues that are of top priority to the company's external stakeholders. In 2018, the company evolved its materiality assessment to include ESG risks with other financial risks and align them better with business operations. This evolution included integrating the identified material issues within the company's ERM process.

Source: Ramani, Veena, and Hannah Saltman Ceres. 2019. *Running the Risks: How Corporate Boards Can Oversee Environmental, Social and Governance Issues*. Harvard Law School Forum on Corporate Governance.

management reporting and oversight. These metrics should link to existing portfolios, concentration and exposure thresholds and limits, and align with the company's disclosures on climate-related risks and commitments. These are discussed in detail in Part IV, Module 3.

- **Risk mitigation**: Climate-risk analysis needs to support decision-making on how to manage the company's physical risks as well as how it affects the way they serve their customers and clients. Mitigation and adaptation strategies could include capital allocation, mergers and acquisitions, policy advocacy and lobbying, insurance, and value creation. As an example – PepsiCo incorporates environmental sustainability criteria into its Capital Expenditure Filter, which is applied to all capital expenditure requests over US$5 million.

CROs will need to develop an independent view on how the company is managing climate change risk and provide counsel to the board and senior management on how well the company is adapting. Some companies are also undertaking scenario analysis to understand and quantify climate risks.

At the same time, companies are also enhancing their operational resilience to physical risks. They are taking few steps to be prepared:

- **Consolidating crisis-management and incident-response frameworks.** Often, a plethora of frameworks get deployed when a weather event occurs and only a few of these frameworks function well together, especially in the context of severe events. Triggers for invoking high-priority or crisis-level protocols—or escalations—are often inconsistent. Larger companies are integrating these frameworks under a companywide crisis-management framework and aligning protocols, playbooks, and triggers.
- **Enhancing communication protocols.** During severe or crisis-level events, internal and external communications often become disjointed. Communications across segments of customers are not consistent, nor are communications across stakeholders (for example, with state/ownership entity); employee communications can sometimes be last on the list, yet they are a key interface with the outside world. A coherent communications strategy in crisis is essential, to put employee and customer safety as a priority and to help guide stakeholders on how to access services during disruption.
- **Assessing the resilience of third parties.** Companies must have a clear view, on which third parties play a role in delivering the most important business services as well as routinely evaluate how resilient those companies are to weather-related (or other) disruptions and have plans to cope with one of those third parties being unavailable for an extended period. Knowing which third-party substitutes can be accessed quickly is important.
- **Testing resilience.** Companies typically conduct an array of tabletop or simulated exercises to evaluate how they would cope with major disruptions, for example, due to extreme, extended weather events. Increasingly, these simulations are being conducted at senior management—or even board—levels, so that leaders are aware of how decisions are made in crises.

Social factor risks

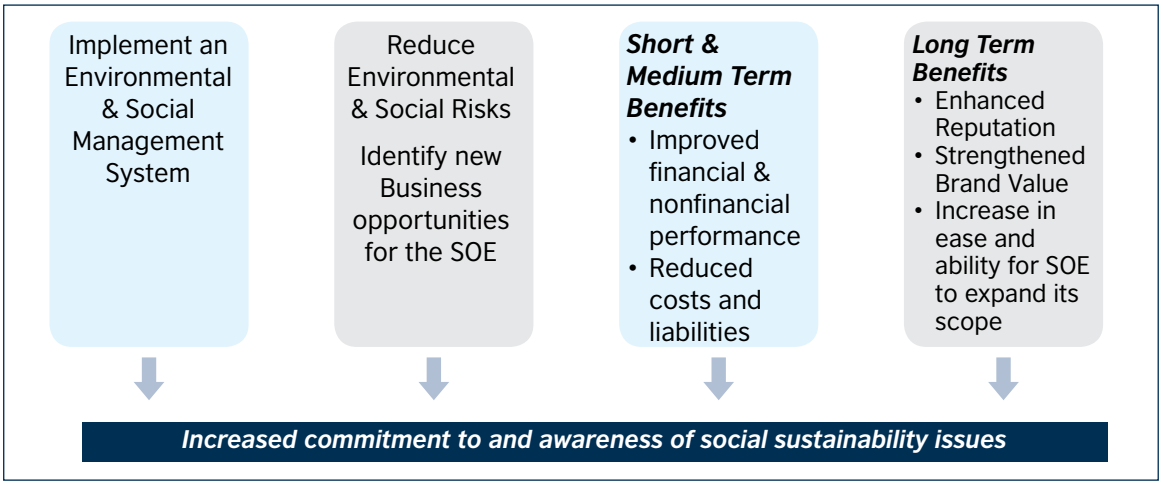
Following the significance of climate and environment-related risks, consideration of social risks as a part of the risk appraisal process within the SOE helps it to decrease its overall risk exposure.

Social risk includes actions that affect the communities within the SOE's situated context. Examples include labor issues, human rights violations within the workforce, and corruption by SOE officials. Public health issues can also be a concern, as they can affect absenteeism and worker morale.

SOEs that have problems with social risk face political backlash, public outcry, and a damaged legal standing, and may not be sustainable in the long term.

SOEs must develop an environmental and social management system (refer Figure 43), which can be integrated into its existing risk management framework, including the risk appraisal process for transactions. A well-developed environmental and social management system can lead to decreased exposure to environmental and social risks, increased market opportunities, and enhanced reputation, which help contribute to the long-term financial viability of the SOE.

Figure 43: Environmental and Social Management System



Source: IFC 2015.

Topic four: Disaster recovery and business continuity planning

Every SOE can experience a serious incident that can prevent it from continuing normal operations. This can range from frequent and severe climate-change-induced extreme weather events, to a serious computer malfunction, or information security incident. More recently, climate-change-related extreme weather incidents or pandemics such as COVID have become common and pronounced resulting primarily from physical risks, either acute or chronic, as described in Table 46. The management has a responsibility to recover from such incidents with a minimum amount of time, disruption, and cost. This requires careful preparation and planning.

One of the board's key tasks is to develop and maintain a disaster recovery and business continuity plan. A serious incident can affect the SOE at any time. The board needs to

ensure that a team representing all functions of the SOE develops the disaster recovery plan. If the SOE is large enough, a formal project needs to be established, which must have the board's approval and support.

One of the first disaster-recovery planning tasks is the preparation of a comprehensive list of the potentially serious incidents that could affect the SOE's normal operations. This list should include all possible incidents, no matter how remote the likelihood of their occurrence. Against each item listed, the project team or manager should note a probability rating. The potential impact of each incident should also be rated in terms of severity.

Once the assessment stage has been completed, the plan's structure can be established. The plan will contain a range of milestones to move the SOE from its disrupted status toward normal operations.

The first important milestone in the process is to deal with the disaster's immediate aftermath. This may involve the emergency services personnel or other specialists who are trained to deal with extreme situations.

The next stage is to determine which critical business functions need to be resumed, and in what order. The plan will be detailed, including identification of key individuals who should be familiar with their duties under the plan.

Once the board develops the disaster recovery plan, it must be subjected to rigorous testing. The testing process, itself, must be properly planned by the executive management and should be carried out in a suitable environment to reproduce authentic conditions, as far as this is feasible.

The board must ensure that the disaster recovery plan is tested by those persons, who would undertake those activities if the situation being tested were to occur in reality. The test procedures should be documented, and the results are to be recorded. This is important to ensure that feedback is obtained for fine-tuning the disaster recovery plan. It is equally important to audit both the plan itself and its contingency arrangements.

All personnel must be made aware of the disaster recovery plan's contents and their related duties. Managers must obtain feedback from staff to ensure that responsibilities are understood, particularly those requiring close dependency on actions being taken by others.

The plan must always be kept up-to-date and applicable to current business circumstances. This means that any change to the business process or changes to the relative importance of each part of the business process must be properly reflected within the disaster recovery plan. The board must ensure that an executive manager is assigned responsibility for ensuring that the disaster recovery plan is maintained and updated regularly, and should, therefore ensure that information concerning changes to the business process are properly communicated. The board must ensure thorough testing of any change or amendment made to the disaster recovery plan. All SOE personnel should also be kept abreast of such changes as far as they affect their duties and responsibilities. Box 48 outlines Business Continuity Planning (BCP) practices in Thailand.

Box 48: Business Continuity Planning (BCP) in Thailand

The 2011 floods in the Central Region of Thailand highlighted the urgent need for government action on BCP promotion and facilitation among small and medium enterprises (SMEs). The flooding affected the operations of over 0.5 million SMEs, throwing 2.4 million locals out of work. Over 80 percent of the losses, estimated at US$46, billion, were incurred by businesses. To help prevent similar losses in the future, the Bangkok-based Asian Disaster Preparedness Center1 (ADPC) devised a 12-month project to promote and facilitate BCP uptake in Ayutthaya, one of the worst-hit areas.

Floods occur regularly in the Central Region and recovery is usually rapid. However, the 2011 floods were the most severe in decades and the extent of the damage was unprecedented. After the floods, the Thai Government mandated that all SOEs develop their own BCPs.

Source: Asia-Pacific Economic Cooperation, 2014. *How to promote Business Continuity Planning to mitigate the impact of disasters, A guide for government officials.*

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Strategy, Risk, and Performance

Leadership Training Toolkit for SOEs

Part III
Caselets

CASE STUDY

1. Balancing SOE public service and commercial obligations

Breakout groups exercise (self-generated real case)

Divide plenary into two groups, one representing the state and the other representing the SOEs/PEs.

Tasks

Each group has been asked by the Head of Government to evaluate and make recommendations from their respective vantage points on the current problems and proposed solutions for addressing both state and commercial obligations. Ask each group the following (Table 47).

Trainer notes

- Divide the participants into groups and explain the exercise
- Remind the participants to refer to Part I, Module 2 on what constitutes PSOs
- Participants need to develop an understanding of each other's issues in balancing such obligations
- Allow 30 minutes for discussion

Table 47: Areas of Discussion with Portfolio Ministry (PM) and Board of Directors (BOD)/Senior Management (SM)

Theme	Representatives of state, that is, PM	Representatives of SOE, that is, BOD/SM
Meaning of PSOs	Ask the group to define PSOs and cite examples	Ask the group to define PSOs and cite examples from their SOE
Issues	• Elaborate on issues faced in defining PSOs • Challenges faced in working with the SOE to optimally meet such PSOs	• Elaborate on issues faced in meeting such PSOs • Whether PSOs contradict their commercial obligations • Challenges faced in working with the state to balance such obligations
Financing/ Compensation for PSOs	• Has any guideline been issued on how to cost these PSOs? • Determination of associated fiscal costs • Have any compensation modalities been defined for PSOs?	• How does the SOE cost for PSOs? • Does the SOE separate accounts for commercial and non-commercial activities? • What are the forms of compensation received from the state? Discuss its adequacy. • Has the SOE financed PSOs through the private sector and what has been the experience like?
Monitoring	• Does the state monitor SOE's performance regarding PSOs? • Are performance metrics pre-defined? • Does the state conduct citizen satisfaction surveys to gauge the taxpayer's end-to-end feedback on PSO delivery? • Does the state have any data-driven insight about citizen satisfaction to inform about PSO delivery quality?	• Does the SOE adequately disclose financial and nonfinancial information on PSOs to facilitate the state's monitoring? • Does the SOE track taxpayer satisfaction through data or customer grievance redressal cells? • Does the customer feedback serve in designing and delivering PSOs better?

Source: Author's consolidation.

Questions to focus discussion

- What are the key factors to determine the priority between PSOs and commercial objectives?
- What tools can be used to help address any conflicting objective and trade-off?
- Is a level playing field maintained by ensuring competitive neutrality?
- If any state/SOE representative has financed PSOs through the private sector, ask them to elaborate on the experience. Seek the state representative's feedback on the same. Use the examples given below to inform other participants about the potential advantages of seeking private sector financing and reducing the burden on state debt and contingent liabilities.

Box 49 provides some case studies of maximizing finance for development (MfD).

Box 49: Maximizing Finance for Development (MfD) Stories

Overview – Achieving the Sustainable Development Goals to end extreme poverty by 2030 will require about US$4.5 trillion annually, far more than multilateral development banks or donors can provide by themselves. To face this challenge, the World Bank Group adopted the Maximizing Finance for Development (MfD) approach, which entails working with governments to crowd-in the private sector while optimizing the use of scarce public resources.

Similarly, state finances are limited. It is essential for SOEs to leverage the private sector in sustainable ways that bolster scarce public resources to effectively deliver its mandate. Below are some examples of MfD success stories:

Argentina: In 2015, the price of Argentina's electricity generation was more than US$70 per MWh, with 70 percent of this borne by the public sector. The government then resolved to increase the share of renewable energy. An estimated US$35 billion would be needed to reach the target – a difficult task given the limited fiscal space of the state budget. This necessitated private sector participation and investment to realize the targets.

Government guarantees backed by the World Bank guarantees attracted several private developers. The first auction, in October 2016, far exceeded expectations and it was quickly followed by two more auctions. So far, 147 projects based all around the country have been awarded under RenovAR, with most using wind and solar. Together they will generate almost 5 GW of energy, approximately 12 percent of Argentina's installed capacity, and reduce GHG emissions by 7 million tons of CO_2 per year. The initiative has attracted almost US$6 billion in commitments to invest in renewable energy, 11 times the total of the World Bank guarantees.

Indonesia: In Indonesia, some 20 million people lack access to electricity—a significant challenge facing this diverse archipelago. At the same time, the country is working to keep up with the growing energy demands, while meeting its national commitments to produce 23 percent of its energy from renewable sources by 2025 and reduce carbon emissions by 29 percent by 2030. Fortunately, Indonesia's geography presents a unique opportunity:

The country is home to 40 percent of the world's geothermal reserves. However, exploration can cost between US$30–50 million initially, with up to US$400 million in later stages, with no way to recoup losses if the geothermal resource proves insufficient.

To close financing gaps and mitigate risks, the World Bank is helping the government establish an innovative credit facility that will channel US$650 million into geothermal exploration. By supporting early-stage geothermal development, the financing is expected to unlock US$4 billion in potential private sector investments.

Source: World Bank. 2018. *Maximizing Finance for Development (MfD).*

CASE STUDY

2. Performance Monitoring Report of SOEs

Learning objective

By the end of this case study, participants will be able to understand the components of a performance monitoring report of SOEs published by the government/government agency.

Question to focus discussion

How does a government's performance monitoring report of SOEs differ from a traditional annual report?

Trainer notes

The trainer may wish to distribute the handout **(Handout H3.3.A)** immediately and move to the discussion of the question.

Alternatively, the trainer may wish to focus on the distinctiveness of an SOE performance monitoring report by showing examples from the report, which can be downloaded at https://www.government.se/4a890e/content-assets/9c99e9a92e8e44fd9434e75dfd568961/annual-report-for-state-owned-enterprises-2017

Introduction to the case

Monitoring reports on SOEs/public corporations summarize the overall financial performance of the sector as well as provide information on individual companies. These reports usually comprise five key topics:

- An overview of the sector and highlights of public corporation activities during the year
- A full list of the companies owned by the government
- An overview of how the government has exercised its ownership policy
- Special topics
- Information on individual companies

Table 48: Performance Monitoring Report of Various Countries

Country	Name of the report
South Africa	Analysis of the Financial Performance of State-Owned Enterprises http://www.gov.za/documents/analysis-financial-performance-state-owned-enterprises
Lithuania	Annual Review of Lithuanian State-Owned Commercial Assets http://www.euroinvestor.dk/pdf/cse/11176061_17359.pdf
Finland	Annual Report of the State's Ownership Steering http://vnk.fi/documents/10616/1221497/2014_OO+vuosikertomus_eng.pdf/1f84341c-ddb7-4a04-9de6-3fb50013c606
France	French State as Shareholder http://www.economie.gouv.fr/files/files/directions_services/agence-participations-etat/Documents/Rapports-de-l-Etat-actionnaire/2013/Overview_2013.pdf
Brazil	Profile of State Companies (Perfil das Empresas Estatais) http://www.planejamento.gov.br/assuntos/empresas-esatais/publicacoes/perfil-dasempresas-estasais
New Zealand	Annual Portfolio Report http://www.treasury.govt.nz/statesector/commercial/portfolio/reporting/annual/2013/apr-13.pdf

Source: Author's consolidation.

The government in the following countries publish a similar performance monitoring report on SOEs. (Table 48)

Questions

How does Nedbank's integrated corporate report differ from a traditional annual report?

The question is likely to generate considerable discussion, and to begin with, is likely to focus on the **detailed content**, including

- Detailed stakeholder specifications
- Global reporting initiative sections
- Sustainability reporting
- Value-added statement

The discussion is then likely to move on to the **format and sequence** of the report with a greater emphasis on stakeholders and their interests rather than solely focusing on shareholders' interests.

The trainer may decide to develop the discussion by asking:

Why does Nedbank publish an integrated corporate report rather than a traditional annual report?

Responses may include

- South African listing rules require companies to produce an integrated report.
- The South African King III corporate governance code recommends that companies publish an integrated report.
- Users may find the integrated report more user-friendly.
- Nedbank's reputation as an innovative bank may be enhanced.

Nedbank's reputation for having a high corporate-responsible focus may be enhanced.

Part IV



Control environment, transparency, and disclosure

Leadership Training Toolkit for SOEs

Introduction to Part IV: Control Environment, Transparency, and Disclosure

> *"The business case for disclosure and transparency is clear: Disclosure and transparency fill information gaps for customers, investors, and employees and, as a result, can have a positive effect on a company's revenues or its access to human capital or financial capital."*
> – IFC Toolkit for Disclosure and Transparency, 2018

Part IV explores various aspects of the internal and external control environment, elements and frameworks for effective disclosure and transparency, and the procurement practices for SOEs.

Table 49: Coverage of OECD Guidelines on Board of State-Owned Enterprises in Part IV

OECD guidelines	Coverage
The rationale for state ownership	
The state's role as an owner	
State-owned enterprises in the marketplace	☑
Equitable treatment of shareholders and other investors	
Stakeholder relations and responsible business	☑
Disclosure and transparency	☑
The responsibilities of the boards of state-owned enterprises	☑

Figure 44: Contents of Part IV

Module 1	Internal and external controls and compliance	• This module provides an overview of control environment, the internal and external audit functions, elements of effective organization structure, and key HR policies and controls for compensation and performance management
Module 2	Financial accounting and disclosure	• This module explains the standards of financial accounting, the key elements and principles of disclosure and transparency of financial information, and the consequences of inadequate financial information
Module 3	Nonfinancial information reporting and disclosure	• This module details and describes the elements and principles for nonfinancial information disclosure, guidance on sustainability reporting, and other narrative methods of reporting and communication
Module 4	SOE procurement	• This module describes the good practices and principles for procurement, provides guidance on developing a procurement strategy, and the key principles for transparency and integrity in SOE procurement.



Control environment, transparency, and disclosure

Leadership Training Toolkit for SOEs

Part IV Module 1
Internal and external controls and compliance

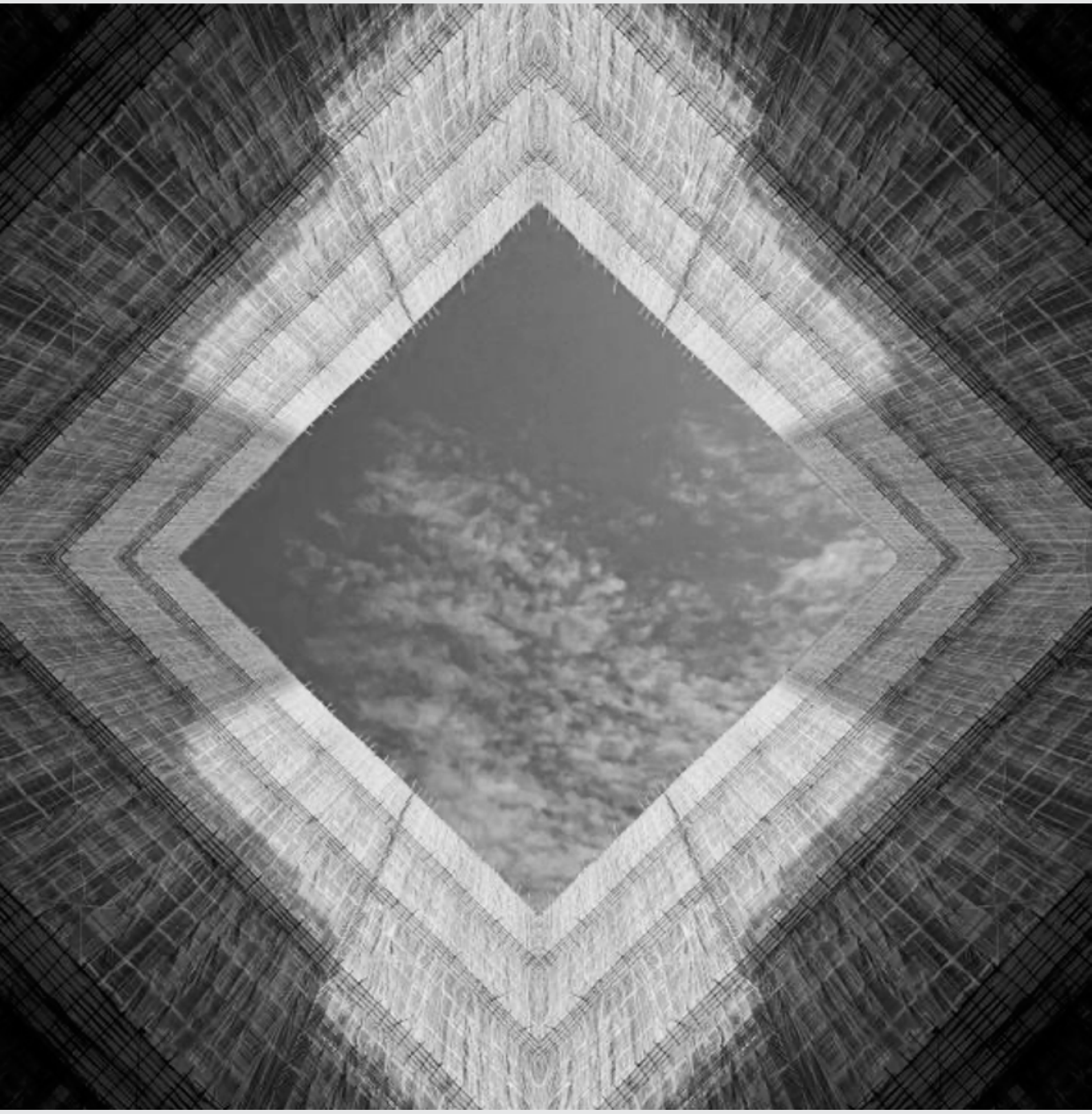


Photo: ©Cyriller Bellier/Wsimg.com

Module 1: Internal and external controls and compliance

This session (module) covers the following topics:

1 Understanding control environment



2 Internal audit, risk assessment, and decision-making frameworks



3 Effective organizational structure



4 Importance of a comprehensive compliance program



5 External audit for SOEs/Role of SAIs, Parliamentary oversight

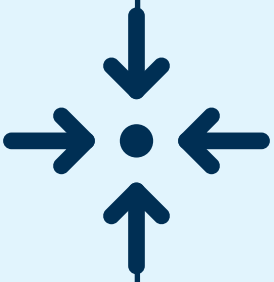


6 HR procedures and control



Learning objectives

By the end of this module, the participants will be able to



- **Understand the key aspects of the internal and external control environment**
- **Understand the importance of the internal and external audit functions**
- **Understand the role of risk assessments and the elements of an effective compliance program**
- **Understand the key principles for HR compensation and performance management**
- **Understand the principles of effective organization structure**

Agenda

Total time: 4 hours 30 min

Time	Topic
30 min	Understanding the control environment including internal and external controls
30 min	Case study
45 min	Internal audit, risk assessment, and decision-making frameworks
45 min	Exercise
30 min	Importance of a comprehensive compliance program
30 min	HR procedures and control (HR compensation, HR performance management)
30 min	Effective organizational structure
30 min	External audit for SOEs / Role of the Supreme Audit Institution/ Parliamentary oversight

Topic one: Understanding the control environment including internal and external controls

The control environment refers to an interconnected system of internal control and risk management structures, processes, and activities that are designed to provide reasonable assurance that the enterprise can deliver on its strategic objectives while operating efficiently and effectively. The control environment should ensure coverage of the entire enterprise holistically.

The Institute of Internal Auditors definition of the control environment states that the control environment is the "foundation on which an effective system of internal control is built and operated in an organization that strives to (1) achieve its strategic objectives, (2) provide reliable financial reporting to internal and external stakeholders, (3) operate its business efficiently and effectively, (4) comply with all applicable laws and regulations, and (5) safeguard its assets."

The systems, standards and procedures that form an enterprise's control environment safeguard the integrity and efficiency of its governance and operations. Internal controls are principally top-down, and the board of directors and senior management establish the tone at the top regarding the importance of internal control including expected standards of conduct.

There are five principles related to a control environment. They include

- Demonstrating a commitment to integrity and ethical values
- Maintaining the independence of the board of directors from management and their oversight of the entity's internal control
- Establishing organizational structure, reporting lines, authority, and responsibilities to pursue business objectives
- Demonstrating a commitment to attract, develop, and maintain competent people
- Maintaining accountability for the execution of internal control responsibilities

Effective internal controls allow top managers to know what is going on in the organization and whether their instructions are being carried out. Management should design internal control procedures with several purposes in mind: to safeguard assets against unauthorized use or disposition, to maintain proper accounting records, and to ensure the reliability of financial information.

Figure 45 on the next page describes the key actors and their roles concerning the control environment of the SOE.

Internal control systems, including the internal audit, are designed to ensure the integrity and reliability of financial statements and nonfinancial reporting as well as compliance with the law and with internal standards and policies. Internal control lays out the scheme of checks and balances, which is a deterrence against possible unfair practices and fraud. This includes the governance of subsidiaries. The system of internal control is designed to identify, evaluate, and manage significant risks associated with the achievement of the organizations' objectives. It is designed to manage risk rather than eliminate the risk altogether. Consequently, it can only provide reasonable and not absolute assurance against material misstatement or loss.

External control mechanisms are often imposed on organizations by external stakeholders in the forms of statutory audits, special audits, and oversight by the respective country's supreme audit institution (SAI), parliamentary committees, and other regulatory guidelines. Adherence to the general legal framework concerning enterprises, that is, the commercial company code, the company law, or corporate governance codes, is defined as part of external control compliance. Accepted accounting and audit standards that the SOEs are expected to comply with are also part of

the external control environment. One of the external control mechanisms is the listing of the SOE on the stock exchange. Listing can be a way to sustain that commitment to good governance and financial reporting.

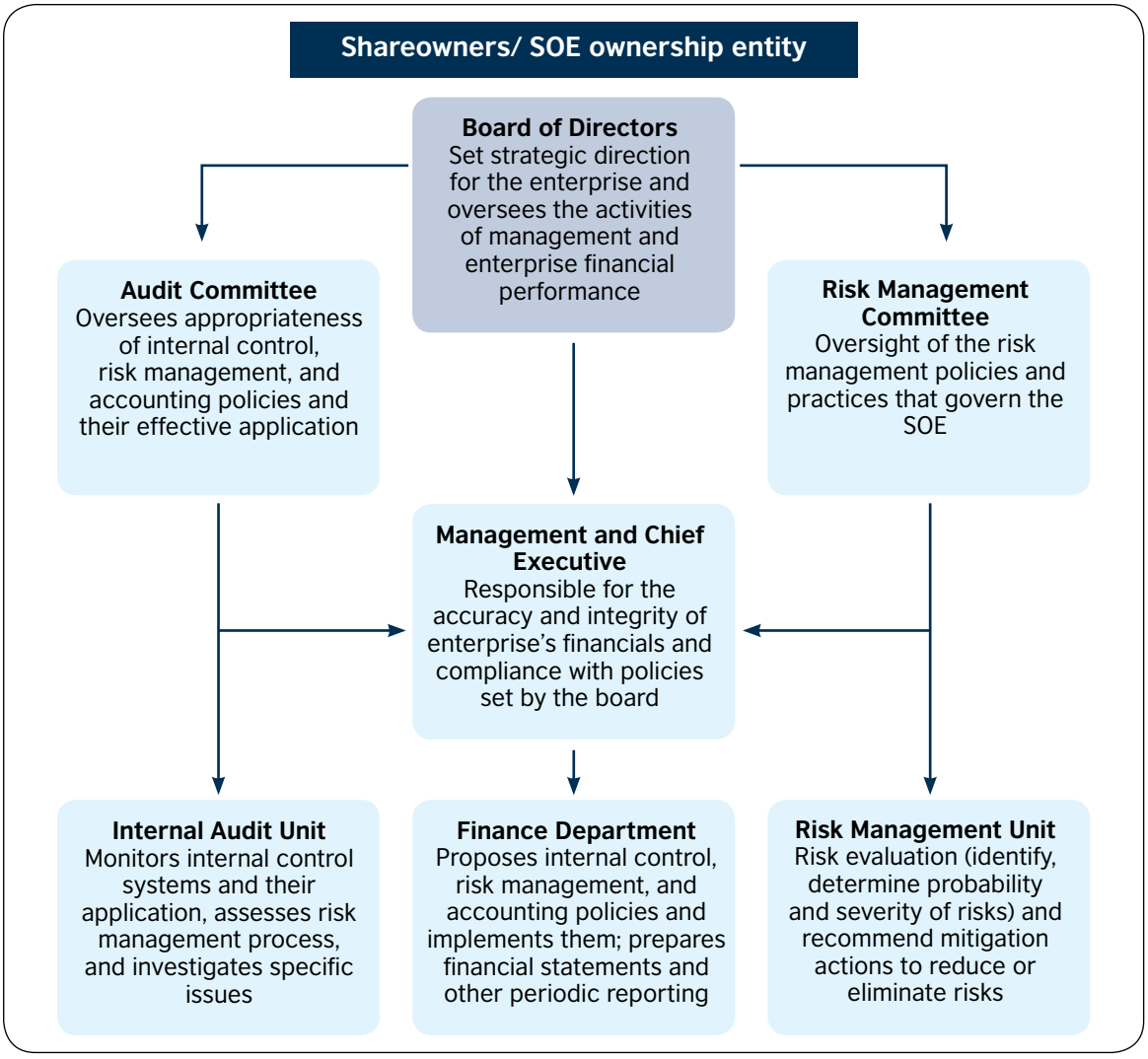
In many SOEs, the basic control systems are weak, and other vital parts of the control environment may focus so narrowly on detecting fraud that they miss the larger issue of the integrity of financial reporting and risk management as a whole. In such cases, the information disclosed to the public may be inaccurate, and SOE boards (and even top management) may have an incomplete understanding of what is happening within the organization or the risks it faces. If so, there can be greater scope for misrepresentation, fraud, and negligence.

Internal control and risk management

The connection between internal controls and risk management runs in both directions: good control systems provide the accurate information needed to manage risk effectively, and an understanding of the risks that the public enterprise faces is important for designing effective control systems. Good practice calls for all public interest entities to have internal controls for integrity and efficiency and to link these controls with risk management systems.

SOEs, like private enterprises, can be subject to myriad risks that can cause financial or reputational damage or threaten their commercial viability. Under their state ownership, SOEs can be subject to different influences that can affect their propensity

Figure 45: Key Actors and Their Roles in the Control Environment



Source: Adapted from World Bank 2014.

for risk-taking behavior. On the one hand, SOEs might engage in excessive risk-taking, because they are not subjected to the risks of bankruptcy or hostile takeovers pressure that induces privately owned companies to establish rigorous risk management and disclosure practices. On the other hand, SOEs might be excessively risk averse compared to their private sector peers, owing to overly burdensome state controls or the absence of well-defined corporate objectives that may allow incentivizing commercially sound risk-taking.

The state, as a shareholder, should define and communicate its risk tolerance levels to SOEs as an integral part of the state's broader responsibilities of defining, communicating and monitoring the implementation of well-defined objectives for SOEs. SOEs should, in turn, establish adequate measures to achieve these well-defined objectives, while respecting the state shareholder's risk tolerance levels. There is a need to strike a fine balance while defining risk tolerance levels to avoid too much regimentation that does not allow flexibility and initiative for decisions as against too liberal systems that could be open to discretion and abuse.

As with privately owned financial institutions, state-owned financial institutions may face substantial market risk from changes in asset prices, exchange rates, and interest rates; liquidity risk from a sudden demand for funds (or lack thereof); and credit risk from counterparties' failure to make payments. As a result, state-owned financial institutions are adding independent and qualified board members and a dedicated risk management function, usually overseen by a chief risk officer (CRO) who reports to the risk management committee of the board. Approaches to risk management in the SOE sector are invariably linked, among others, to the prevailing state ownership arrangements in a given jurisdiction, to SOEs' legal forms, and the degree of control exercised by the government on the SOEs. For example, in countries where most SOEs have been fully 'corporatized', that is, are subject to general companies' law, and where there is a stronger commercial culture (commercial obligations outweighing public service obligations) in the SOE sector, including the presence of boards of directors comprising mainly industry professionals, risk management practices are similar to those in the private corporate sector. On the other hand, where SOEs are run more closely to the public administration (public service obligations outbalancing commercial obligations), risk management systems will be based on the state audit and internal controls that are more common in the public administration.

Role of the board in overseeing internal control

Modern corporate governance practice requires the board, either directly or through a board audit committee, to assume responsibility of reviewing the system of internal controls established by the management. This oversight is important both for ensuring the effectiveness of the controls and for acting as a check on improper behavior by the management. **Good practice suggests a range of specific tasks for the board in overseeing the internal controls.**

These tasks are listed below:

- Making sure that the management puts in place functional, operating, financial, and management reporting standards across the entire SOE and any subsidiaries
- Verifying that procedures are in place to identify, control, and report on such major risks as breaches of laws or regulations, unauthorized activities, and fraud
- Annually review the effectiveness of internal controls and procedures (including financial, operational, compliance, and risk management) and reporting the findings to shareholders
- Confirming that internal controls include procedures for identifying and reporting conflicts of interest to the board, and where appropriate, to owners
- Another complementary function of the SOE board is to understand the risks the enterprise faces, the possible consequences of those risks, and how to mitigate them. India, Malaysia, South Africa, and Thailand have guidelines that highlight

the importance of risk management for SOEs and the need for the board to engage in this function. According to the Malaysian guidelines, the board is to understand risk, set the SOE's risk appetite and limits, ensure that risk is taken into account before making a major decisions, and see that internal controls and plans for handling significant risks are in place. In some countries, SOEs must have a dedicated risk committee. For example, in the Philippines, all the SOEs must establish a risk management committee as per the Code of Corporate Governance for Government Owned and Controlled Corporations.[1]

Topic two: Internal audit, risk assessment, and decision-making frameworks

Traditionally, risk managers have approached their duties intending to protect the organization's assets and balance sheet, while internal auditors have been concerned with reviewing the efficiencies and effectiveness of internal controls. However, lately, an integration of risk management and internal audit is being advocated, since a collaboration of the two streams can lead to stronger risk practices in meeting stakeholder expectations and efficiencies, better decision-making, and improved results by forming strong alliances between the risk management and internal audit functions.

Internal audit is an essential component of the internal control system that contributes to the success of an organization by enhancing the quality of corporate governance through its oversight role. It also improves the control and monitoring environment of an organization and mitigates fraud risk.

Internal audit is an independent, objective assurance, and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic and disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes.[2]

All SOEs should have internal auditors. The internal auditor must have open access to the board to examine any issue within the scope of the audit. Moreover, for the internal audit function to be independent, the chief internal auditor must report directly to the board. The annual internal audit plan must be reviewed and approved by the audit committee, and its progress must also be monitored by this board committee.

As defined by the Institute of Internal Auditors, the internal audit functions must ensure the following:

- Monitoring of the SOEs' control systems
- Evaluating risk exposures related to the enterprise's governance, operations, and information systems
- Reliability and integrity of financial and operational information
- Effectiveness and efficiency of operations and programs
- Safeguarding of assets
- Compliance with laws, regulations, policies, procedures, and contracts

The fundamental role of Internal Audit is to provide assurance. Also, in line with risk management, internal audit activities include:

- Giving assurance on the risk management process
- Giving assurance that risks are properly evaluated
- Evaluating risk management process
- Evaluating the reporting of key risks
- Reviewing the management of key risks

Risk assessment is the management's process of identifying risks and rating the likelihood and impact of a risk event.[3] This takes the risk assessment and maps internal controls to the risks to determine if there are gaps between risks and controls. Control is an activity that helps ensure that management directives to mitigate risks are carried out.

A risk assessment should document the internal audit function's understanding of the organization's business activities and the associated risks. This is often referred to as a 'bottom-up' assessment of risks. A comprehensive risk assessment should analyze the key risks applicable to each of the auditable entities and may also include an assessment of risk functions across all the levels within the organization. The risk assessments should also consider thematic control issues, risk tolerance, and governance within the organization.

The risk assessment process should be viewed as a 'live' document, being updated regularly (at least annually although more often is recommended) to reflect changes to processes, controls, systems, changes in the business model, laws, and regulations. Further, changes in the business environment and/or market conditions may also require reassessment of risks the business is exposed to.

Continuous monitoring should utilize data analytics, where appropriate to provide information on key trends and metrics for larger data sets. Continuous monitoring results can include management reporting, metrics, periodic audit summaries, and updated risk assessments to substantiate that the process is operating as designed. Critical issues identified through the monitoring process should be communicated to the audit committee.

The bottom-up approach of risk assessment should be complemented by a top-down approach of risk assessment that covers the organization's objectives, key risks, external business environment, and regulatory challenges, and recognizes emerging risks. This may be done by identifying potential risks, themes, and topics that present the highest risk to the organization based on industry or regulatory hot topics, internal or external events, and other available information. The identification and classification of these risks into business risks, operational risks, external risks, and so on should be executed by the SOE management with guidance from the board.

The risk identification and assessment exercise will provide information to the audit committee on areas of risks to subsequently initiate control system design/updates and policies based on the SOE's risk appetite. The internal audit exercise subsequently validates compliance with the control environment by providing assurance. The changing role of internal audit has transformed the internal audit's focus from whether or not a control is being followed to whether the control is being exercised properly and cost-effectively. Emphasis is re-laid from detective controls to preventive controls. An optimally managed internal audit can prove to be the best tool for designing key strategies and making pragmatic business decisions.

The board of directors has the primary oversight responsibility for developing and implementing the organization's mission, values, and strategy, and must carefully review corporate processes of risk identification, monitoring, and management. The board also originates risk philosophy, risk appetite, and risk tolerances. Specific reviews of financial objectives, plans, major capital expenditures, and other significant material transactions also typically fall within a board's responsibility. These responsibilities require broad and transparent reporting on various organizational risks—strategic, operational, reporting and compliance risks.

Board responsibilities and procedures require audit committees to be informed about significant deficiencies and material weaknesses in internal control over financial reporting. More specifically, the audit committee has been given delegated responsibility from the board of directors to direct oversight over internal control and must receive assurance of and other information regarding internal control from members of the management, directly responsible for achieving internal control objectives.[4]

Internal audit is a catalyst for improving an organization's governance, risk management, and management controls by providing insights and recommendations based on analysis and assessments of data and business processes. A robust internal audit system is well connected and informed in the organization. It can communicate relevant information and the latest developments to different stakeholders for informed decision-making and effect change by convincing the management that action is necessary, appropriate, and urgently required.

Topic three: Importance of a comprehensive compliance program

A corporate compliance program is generally defined as a formal program specifying an organization's policies, procedures, and actions within a process to help prevent and detect violations of laws and regulations.[5] It goes beyond a corporate code of conduct since it is an operational program, not simply a code of expected ethical behavior. A code of conduct is an important component of a compliance program and ethics remains the heart and soul of all corporate compliance programs. However, a comprehensive program goes further by applying the code to the specific risks of an organization and integrating measures to address those risks.

A more integrated compliance approach focuses on legal as well as internal compliance to mitigate the risks of fraud as well as to reach strategic, operational, and financial reporting objectives. It is essentially a codification of applicable regulatory and internal compliance requirements as well as a roadmap to action. A comprehensive program helps position an enterprise to divert disasters, meet objectives, and grow shareholder value.

Often, companies may have extensive policies, procedures, and testing to assess the effectiveness of entity-level controls; however, these efforts may not be properly integrated with other regulations such as the labor laws, corruption/fraud laws, and any other law as required under the country regulations.

Compliance goes hand in hand with governance and risk management, otherwise known as GRC. It is very difficult to successfully isolate one without considering the other two. All three areas are highly interwoven in concept and practice. This occurs because each element of governance, risk, and compliance encompasses organizational factors, people, processes, and technologies that cannot, and should not, be viewed separately.

A well-balanced corporate compliance program will help ensure that an enterprise's organizational structure, people, processes, and technology are working in harmony to manage risks, keep customers happy, grow the business, oversee vendors, and achieve its overall mission and goals.

The major elements of an effective compliance program are[6]

- Written policies and procedures
- Designated compliance officer and compliance committee
- Effective training and education
- Effective lines of communication
- Internal monitoring and auditing
- Enforcement of standards through well-publicized disciplinary guidelines
- Prompt response to detected problems through corrective actions

Topic four: HR procedures and control (HR compensation, HR performance management)

HR compensation

The compensation of SOE employees plays an important role in attracting qualified workers as well as motivating and retaining them. Changes in compensation structures among all public sector bodies, including SOEs, need to be handled with great sensitivity, as they can trigger anxiety among staff, resistance, and ultimately are likely to create resistance.

To avoid resistance, it is recommended that SOEs employ

- Creation of a task-force of representatives from within the SOE to champion any change that may be proposed
- Development of a communications strategy to keep staff and stakeholders informed of the plans and their progress
- Studies of the best practices in affecting the change in SOEs

Compensation policies in SOEs must adhere to incorporating the best practices, such as

- Ensuring that salaries and benefits are market competitive
- Salaries and benefits are offered based on competencies and/or abilities of staff and not only the grade/cadre of recruitment
- Pay survey is conducted regularly
- Nonfinancial fringe benefits are highlighted

The concept of pay bands for different individuals based on their position in the hierarchy has been adopted by public sector entities, similar to the structure existing in the private sector. In drafting compensation policies for SOEs, it is also important to take remuneration for the board into account, ensuring that it is competitive and is decided transparently for all directors, including independent and state nominees.

A growing trend among SOEs globally is to introduce performance-based pay for SOE staff. While this is in congruence with the larger aim of bringing SOEs on a level playing field to private entities, it has been a challenging transition even in developed economies. However, there has been a higher incidence of adopting performance-related pay in the form of pecuniary and nonfinancial incentives in recent years.

Performance-related pay is seen as a way of increasing flexibility in working practices and enhancing individual accountability. Further, it has also been cited to increase staff motivation and attracting more dynamic employees. To circumvent the expected resistance to performance-based compensation structures, it is advisable to introduce incentives applauding good performance initially rather than sanctions on poor performance. This ensures a positive view of the transition to the compensation structure and policy. Additionally, the system also aids in communicating a message of effective utilization of taxpayer income as regards rewarding good performance, in line with the excessive scrutiny that SOEs are subject to.

Facilitating dialogue on performance-based compensation is also critical in establishing the message that at the very least, the management considers employee performance to be of great significance.

HR performance management

SOEs face several challenges concerning optimal performance management that are related largely to the history and culture of managing performances in the sector:

- **Unclear/poorly defined organizational strategies:** In most SOEs, staff are unclear or uninformed on the organization's overall strategy and development plan. As such, there is a lack of the priorities of the SOE, resulting in a possible focus on areas that do not contribute to the set-out goals of the SOE.
- **Performance management time-lapse**: In most SOEs, performance-related feedback is saved for the stipulated year-end cycle. While this complies with

policies, on a people management level, it fails to curb and reduce unwanted behaviors or approaches in the organization. Developing a continuous, communicative, and transparent feedback network is essential in making SOEs reach their organizational goals and retaining conducive practices among staff.

- **Awareness of unionizing tendencies**: SOEs, operating in public sector ownership set up, are characterized by unionizing tendencies among staff. This makes the management of the SOE risk-averse in communicating feedback, especially on improvement areas. Identifying this limitation is a key effort in ironing out performance management issues in SOEs.
- **Limited performance-related incentives**: The link between performance and incentives is not as clear among SOEs, as it is in the private sector. Rewards are generally linked to tenure and abilities to meet standardized performance criteria. Employees seeking career advancement thus tend to transfer to other departments to advance their career trajectory.

These challenges can be addressed by the leadership and in the HR practices of the SOE in the following ways (Figure 46).

Figure 46: Ways to Address Performance Management Related Challenges

	• Draft clear, concise and realistic organizational goals • Identify and make use of all opportunities to communicate the goals to SOE staff • Management in the SOE must communicate with their respective teams to ensure that their own development goals are in alignment with that of the SOE
	• Define meaningful performance metrics to ensure transparency on performance measurement • Develop targeted indicators of performance that can be measured accurately and consistently • Where possible, the metrics must allow staff to see the direct effect on performance
	• Create tools and procedures for sharing information, including making use of digital tools • KPIs and stretch targets should be visible to SOE staff and shared in real time • Further, create procedures to encourage two-way conversations to engage in timely feedback and problem solving scenarios • Identify and applaud desired behaviour at its occurrence • Invest time in understanding collective concerns to circumvent fear of unionization. This will also help draft effective KPIs, in line with the concerns and goals of the SOE staff
	• Emphasize nonfinancial incentives • Map incentive plans in accordance with the aspirations of the SOE staff and their behaviours to achieve high levels of performance
	• Identify and invest in developing skills among staff as and where required • Capacity building is essential in ensuring sustenance of high performance levels

Source: Author's consolidation.

Topic five: Effective organizational structure

The organizational structure of an enterprise is the enabler of the policies, mission, vision, goals, and so on, and is akin to the human anatomy defining every position, role, relationship, and how they interact. It defines the way in which the SOE wants to organize its human resources and empower them to carry the mandate ahead. Both internal and external auditors study the structure and underlying levels of authority/responsibility to determine architecture of control design and assess the degree of compliance. There is a close interrelationship between the organizational structure and design/testing of controls.

An effective organizational design considers five interrelated components:[7]

- Leadership that sets clear vision and priorities and provides a cohesive leadership team building. From an SOE perspective, the state, the board, and the management, have the collective responsibility to identify the vision and mission of the organization (also see Part III Strategy, risk, and performance).
- Decision-making structures that define the clear roles and responsibilities in this regard. that is, strategic decision-making is the responsibility of the state and the board and operational decision-making, which is often the responsibility of the management and line managers.
- People component that outlines the organizational and individual talent necessary for success and defines the performance measures and incentives aligned with the objectives of the organization. (See the topic: HR compensation and performance management.)
- Work process and systems, which explicate efficient and effective support processes and systems for the execution of programmatic work processes.
- Culture component that transcends across the organization and supports high-performance values and behaviors. The culture also supports an environment of learning and the capacity to change.

The primary benefits of an effective organization structure:

- Eases strategic planning as a result of seamless flow of communication and chain of command;
- Promotes upward mobility of people, which is one of the motivating factors for performance;
- Refines the decision-making process with the top-down flow of authority and bottom-up span of control;[8]
- Promotes open communication and teamwork.

Topic six: External audit for SOEs/Role of the supreme audit institution, parliamentary oversight

External audit for SOEs

External audits of SOEs should be conducted based on the same standards and scrutiny as their public sector counterparts, and under similar legal provisions. Thus, when private sector public interest entities are required to have their financial statements audited in line with International Standards on Auditing, the applicable provisions should apply to SOEs (private sector equivalent auditing standards/ international or country-specific auditing standards).

External auditors carry out the independent audit of financial statements and selected nonfinancial information. External auditors report to the owners/shareholders. The main motivation behind requiring these audits is the central role that financial information plays in informing a wide array of economic agents and public bodies and in helping investors and stakeholders hold the management of audited companies accountable for their actions and performance. The audit provides reasonable assurance that the financial statements present fairly, in all material respects, the financial position of the entity and the results of its operations and related cash flows.

The unique Principal-Agent characteristic of SOEs makes external audit all the more imperative to ensure efficient use and stewardship of resources for the accomplishment of SOEs' (public) objectives. The principal relies on the auditor to provide an independent and objective evaluation of the accuracy of the agent's accounting and to report on whether the agent uses the resources following the specified public policy/ commercial objectives.

The role of the external auditor is to provide reasonable assurance that the financial statements are a fair statement of the SOE's financial position. It is not within the purview of the external auditor to provide any guarantee to the various stakeholders against erroneous or fraudulent reporting, although it does afford some additional protection to those who rely on the information.

SOE auditors should also fall under the same regulatory and professional framework as auditors of listed companies and banks, including requirements related to qualifications, professionalism, and independence. External auditors are also subject to external quality assurance.

As with privately owned public interest entities, a good practice is for the SOE board's audit committee to oversee the selection and appointment of the external auditor and the management of the audit process. In that way, the SOE's management is not directly involved in choosing the auditor, and the lines of responsibility for managing the audit process within the SOE's governance structure are clear. Alternatively, the external auditor may also be chosen by the government in its capacity as the owner.

During the audit process, the audit committee should have direct communications with the external auditor and be able to meet with the external auditor without management. When an SOE lacks an independent audit committee, the independent directors on the board should carry out these responsibilities to prevent SOE executives from influencing the external audit.

Role of supreme audit institutions

An SAI is a public body of a state or supranational organization, which, however designated, constituted or organized, exercised, under the law, or other formal action of the state or the supranational organization, the highest public auditing function of that state or supranational organization in an independent manner, with or without jurisdictional competence.[9]

The objective of the SAI (state auditor) is usually different from that of an independent audit firm acting as the external auditor and can vary from country to country. While the

state auditor will seek to verify the legality of SOE expenditures and make certain that the SOE complies with its budget—functions essentially similar to those of the internal auditor or internal control, the independent external auditor focuses on assuring the veracity of the financial statements and proper application of accounting standards. Essential enabling factors for an SAI to execute their function effectively include supportive environment; clear mandates; independence; adequate funding, facilities, and staff; sharing of knowledge and experience; and adherence to international auditing standards.

SAIs may undertake mainly three audit types: financial (or attest), compliance, and performance (or value-for-money). In financial auditing, the auditor assesses the accuracy and fairness of an organization's financial statements. In compliance auditing, the auditor checks whether the government revenue and spending have been authorized and used for approved purposes. The performance or value-for-money auditing determines whether taxpayers have received value for their taxes.

Box 50 provides an overview of the role of the state auditor and competitive neutrality.

Box 50: Role of State Auditor and Competitive Neutrality

SOEs are often subject to more stringent monitoring and oversight compared to their private sector counterparts. Government-owned businesses/SOEs involve a complex system of oversight and monitoring above and beyond their day-to-day corporate governance structures. In addition to competition authorities and sector regulators, line/sector ministries, parliaments and state audit institutions have a stake in ensuring effective oversight and monitoring of SOEs. The additional burden of ensuring transparency and optimal disclosure when subject to the SAI's audit, may unfairly result in a constraint on an SOE's competitive neutrality.

With regard to the overall regulatory neutrality, some public undertakings are subject to additional regulatory advantages in the form of lower compliance costs, which usually lowers the cost of doing business; whereas other regulatory advantages may be in the form of preferential treatment for public undertakings. Only a few countries report that their SOEs are subject to regulatory disadvantages (Austria, Finland, Mexico and the United States) - in these cases disadvantages may be attributed to more stringent requirements where public funds and public service obligations are concerned.

The nature of state ownership also has a bearing on the role that the state auditor exercises and its relative impact on SOE's competitive neutrality. The role of the state auditor in closely held departmental SOEs differed from that in more legally autonomous SOEs, like companies or corporations, and this may act as a hindrance to creating a level playing field for business to enable such SOEs to compete effectively with the private sector. The nature of state audit of departmental enterprises (that is those fully owned by some government entity or department) and SOEs fully or partially dependent on government funding support from the budget may vary with those SOEs that are corporatized, and therefore, more independent and enjoy autonomy in operational decisions.

For example: In India the departmental or non-corporatized SOEs are fully subject to both internal audit by state audit institutions and also to Comptroller and Auditor General of India (CAG) audits and stringent compliance requirements as prescribed by their reporting authorities/departments/line ministries apart from the centralized decisions on all critical aspects, all of which can be subject to propriety oversight of the state audit agency. Whereas an SOE that is a company, is governed by transparent reporting requirements of statute and is audited by independent external auditors and could enjoy greater autonomy in business decisions with accountability to the shareholders/owners.

In the former category, the SOE is usually subject to numerous decision levels across government levels/ministries, face relative inflexibility in costing and pricing decisions and is subjected to multiple audits, which could impair their competitive neutrality as against the more legally distant corporatized SOE that could be more ready for competition. Therefore, competitive neutrality is not affected by the nature of audit alone but more substantially on the structures of ownership and control, which significantly influence the operational efficiency and competitive readiness for the market.

Source: OECD. 2012. *Competitive Neutrality, Maintaining a Level Playing Field between Public and Private Business.*

The International Organization of Supreme Audit Institutions (INTOSAI)[10] is an international body that develops standards for public sector auditing and provides a forum for external government auditors from around the world to work on issues of mutual concern and keep abreast of the latest developments in auditing and other applicable professional standards and best practices.

INTOSAI Professional Pronouncements are the formal and authoritative announcements or declarations of the INTOSAI community. They draw on the collective professional expertise of INTOSAI's members and provide INTOSAI's official statements on audit-related matters. The **INTOSAI Framework of Professional Pronouncements (IFPP)**[11] contains three categories of professional pronouncements:

- **The INTOSAI Principles (INTOSAI-P)** is categorized into founding principles and core principles. While the founding principles specify the role and functions which SAIs should aspire to, the core principles clarify the SAI's role in society as well as high-level prerequisites for its proper functioning and professional conduct.
- **The International Standards of Supreme Audit Institutions (ISSAI)** are the authoritative international standards on public sector auditing.
- **The INTOSAI Guidance (GUID)** is meant to support the SAI and individual auditors in
  - How to apply the ISSAIs in practice in the financial, performance, or compliance audit processes
  - How to apply the ISSAIs in practice in other engagements
  - Understanding a specific subject matter and the application of the relevant ISSAIs

Parliamentary oversight

As a representative of the citizens, the government has the responsibility of protecting the interests of the citizen through oversight of the executive. Through its oversight function, the parliament holds the government accountable and ensures that policies are efficient and in keeping with the needs of the citizens. This oversight function is performed through (a) questions and debates on the floor of the parliament and (b) parliamentary committees. Parliamentary committees scrutinize the functioning of SOEs.

The legislature generally establishes parliamentary committees, which play a critical role in ensuring that public funds are spent effectively, efficiently, and economically for the benefit of the public.[12] Public Accounts Committees (PACs) are one of such standing committees that have been established to conduct oversight and hold the executive,

Box 51: Citizen Participatory Audit (CPA) in the Philippines

The CPA is founded on the premise that public accountability can prosper only with a vigilant and informed citizenry. The CPA is a recognition of the people's fundamental right to make government accountable for its actions. It provides a way for citizens to be directly involved in the public audit and to find for themselves ways that they can contribute to prudent use of public money. Therefore, the CPA forms a strategic partnership with citizens and their shared goals and objectives.

The Commission on Audit (COA) is an independent constitutional commission. Hence, it is a government agency that was created by the Philippine Constitution independent of the executive, legislative, and judicial branches of government. It has exclusive authority to define the scope of its audit and examination, establish the techniques and methods required thereof, and promulgate accounting and auditing rules and regulations. CPA fuses the exclusive authorities vested in the COA with the state's policies on citizen empowerment and nongovernmental organizations and the vital role of communication and information.

Significant outcomes of the CPA included an enlightened and accountable citizenry, a better-informed citizenry, a more involved and vigilant citizenry, a more accountable and responsive government, and a more efficient and effective SAI.

Source: Tan, Maria Gracia P. 2019. *Citizen Participatory Audit in the Philippines— Pilot Phase I (2012–2014).* World Bank Group, Washington, DC.

including SOEs accountable for their action when spending public funds.

Generally, the parliament, through the work of the PACs, exercises its oversight role by overseeing the financial performance of SOEs through interrogating their reports and conducting site visits to verify whether projects indicated in the report exist and whether those projects benefited the public. The PACs, therefore, focus mainly on financial matters, presented in the SAI's audit report, which is found within the annual report. However, the portfolio committee (for example, nomenclature in South Africa) oversees the nonfinancial performance, that is, it focuses more on policy and service delivery matters. Regardless of the separation of functions between PACs and portfolio committees, these committees need to work together and share information to enhance effective oversight and accountability and ensure that quality service is delivered to the public.

The PACs fulfil the responsibility of overseeing the financial performance of the SOEs using the financial audit report, which in most cases is prepared by the SAIs. Therefore, the PACs play an important and specialized role of being the guider and protector of public monies.

Challenges of oversight activity of PACs:

- **Lack of implementation of resolutions:** Most of the resolutions taken by PACS are not implemented, and in most cases, no action is being taken to address issues raised by the PACs.
- **Varying audit reports:** The challenge is that the reporting structure between the SAI and private audit firms differs, thus making it difficult to conduct effective oversight and holding the Executive accountable.
- **Lack of effective monitoring and transparency:** There is a lack of continuous monitoring of the SOEs, and in most instances, the submission of SOEs' annual reports to the parliament is deliberately or unintentionally delayed. As a result of those delays, it further negatively affects the effective scrutiny of the report, resulting in those reports being accepted for the sake of compliance.
- **Capacity constraints:** There is a lack of skills that can cover all aspects required to conduct effective oversight. Additionally, the continuity of members of PACs is inadequate, as members are redeployed mainly due to political reasons, and most of the members serving at PACs are not retained after elections.
- **Budget constraints:** Lack of adequate budget implies that few members and support staff will be nominated to attend the training. Budget constraints further determine the number of oversight visits and public hearings that can be conducted, which thus hinders the effectiveness of the PACs in overseeing the performance of SOEs.



Handout H4.1A: The control environment – Whistle-blowing

Learning objective

Evaluate the company's whistle-blowing policy and its place in corporate governance.

Instructions

This case examines a board-approved whistle-blower policy. Participants review the new policy and assess its strengths and weaknesses. The discussions will cover

- Key components of a whistle-blower policy
- Company's commitment—how to demonstrate the 'tone at the top'?
- The importance of educating employees, others about the policy

The trainer will engage all participants in a discussion about the policy's merits and failings.

Narrative

Organic Company Ltd.'s board approved the following whistle-blower policy:

Organic Company Limited Policy on Filing, Treating Complaints

I. Commitment to High Ethical Standards: Organic Company Limited is committed to complying with all applicable laws and regulations governing its operations. Beyond that, the company strives to conduct its business by the highest ethical standards. As part of that commitment, the board has approved a policy and procedures to encourage reporting of suspected improper conduct by the company's employees, directors, collaborators, vendors, and others.

II. Complaints, Procedures: Any employee, director, collaborator, vendor, or others may submit a good faith complaint regarding

- Accounting, internal controls or auditing matters
- Illegal, dishonest, or unethical conduct
- Fraud or violation of any law or regulation, including suspected violations
- A potential or actual conflict of interest
- Serious damage to the company's brand or reputation
- Potential material liability, or
- Any other violation of the company's code of conduct and ethics.

Anyone submitting any such complaint may do so without fear of dismissal or retaliation. Submissions may be anonymous. The person must exercise sound judgment to avoid baseless allegations. Anyone who intentionally files a knowingly false report of wrongdoing may be subject to discipline.

The person must exercise sound judgment to avoid baseless allegations. Anyone who intentionally files a knowingly false report of wrongdoing may be subject to discipline.

Anyone with concerns may contact the compliance officer directly in person, in writing (e-mail or a letter), or by phone. Written complaints should be marked as 'confidential'. The officer will keep all information confidential unless as is the case with certain crimes, a law requires that any name you supply be provided to enforcement officials or a court.

A hotline is also available. You do not need to identify yourself by name. If you choose to give your name, it will be kept confidential unless, as noted above, the law requires the company to contact enforcement officials or a court.

III. Company's Treatment of Complaints: The company will not discharge, demote, suspend, threaten, harass, or in any manner discriminate against any employee in the terms and conditions of employment based on any lawful actions of the employee in their good faith reporting of complaints.

Other parties will similarly be protected against retaliation of any form. The company's officials in charge of investigating the complaint are bound to do so in strictest confidence. They

must complete their initial assessment within one week of the day on which the complaint was lodged.

Employees, who are the subject of an investigation, should not be interrogated, terminated, disciplined, or otherwise advised of investigations until management has reason to proceed to do so.

The company's compliance officer will maintain a log of all complaints, tracking their receipt, investigation, and resolution. The officer will provide a periodic summary report to the board.

IV. Learning More about the Process: Through the toll-free hotline, our website, employee newsletters, posters, and orientation materials, there are several means available to learn about the program.

Questions to focus discussion

- What are the strengths of this policy?
- The weaknesses?
- Does the commitment of the company come through strongly?
- Would a whistle-blower feel confident that they would be protected? What about the section cautioning that the company may have to report the information to law enforcement officers or a court?
- Are the procedures clear for how a whistle-blower should lodge a complain?
- Is it clear how the company will handle the investigation?
- Does the policy convey a reasonable tone to guard against frivolous, unfounded complaints?
- Are protections of employees, who are the subject of an investigation, sufficiently and clearly explained?
- It can be said that the 'tone' of the organization, its culture, and its commitment determine the effectiveness of a whistle-blower policy. What are some examples of how this tone can be established?



Handout H4.1B: IFC progression matrix for control environment

	1. Basic Practices	2. Intermediate Practices	3. Good International Practices	4. Leadership
Internal Control	• The SOE has established documented internal control policies and procedures	• The audit committee ensures corrective actions on control deficiencies identified in Management Letters.	• "Three lines of defense" model of risk management, internal control and internal audit has been adopted.	• Control environment in accordance with highest international standards, including but not limited to IIA, COSO, ISO 31000, 19600, 37001, and 27001
Internal Audit	• The SOE has an in-house or outsourced internal audit function. • The state audit institution, if any, interfaces with the internal auditors.	• Internal audit function regularly interfaces with external auditors and • is accountable to the board	• Head of internal audit reports to the audit committee and administratively to management. • The Internal audit function is independent, objective, risk-based, and has unlimited scope of activity.	• The internal audit function meets standards of the Institute of Internal Auditors (IIA). • The audit committee ensures that the internal audit function is subject to periodic quality assessment by third party.

	1. Basic Practices	2. Intermediate Practices	3. Good International Practices	4. Leadership
Risk Governance		• The Board receives and reviews information on key risks.	• The Board approves risk appetite. • The SOE has established risk-management framework with a chief risk officer (CRO) or equivalent with unfettered access to the Board.	• The board routinely monitors risk management and compliance with policies and procedures and discloses risk appetite information. • The CRO reports to board-level risk management committee or equivalent.
Compliance		• A designated compliance officer is appointed.	• Comprehensive compliance program annually reviewed, with mechanisms to report wrongdoing and misconduct.	• The chief compliance officer reports to the audit committee and administratively to management.
External Audit	• The SOE is audited by an independent external auditor (EA) irrespective of any state audit conducted. • Written Management Letters provided by an EA.	• The audit committee is responsible for the selection of the External Audit and ensures their independence, including in relation to the provision of non-audit services.	• Audit committee owns relationship with EA; agrees on scope and audit fees, has an early discussion on key audit matters and generally oversees the conduct of the external audit.	• The audit committee undertakes a periodic EA quality assessment, using Audit Quality Indicators (AQI) and reviews EA long association.
Subsidiary Governance		• The SOE has policies and procedures to control the creation and dissolution of subsidiaries.	• A formal, merit-based, and transparent process for the selection and nomination of board members of subsidiaries, such as a board nomination policy is in place and disclosed.	• The board of the holding SOE exercises oversight over the corporate governance framework of its subsidiaries.
Integrating of E&S		• 7. The SOE has established industry practices in its E&S risk management practices.	• Comprehensive ESMS integrated in risk-management framework, and E&S risks are part of establishing the risk appetite. • E&S/sustainability head has unfettered access to senior management and CRO.	• The board or sustainability committee ensures corrective actions on E&S issues. • The head of ESG reports to the board's E&S/ sustainability committee. • ESMS is consistent with international standards (e.g., ISO 14001).

Notes:

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Control environment, transparency, and disclosure

Leadership Training Toolkit for SOEs

Part IV Module 2
Financial accounting and disclosure



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Module 2: Financial accounting and disclosure

This session (module) covers the following topics:

1 Disclosure and transparency of financial information



2 International and local accounting environment for SOEs



3 Financial reporting of SOEs and key users and their need

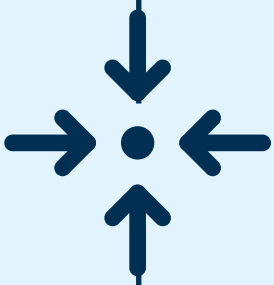


4 Consequences of inadequate financial information



Learning objectives

By the end of this module, the participants will be able to



- **Explain company information (financial and nonfinancial) that should be disclosed**
- **Discuss the international and local accounting environment**
- **Understand the reporting environment and identify the key users and their information needs**
- **Identify the consequences of inadequate financial information**

Agenda

Total time: 2 hours 50 min

Time	Topic
15 min	Disclosure and transparency of financial information
45 min	International and local accounting environment for SOEs
30 min	Financial reporting of SOEs and key users and their need for information
30 min	Exercise: Financial reporting of SOEs and key users and their need for information
20 min	Consequences of inadequate financial information
30 min	Case study: Consequences of inadequate financial information

Topic one: Transparency and disclosure of financial information

Introduction

According to the IFC's Toolkit for Disclosure and Transparency, 'Beyond the Balance Sheet',[13]

"The business case for disclosure and transparency is clear: Disclosure and transparency fill information gaps for customers, investors, and employees and, as a result, can have a positive effect on a company's revenues or its access to human capital or financial capital. Their use also promotes more efficient capital markets by ensuring 'fair disclosure' to all investors and preventing asymmetric information. These benefits are amplified when companies take into account wider sustainability concerns, such as environmental, social, and governance (ESG) issues, and disclose how they manage material environmental and social issues and stakeholder concerns."

Disclosure and transparency are considered to be two of the most important elements of sound corporate governance. The G-20/OECD Principles of Corporate Governance (2015) state:

"The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company."

The OECD disclosure obligations include

- Financial and operating results
- Company objectives
- Major share ownership and voting rights
- Remuneration policy for board members and key executives
- Related-party transactions
- Foreseeable risk factors
- Issues regarding employees and other stakeholders
- Governance structures and policies

Greater transparency leads to building or restoring trust among stakeholders. A high level of trust, in turn, leads to

- Increased access to external capital
- Lower cost of capital
- Improved operational performance
- Reduced risk of corporate crises, scandals
- Enhanced trust

Disclosure of financial information

There are two types of corporate information: financial and nonfinancial. About financial information disclosure, guidance on good practices in corporate governance disclosure produced by the United Nations Conference on Trade and Development (UNCTAD)[14] recommends that

- Companies should disclose their financial and operating results: This key board responsibility ensures that shareowners and other stakeholders are provided with high-quality disclosure on the company's financial and operating results that the board has been entrusted with governing.
- The board's responsibilities regarding financial communications should be disclosed: Boards should disclose their duties in overseeing the production of the financial statements.
- Companies should fully disclose significant transactions with related parties: Shareowners are interested in information that would help them determine whether the directors have their company's best interests in mind.

The board has the responsibility of reporting on the company's financial and operating results. This typically should include

- Balance sheet
- Income statement
- Statement of changes in owners' equity
- A cash flow statement
- Explanatory notes (other disclosures)

Transparency and disclosure are vital to holding SOEs accountable for their performance. This implies that SOEs should be subject to reporting requirements at least as rigorous as those imposed on privately owned public interest entities (refer Box 52 on IFC's principles of corporate disclosure and transparency in emerging markets). However, specific features that are unique to an SOE need to be factored in while designing the reporting framework, such as SOEs may be subject to special rules imposed only on the public sector; SOE may be subject to particular public service obligations (say, limits on the prices they can charge to particular consumers); the active role of the state in decision-making in the SOE; and specific needs of the SAI that has been assigned the auditing role for the SOE.

The starting point of disclosure and transparency of financial reporting is the adoption of widely accepted international standards, and in this case, it is International Financial Reporting Standards (IFRS) laid down by International Accounting Standards Board (IASB). In addition to this, stock market listing of SOEs can lead to increased transparency and disclosure requirements (refer Box 53 on the next page).

Financial reporting

As expected of any large corporate entity, all SOEs should produce annual financial statements, including a balance sheet, cash flow statement, profit and loss statement, statement of changes to owners' equity, and notes. These statements should generally be finalized three to six months after the end of the financial year. The same reporting standards as private sector enterprises allow SOEs to draw on an established independent body of expertise for organizing and auditing their financial statements as well as for evaluating their significance should be used. In contrast, using reporting standards developed specifically for SOEs can result in less transparent and non-comparable financial reports, reducing their likely impact in improving SOE performance.

A management commentary—often referred to as 'management discussion and analysis'—should accompany annual financial statements. It sets out the key aspects of the SOE's performance during the reporting period and its prospects for the immediate future. This commentary can provide a more complete picture of the SOE and make it easier for the ownership entity and the wider public to evaluate its performance.

Some countries require listed companies to produce semi-annual or even quarterly financial statements. Given the costs involved, requiring quarterly reporting may be excessive, and semi-annual reporting should be a requirement only for the largest and most economically significant SOEs. It is much more important for SOEs to issue public statements summarizing the impact of changes in their circumstances or the market environment ('material events'), whenever these are significant, even if those statements fall outside the usual reporting cycle.

Box 52: IFC's Principles of Corporate Disclosure and Transparency in Emerging Markets

Connected – Links strategic, governance, and financial information

Integrated – Sustainability addressed as part of the company's core management and governance functions

Open – Promotes a culture of openness and transparency within and outside the organization, based on dialogues and feedback loops and a dynamic information management system

Inclusive – Supports dialogue and mutual learning between the company and its stakeholders

Material – Relevant, based on the context of operation, especially in emerging markets

Credible/reliable – Robust management process for internal data collection and external verification, including ESG information

Source: IFC. 2018. *Beyond the Balance Sheet, IFC Toolkit for Disclosure and Transparency.*

Box 53: Stock Market Listing Can Lead to Increased Transparency

The municipality of São Paolo is the majority owner of Sabesp, which supplies water and sewerage services to over 20 million consumers. To raise additional capital for infrastructure investment to improve the quality of its water supply and to reduce high leakage rates, Sabesp floated minority stakes on stock markets in Brazil and New York.

In addition to raising funds for investment, Sabesp had to meet the requirements of a stock market listing, including improving its financial reporting and corporate governance arrangements and thus increasing its transparency and making its management more accountable for its performance.

Colombia's state-owned transmission company Interconexion Electrica S.A., which operates electricity transmission networks in Colombia and several other countries in Central and South America, is majority owned by the Colombian state. A minority stake in the company was sold through the government's 'shareholdings for all' initiative, and the company has been listed on the Colombian Stock Exchange since 2001. Following the decision to list the company and then to list American depository receipts on U.S. stock markets, the company has significantly improved the quality of its financial reporting. Sabesp adopted a good governance code in 2001, setting out its principles of corporate governance, and produces an annual report on corporate social responsibility in addition to its annual financial report.

Source: World Bank Group. 2014. *Corporate Governance of State-Owned Enterprises: A Toolkit.* Washington. DC: World Bank.

Ensuring public access to the information that SOEs produce is vital. Often, a lack of consensus or considerable resistance within SOEs and in their ownership entities prevents financial and nonfinancial information on the performance of SOEs from being widely available. However, unless this information is easily accessible (through the SOE's website, for instance), the positive impact from efforts to improve the quality of SOE disclosure will be reduced. Besides making this information available on their websites, SOEs should also provide it through other channels, including the company registrar (when corporatized) and the stock exchange and securities regulator (when listed). The ownership entity or coordinating body for SOEs should also offer relevant information for each SOE on its website.

SOEs often engage in substantial business with the government, other SOEs, or entities to which the government or other SOEs may be linked. Transactions between private sector entities with a common owner or large shareholders are treated as "related-party transactions" and are usually required to be disclosed to "draw attention to the possibility that the financial position may have been affected" by the transactions (in the words of International Accounting Standard, or IAS, 24). The main international standard for disclosure of such transactions, IAS 24, does not require all transactions among SOEs or between SOEs and the government to be treated as related-party transactions (this is for jurisdictions with large numbers of SOEs, where many such transactions may be a normal part of the business). However, IAS 24 does require disclosure on such transactions if they are individually or collectively significant or made on non-market terms and are of material significance.

The board is responsible for reviewing and approving financial statements before these are publicly issued. The board, in addition to the external auditor, provides some level of assurance that the financial statements accurately represent the company's situation. **Providing credible assurances involves**

- Checking the consistency of the disclosed accounting and financial statements
- Ensuring the accuracy and integrity of the company's accounting and financial reporting systems
- Overseeing the independent internal audit processes
- Maintaining an appropriate relationship with the external auditors

Box 54 (on the next page) outlines some country case studies on disclosure, and reporting obligations placed on SOEs.

Box 54: Disclosure and Reporting Obligations Placed on SOEs Country Case Studies

Sweden and Korea have arguably the most elaborate and explicit regulatory framework on SOE transparency and disclosure among the surveyed countries. According to its Guidelines for External Reporting of State-Owned Enterprises, in Sweden, SOEs are obliged to issue the annual report, interim reports, the corporate governance report, the statement on internal control and the sustainability report. Under the Official Information Disclosure Act, all public institutions including all SOEs in Korea are required to report and disclose corporate information to the general public through the internet-based portal called ALIO (All Public Information in One) inventory system.

SOEs in the **Philippines** are subject to disclosure requirements elaborated by the ownership coordination entity (Governance Commission for GOCCs, or GCG) including requirements for developing a website and posting both financial and nonfinancial information of SOEs for public access.

Companies in **Lithuania**–including SOEs–can choose to prepare their financial statements in accordance with either International Financial Reporting Standards (IFRS) or Business Accounting Standards (domestic standards).

Paraguay has a new Access to Information Law, which also covers the SOEs, but nothing specific for SOEs has been implemented. The National Council of Public Enterprises has also been working on the development of a Code of Corporate Governance for SOEs.

Control environment: Internal and external audit function– Country Case Studies

In India, SOEs' financial statements are subject to both a constitutional audit by the supreme audit institution (CAG) and statutory audits by an external auditor. The audits are undertaken in accordance with the standards set by the Institute of Chartered Accountants of India.

In Lithuania, the establishment of an internal audit is only mandatory for statutory state enterprises and SOEs are subject to either IFRS or domestic accounting standards, which are of varying qualities.

In Malaysia, only SOEs with the status of Government-Linked Company (GLC) that are listed on the national stock exchange are required to have an internal audit function as specified by the Securities Commission and Bursa Malaysia (stock exchange). Auditing and accounting practices and information disclosure (both financial and nonfinancial) for unlisted SOEs differ depending on the requirements of the relevant controlling stakeholder.

Sweden has established SOE internal control systems that are very similar to the one in the private corporate sector. All SOEs are subject to the same accounting and auditing standards as listed companies. The auditing of SOEs is carried out by independent auditors according to internal auditing standards and The National Audit Office can do performance audits of SOEs when the state is a majority shareholder.

Source: OECD. 2016. *Transparency and Disclosure Measures for State-Owned Enterprises (SOEs): Stocktaking of National Practices.*

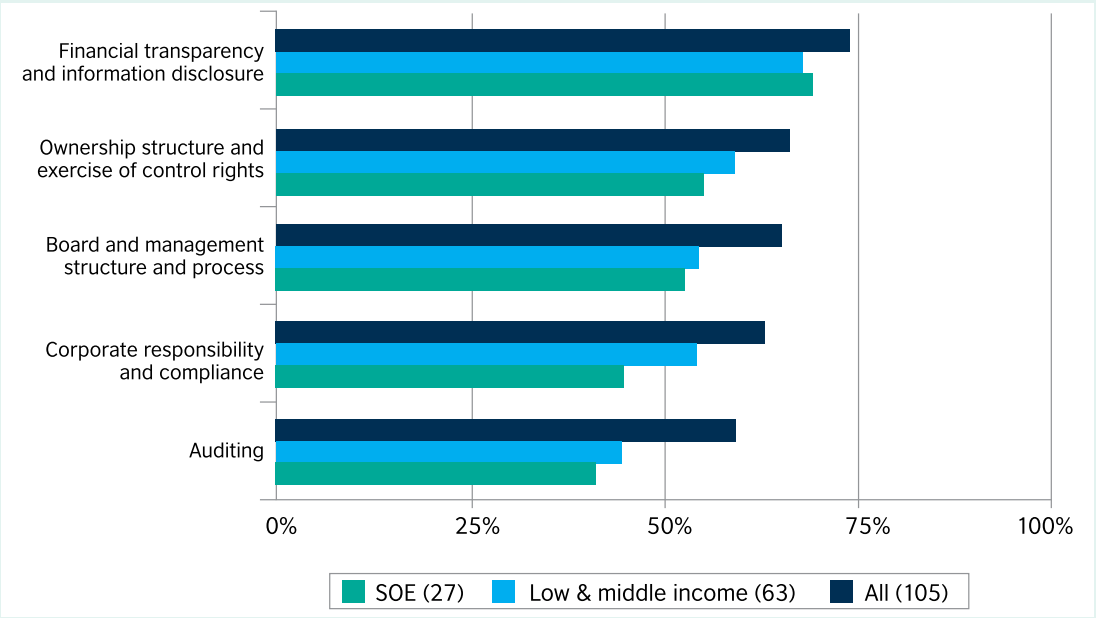
Box 55 on the next page provides a comparison of disclosure between SOEs and enterprises from low and middle-income countries.

Cross-cutting theme: climate change and resilience

The Task Force on Climate-related Financial Disclosures (TCFD) has developed four widely adoptable recommendations on climate-related financial disclosures applicable to the organizations across sectors and jurisdictions. The Task Force has structured its recommendations around four thematic areas that represent core elements of how organizations operate—governance, strategy, risk management, and metrics and targets.[15] These are described in Table 50 on the next page.

In some situations, climate factors may represent significant judgements in determining whether assets are impaired and/or a key assumption in impairment calculation. Where there is a significant risk that these assumptions may change within the next financial year (for example because of an uncertain regulatory environment), IAS_1 requires the assumptions on which

Box 55: Comparison of Disclosure Between SOEs and Enterprises from Low- and Middle-Income Countries



In a survey conducted by UNCTAD on International Accounting and Reporting Issues (2005 Review), one-third of the enterprises in the survey were SOEs. When viewed as a group, SOEs in the survey tend to underperform the average rate of disclosure for enterprises from low- and middle-income countries and significantly underperform the average rate of disclosure for all the enterprises surveyed.

Despite the relatively low performance of SOEs as a group, it is important to recognize a significant difference between SOEs: internationally listed SOEs perform much better than non-listed or only locally listed SOEs. The disclosure rate of SOEs that are listed internationally is significantly higher than both the rate of all other SOEs as well as the rate for low and middle-income countries generally. The disclosure rate of internationally listed SOEs is close to the disclosure rate of all internationally listed enterprises surveyed.

Source: UNCTAD. 2005. *International Accounting and Reporting Issues, 2005 Review*.

the accounting is based to be explained. There may also be significant judgement as to whether climate factors result in a provision being recognized or a contingent liability disclosed. For assets carried at fair value, expectations of climate factors may be a significant component of the fair value assumptions required to be disclosed under IFRS 13. The climate-related risk may also be a consideration in impairment assessments for goodwill or indefinite life intangible assets. Where this represents a key assumption in the assessment (for example, because the assessment makes assumptions about particular regulatory outcomes), IAS 36 requires this to be explained, along with the impact of a reasonably possible change in this assumption (if material).

Contingent climate-related liabilities (such as those relating to environmental remediation) are disclosed under IAS 37 where the likelihood of settlement is less than probable, but not remote. The systemic nature of climate risk may create pockets of 'concentration risk' for some entities (for example equity investments carrying exposure to a particular climate-exposed sector, geography, or wider climate outcome). IFRS 7 requires the identification of groups of financial instruments that are exposed to a particular risk characteristic.

On disclosure considerations of climate effects in the financial statements, the senior management should, therefore, consider

the following IAS for potentially applicable disclosure requirements:[16]

- IAS 1: Presentation of financial statements
- IAS 36: Impairment of assets
- IAS 37: Provisions, contingent liabilities, and contingent assets
- IFRS 7: Financial instruments disclosures
- IFRS 13: Fair value measurement

Box 56 (on the next page) provides an overview of climate risk management in the banking sector.

Table 50: TCFD's Recommendations and Supporting Recommended Disclosures

Themes	Governance	Strategy	Risk Management	Metrics and Targets
Description	Disclose the organization's governance around climate-related risks and opportunities	Disclose the actual and potential impacts of climate-related risks and opportunities on the organization's businesses, strategy, and financial planning where such information is material	Disclose how the organization identifies, assesses, and manages climate-related risks	Disclose the metrics and targets used to assess and manage relevant climate-related risks and opportunities where such information is material
Recommended Disclosures	a) Describe the board's oversight of climate-related risks and opportunities	a) Describe the climate-related risks and opportunities the organization has identified over the short, medium, and long term	a) Describe the organization's processes for identifying and assessing climate-related risks	a) Disclose the metrics used by the organization to assess climate-related risks and opportunities in line with its strategy and risk management process.
	b) Describe management's role in assessing and managing climate-related risks and opportunities	b) Describe the impact of climate-related risks and opportunities on the organization's businesses, strategy and financial planning	b) Describe the organization's processes for managing climate-related risks	b) Disclose Scope 1, Scope 2, and, if appropriate, Scope 3 GHG emissions, and the related risks.
		c) Describe the resilience of the organization's strategy, taking into consideration different climate-related scenarios, including a 2°C or lower scenario	c) Describe how processes for identifying, assessing, and managing climate-related risks are integrated into the organization's overall risk management	c) Describe the targets used by the organization to manage climate-related risks and opportunities and performance against targets

Source: Adapted from TFCD 2017.

Disclosure in line with above the recommendations will provide better information to support informed investment, lending, and insurance underwriting decisions and improve understanding and analysis of climate-related risks and opportunities. Better information will also help investors engage with SOEs on the resilience of their strategies and capital spending, which should help promote a smooth rather than an abrupt transition to a lower-carbon economy.

Box 56: Climate Risk in the Banking Sector

The framework to consider climate risk used by financial regulators with regard to the banks/financial institutions they supervise is similar to the framework that could be used by Ministries of Finance in their engagement with state-owned banks. An overview of the different channels, through which climate change affects the banking sector and sets out the regulatory approach is given below:

The financial risks from climate change arise from two primary channels: physical and transition. Physical risks can arise out of climate and weather-related events, such as heatwaves, droughts, floods, storms and sea level rise. They can potentially result in large financial losses, impairing asset values and the creditworthiness of borrowers

Transition risks can arise out of the process of adjustment toward a low-carbon economy. Changes in policy, technology, and sentiment could prompt a reassessment of the value of a large range of assets and create credit exposures for banks and other lenders as costs and opportunities become apparent. For banks, these climate-related risk factors manifest as increasing credit, market, and operational risks.

State-owned banks and green finance examples

Brazil: Protocolo Verde (Green Protocol). The protocol was facilitated by the Ministry of the Environment and supported the commitment of five state-owned banks to voluntary guidelines entitled Protocolo Verde (Green Protocol). The protocol signatories commit to financing green and sustainable development by means of lines of credit and other programs and incorporate environmental criteria in credit risk analyses. Brazilian Banco Nacional de Desenvolvimento Econômico e Social (BNDES) recently revised its mission strategy to include environmental sustainability

China Development Bank and China Import Export Bank: China's banks can play a key role in directly providing capital for green investment, in establishing markets and best practices for commercial banks and in leading the way to integrate climate change considerations into risk management practice.

Southern Africa Development Bank: Recently adopted a Climate Change Policy Framework, which clarifies the bank's role in contributing to South Africa's Nationally Determined Contributions (NDCs). It also developed a detailed reporting framework for all the development aspects, including climate change, and an approach to integrate climate considerations into each stage of the project cycle.

Latin America and Caribbean: Inter-American Development Bank and Latin American Association of Development Financing Institutions (ALIDE) are collaborating to prepare a Guide for National Development Banks (NDBs) on climate risk.

Policy recommendations to government/ministries for greening state-owned banks (SOBs)

- Give SOBs/NDBs a clear and stable 'green' mandate that includes supporting the implementation of a country's NDCs and other climate objectives. This could include not just funding and encouraging investment in low-carbon activities, but also restricting the funding of investment in high-carbon activities, such as fossil-fuel based electricity generation.
- Integrate SOBs/NDBs into their policy framework and design and ensure that supportive policy and regulatory frameworks are in place. This will facilitate NDBs' direct lending and investment in long-term activities to support green transformation and help catalyze private flows to those activities.
- Build capacity within SOBs to help them understand, identify, and manage the transitional and physical risks of climate change to their lending and investment portfolios.

Source:

Climate Policy Initiative. 2013. *The Role of National Development Banks in Catalyzing International Climate Finance, Barbara Buchner and Chiara Trabacchi.*

Griffith-Jones Stephany, Attridge Samantha and Gouett Matthew. 2020. *Securing climate finance through national development banks.* ODI.

Topic two: International and local accounting environment for SOEs

Accounting is the systematic process by which a company's transactions and other events are recorded by applying standards specific to each jurisdiction such as generally accepted accounting principles (GAAP), International Accounting Standards (IAS), or IFRS, other accounting frameworks, standards, and policies. The information is then used to develop and provide reports to users of financial information, including directors and capital providers. Technology is critical in this process.

Generally accepted accounting principles (GAAP)

GAAP are the accounting rules used in a country to prepare financial statements for publicly traded companies and publicly and privately held companies. The *IASB Framework for the Preparation and Presentation of Financial Statements* is accepted in about 100 countries as the accounting framework for GAAP applicable to listed companies in those countries. The IASB standards are referred to as International Accounting Standards (IAS) or International Financial Reporting Standards (IFRS), which are used in the European Union (EU), Russia, South Africa, Hong Kong, Australia, and Singapore.

Accounting standards

The body of accounting standards applicable if a country is fully applying IFRS includes

- All IFRS
- All IAS
- All applicable interpretations including interpretations from the Standards Interpretations Committee of the former IASC (SIC) and interpretations from the International Financial Reporting Interpretations Committee of the current IASB (IFRIC)

Transnational comparisons

While IFRS are widely applied, there may be distinct differences between accounting standards applicable in particular countries. In the United States, the Financial Accounting Standards Board (FASB) develops the framework and accounting standards applied. These, however, differ from IFRS, but efforts are under way to converge these two standards' frameworks. Some countries, which are yet to transition to IFRS, might continue to adopt their local GAAP or localized adaption of IFRS.

Intra-national comparisons

Even when comparing financial statements of two countries that apply IFRS, there may still be differences that arise from particular jurisdictional requirements. For example, IFRS applied in Australian financial statements will differ from those of companies reporting to IFRS in EU member states. Both Australia and the EU have amended the IFRS standards, as issued by the IASB, marginally in each jurisdiction and in different ways.

General assumptions of accounting

Accounting generally assumes that

- A business is a separate economic entity from its owners or other businesses.
- All financial information relating to the company, such as revenues and expenses, should be kept separate from personal expenses.
- A company's financial information should include any item if it is probable that any benefit or cost will flow to or from the company in the future and the item has a cost or value that can be reliably measured. Such information will be expressed and presented in monetary unit terms, presented periodically (most common periods are months, quarters, and years) for comparison between present and past performance.
- When choosing between two possible and available accounting treatments, the one that will least likely overstate assets and income is the preferred choice.

The underlying assumptions are as follows:

- **Accrual basis assumption** – This assumes that revenues are recorded and recognized in the period, in which they are incurred and matched with related expenses (a process known as 'matching'). Even though cash may not be received or paid in a credit transaction, the revenues are recorded because they are consequential in a company's future income and cash flow. Transactions or events are recognized, when they occur and are recorded in the accounting records and reported in the financial statements of the periods to which they relate. For example, this requires companies to record when their revenue is
  - o Realized or realizable, and
  - o Earned, not when cash is received
- **Going concern assumption** – This assumes that the company will continue to operate shortly and will be able to realize assets and discharge liabilities in the normal course of operations. It assumes that there is no intention to liquidate or materially limit the scale of the company's operations. The 'going concern' assumption validates the methods of asset capitalization, depreciation, and amortization. If liquidation is looming, special financial reports will be required and then the 'going concern' assumption no longer applies.

Qualities of financial information

A company's accounting policies should ensure that financial statements include information that is useful to a broad range of users. The IASB Framework states that this information should be relevant, reliable, understandable, and comparable. Other issues such as faithful representation, materiality, consistency, and completeness also apply. The following is adapted from the IFRS Framework.

Relevance – Information contained in the annual accounts is considered relevant to investors in case of listed SOEs if it assists them in making economic decisions (for example, buying or selling shares) by helping them to evaluate past, present, and future events. The information must be provided in sufficient time so that boards, executive managers, state, and investors can use it for effective decisions.

Reliability – Information in financial statements should be free from material error, verifiable (for example, when independent auditors use the same methods, they should get similar results), neutral (free from bias), and demonstrate representational faithfulness (for example, describe events or transactions, as they happened or existed).

Faithful representation – Financial statements must fairly present an entity's financial position, financial performance, and cash flows. The statements must be faithful representations of a company's transactions and events, apply appropriate accounting policies and standards, and present financial information with certain qualities (understandable, relevant, reliable, complete, and comparable information). Fair presentation is assumed to be achieved through the correct, full, and appropriate application of IFRS.

Completeness – Financial information in financial statements is expected to be complete within the bounds of materiality and cost. If by omitting an item, the resulting information will be misleading, it should be included.

Materiality – The significance of all accounting items in the published accounts should be considered. An item should be considered significant or material if it is likely to affect the decision-making of a reasonable individual.

Understandability – People other than accounting specialists, who have a reasonable knowledge of business and economic activities and accounting, should generally understand the financial corporate reports.

Comparability – The financial information must be measured and reported similarly over time to allow financial statements to be compared for trends within the company, and comparisons between different companies and different sectors. IFRS requires that a financial statement be prepared using uniform accounting policies for similar transactions.

Consistency – The same accounting methods should be applied from period to period. Any change in accounting methods should be well explained and justified. Frequent and unnecessary changes to accounting policies will weaken their comparability.

SOE accounting environment

On many occasions, directors will be presented with financial statements to be examined. They may be required to do the following:

- Approve next year's budget
- Approve the five-year financial plan
- Examine the financial statements before publication
- Examine accounts of acquisition targets

Elements and components of financial statements

The five key elements of financial statements are

- **Assets** resources controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity
- **Liabilities** present obligations of the entity from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits
- **Equity** is the residual interest in the assets of the entity after deducting all its liabilities
- **Income** revenues arising in the course of the ordinary activities of an entity (for example, sales, fees, interest, dividends, royalties, and rent) and realized and unrealized gains, which represent 'increases in economic benefits' and meet the definition of income (for example, those arising on the disposal of non-current assets; arising on the revaluation of marketable securities or increases in the carrying amount of long-term assets)
- **Expenses** encompass losses as well as those expenses that arise in the course of the ordinary activities of the entity

The accounting system – source and flow of accounting information

Accounting system information is derived from the application of accounting standards, principles, and policies to capital transactions, operating and other events, and transactions that may occur. It is from this accounting system, and after adjustment for items (for example, depreciation on assets such as plant and equipment), that the financial statements and other financial reports will be drawn.

Accounting policies

A company should apply consistent accounting policies to similar transactions periodically. Therefore, there should be few changes in accounting policies, unless there is a new standard applied, or the company undertakes new types of transactions or events, or if there is a correction of an error from previous practices. Further, changes to accounting policies are only permitted if they result in more relevant and reliable information in financial statements or are required by IFRS. This limits accounting policy arbitrage opportunities.

Critical accounting policies and issues for the SOE

Many countries' regulations require that an SOE's annual financial statements (and sometimes the quarterly reports) describe critical accounting policies in detail. Such policies are likely to vary from company to company and from industry to industry.

A critical accounting policy is considered to have a highly subjective element and perhaps involve complex judgments (for example, methodology for calculations, assumptions, and estimates), including those that have a material impact on the SOE's financial statements.

Critical accounting policies are believed to be more open to abuse by creative accounting. Creative accounting is not supportable and may involve hiding excess earnings from a good quarter or year by changing the subjective element of a critical accounting policy. The hidden funds can then be returned to a company's reported profit in a bad quarter. Companies may do this because there

is a general belief that an ideal company is the one that is always consistently increasing earnings.

Examples of critical accounting policies may include the following:

- The estimate of uncollectible accounts/ bad debts (for example, receivables that will never be paid and will have to be written off)
- Fair value accounting for derivatives
- The judgment of the expected lifetime of an asset when calculating depreciation
- The estimation of defined benefit plan liabilities
- The estimation of taxes owed can sometimes be a critical accounting policy

Challenges in implementation of international accounting frameworks for SOE boards

Given the wide stakeholder group that an SOE caters to and who may have an interest in its financial performance and overall health, it faces unique challenges concerning convergence with international standards. Moreover, given their presence in strategic sectors of the economy, these challenges are further compounded.

The following are the key challenges in the implementation of such standards:

- **Lack of qualified and skilled IFRS professionals:** IFRS is a relatively new, niche, and vast subject. Without adequate skilled professionals to guide and monitor the transition, both internally and externally, it is difficult for the SOEs to steer in this direction. Moreover, the different users of financial information of SOE also need to be adequately informed about the tenets of IFRS to comprehend the myriad of information that is required to be reported under IFRS compliant financial statements.
- **IFRS implementation—A costly affair:** Globally, the plight of SOEs is generally worrisome and they are beset with a crunch of funds with few exceptions. In many countries, despite their strategic orientation, SOEs are generally sick and necessitate restructuring. Given that implementation of IFRS is a cost-intensive initiative requiring training of employees and top management, an overhaul of accounting systems, recruitment of consultants for impact assessment, and so on, it may become unviable for SOEs to pursue this transition even though the comparative benefits may outweigh the initial costs in the long run.
- **Fair value measurement:** IFRS uses fair value as a measurement base for valuing most of the items of financial statements. The use of fair value accounting can bring a lot of volatility and subjectivity to the financial statements of the SOE. Therefore, this amounts to a fundamental change in the accounting methodology of the SOE.
- **Interface with government standards for consolidation:** In line with international practices, national governments follow the International Public Sector Accounting Standards (IPSAS) for accounting purposes. As government-owned entities, the financial statements of SOEs also need to be consolidated. Since the SOEs are required to follow IFRS for the preparation of financial statements, consolidation with government accounts may pose challenges and become a cumbersome procedure. However, the International Public Sector Accounting Standards Board (IPSASB) has compiled a document with questions and answers related to the compatibility for consolidation purposes of IPSAS and commercial public sector entities.

Topic three: Financial reporting of SOEs, key users and their need for information

The components to a set of financial statements required by law normally comprise

- Income statement
- Balance sheet
- Cash flow statement
- Statement of changes in equity
- Notes to the accounts

Methods of disclosing information

Channels for the dissemination of information can be as important as the information's content itself but filing and accessing that information can be cumbersome and costly. Filing of statutory reports has been greatly enhanced in some countries by electronic filing and data retrieval systems. Some countries are now moving to the next stage by integrating different sources of company information, including shareowner filings, using XBRL which stands for e**X**tensible **B**usiness **R**eporting **L**anguage.

Annual Report – The annual report is a legal requirement, but it should also be seen as a useful tool for informing the company's shareowners of a company's accomplishments and attracting potential investors. These reports include the Management Discussion and Analysis (MD&A), stock price history, and financial data (for example, revenues, expenses, earnings, margins, and a balance sheet). The report should present a balanced fair view that not only focuses on success but also explains any setback. The manner, in which a company's information is presented, how that information is grouped, and the key elements of the document's layout and structure, can all have a significant impact on readers. Defining both the target audience and their expectations for disclosure are important. Moreover, the report and accounts should do more than simply reciting the company's recent financial achievements; they should reflect the dynamics of the company's current and future development.

Regulatory filings – Every country has its own regulations concerning the filing of the annual report and other corporate documents. In many cases, boards delegate to the company secretary the administrative duty of supplying the appropriate information to the regulatory bodies. All directors are recommended to ensure that this activity is being undertaken in a professional and timely manner because they can be held individually responsible if the documents are incorrectly filed.

The disclosure of price-sensitive information – Listed SOEs have a general obligation to give sufficient and timely information to the market of any news that may move the SOE's share price. Examples of news items include acquisitions and disposals, interim and preliminary results, forthcoming and recommended dividends, board appointments and departures, details of share dealings by directors or substantial shareowners, profit warning, rights issues, and other offers of securities. A prudent board should have a policy on information dissemination to ensure that price-sensitive information is either made public in a timely and appropriate way or is kept strictly confidential.

Electronic communications – Most private companies have initiated the use of electronic mediums for the dissemination of information and SOEs should not be an exception to this. In fact, in some countries, it is mandated to host company financial and nonfinancial information on their website. The Institute of Chartered Secretaries in the United Kingdom has produced detailed guidance on such issues as

- Offering the facility to shareowners and maintaining an appropriate register
- What to do if electronic communications fail
- Records necessary to establish proof of sending
- Security, use of a unique identifier, encryption, and so on

- Identification of audited material on a website
- Electronic delivery of a proxy form

Financial report users and their needs

Table 51 identifies potential users of the corporate report and the reasons for their interest in the SOE's financial situation, performance, ownership, and governance.

Table 51: Users of Financial Reporting

Type of user group	Examples of users	Reason for interest in SOE
Government and regulators	Regional, central (federal), local (state)	Owner of the majority stake; ensures that there is no abuse of public interest; delivering public service obligations effectively; interest in the efficient allocation of economic resources, and/or regulating the entity, and/or determining and applying taxation to the entity and/or for preparing national statistics
Financial institutions/ private investors	Pension funds, insurance companies, banks,	Concerning their minority financial stake, ascertain the returns and dividend position
Customers	Organizations or individuals that use the company's products or services	The capacity for the continued supply of goods or services, especially if these customers have a long-term association with or are dependent on the entity. These may also include goods of national importance.
Lenders	Financial institutions	Interested in the amounts, timing, and uncertainty of future cash flows that will give rise to interest, repayment of borrowings, and/or increases in the prices of debt securities. They are interested in the security of their debt.
Suppliers	Organizations or individuals that supply the company with products or services	Interested in the fact that the entity may be able to pay a debt, when it comes due, for goods or services provided to the entity.
Employees	Individuals that supply their labor to the company	Interested in the stability, profitability, and growth of their employer, which gives rise to the continuing ability to pay salaries, wages, and other employment-associated benefits.
Media	Web-based media, social media, newspaper, television, wire, radio, and so on	Newsworthy stories that they can present to their audiences and provide analysis
Stock exchange	Stock exchange regulators, where the SOE is listed	Ensures that there is no abuse of public disclosure, insider dealing, and so on
Pressure groups / lobbyists	NGOs, environmental groups, business associations, trade unions, investors	Ensures that corporate behavior is responsible, guided by shareowners' interests
Public	Researchers, students and the public at large	Determines if taxpayers' money is being appropriately utilized including the assessment of the entity's prosperity, activities and ability to continue participation in the local economy and local activities.

Source: Adapted from IFC 2008.

Topic four: Consequences of inadequate financial information

If adequate financial information is not available, especially to the board and management, to the state, and other minority stakeholders and regulators such as the stock exchange regulator where the SOE is listed, or the company registrar, the consequences are serious and may include the following:

- Delisting or suspension of the listed SOE
- Restatement of inadequate financial statements in case of incorrect information
- Investors seeking the return of their investment or being reluctant to invest in the listed SOE
- Inappropriate board and management decisions
- Legal proceedings against directors, such as for negligence
- Early warning signals for any potential fraud or bankruptcy may be missed



Handout H4.2A: Exercise – Users of financial information, and their needs and interests

Table 52: Users of Financial Information and Their Information Needs

Report users	Information needs	Reason for needs
Government and regulators		
Financial institutions/ private investors		
Customers		
Lenders		
Suppliers		
Employees		
Media		
Stock exchange		
Pressure groups/lobbyists		
Public		

Source: Author's consolidation.



Handout H4.2B: Action ideas

Complete the following three statements:

1. I plan to take the following actions upon my return to my company:

_____

2. Obstacles that may prevent me from implementing these actions are:

_____

3. Actions to overcome anticipated problems are:

_____



Handout H4.2C: Case study on Board Director Demands Greater Transparency through a Disclosure Policy

Learning objective

Explain best practices for transparency and disclosure requirements and why these are the core principles of corporate governance.

Instructions

In this exercise, the trainer will divide participants into two groups to debate the merits of more detailed disclosures and enhanced transparency. One side aligns with the non-executive director **Ivan** and favors greater transparency for related-party transactions and financial statement disclosures. The other aligns with the founders and opposes greater disclosures.

In preparation, please review the case study overview given in the narrative below.

Within your group, prepare five reasons in support or opposition of the board's adoption of disclosure practices. Each group designates one person to present their recommendations. After 10 minutes, your group will join the others for the presentations.

The discussion will focus on the benefits and risks of disclosure and a disclosure policy's components.

Narrative

Company ABC Ltd. discloses little about its finances to the public, since it has few disclosure and transparency obligations. Its home country's securities laws require minimal disclosures for SOEs.

Ivan, the non-executive director, has been working to convince the other board directors to develop more transparent disclosure policies, including mandatory external audits of financial statements. The company engages in many transactions with other SOEs, their directors/KMP and their relatives. **Ivan** wants to disclose these related-party transactions.

Ivan is joined in his demands by **Ceylon** and **Sami**, who are seeking to raise capital by taking the company public. Induced by undue motivation, they want to use the proceeds to develop their own financial services company. They know the company will have to improve their disclosure policies to meet such international guidelines as the OECD *Principles of Corporate Governance*. They want to remove obstacles in taking the company public.

Within the board, there has been skepticism about related-party transactions and the company's financial statements. They question the processes with which related-party transactions are reviewed and decided on. They are also skeptical about the reliability of the company's financial statements.

Questions to focus discussion

- What is transparency? What are the benefits?
- What is meant by timely, accurate disclosures?
- Is disclosure of related-party transactions a good idea? A bad one? Why?
- If the company plans to go public, what disclosure standards must they adhere to? What are the best practices?

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Control environment, transparency, and disclosure

Leadership Training Toolkit for SOEs

Part IV Module 3
Nonfinancial information reporting and disclosure



Photo: ©Nicoel Nino/123rf.com

Module 3: Nonfinancial information reporting and disclosure

This session (module) covers the following topics:

1 Nonfinancial information disclosure



2 Disclosure provisions under global guidelines



3 Sustainability reporting

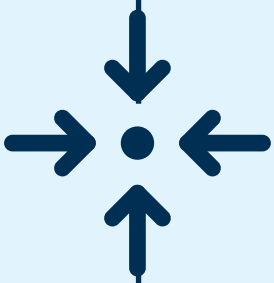


4 Narrative reporting and methods of communication



Learning objectives

By the end of this module, the participants will be able to



- **Discuss the benefits of providing timely and accurate disclosures**
- **Explain SOE nonfinancial information that should be disclosed**
- **Understand the importance of effective narrative reporting practices**

Agenda

Total time: 1 hour 45 min

Time	Topic
15 min	Nonfinancial information disclosure
30 min	Disclosure provisions under global guidelines
30 min	Sustainability reporting
30 min	Narrative reporting and methods of communication

Topic one: Nonfinancial information disclosure

Transparency and disclosure are vital to holding SOEs accountable for their performance. An effective reporting regime requires SOEs to increase the effectiveness of nonfinancial reporting and to disclose both financial and nonfinancial information publicly. A sound control environment captures and transmits relevant information in a timely and reliable manner and protects the integrity and efficiency of the SOE's governance and operations, while a qualified independent external audit is one of the major ways to increase the reliability and credibility of SOE reporting.

Nonfinancial disclosure refers to qualitative information that SOEs release about their operations. Two broad categories of nonfinancial information are often disclosed:

- Information about an SOE's structure and governance and
- Information on its operational performance.

The first category consists of matters such as the ownership and voting structure of the SOE and the remuneration of key executives. The second category includes matters such as quality-of-service measures and safety performance. Notwithstanding their qualitative nature, nonfinancial disclosures can be mandatory (for instance, as part of annual reporting requirements), but generally, these more expansive public disclosures are part of a voluntary or shareholder-led regime for greater transparency. Box 57 below outlines the European Commission's (EC) guidelines on nonfinancial reporting.

Box 57: European Commission's Guidelines on Nonfinancial Reporting

Directive 2014/95/EU of the European Parliament and of the Council on disclosure of nonfinancial and diversity information by certain large undertakings and groups ('the Directive') entered into force on December 6, 2014. The disclosure requirements for nonfinancial information apply to certain large companies with more than 500 employees.

EU Principles of Nonfinancial Reporting with examples:

- **Disclose material information** – A company having impacts on land use and ecosystem change (for example deforestation), directly or through its supply chain, may consider appropriate disclosures on the due diligence applied. A company which is involved in the supply chains of minerals from conflict-affected and high-risk areas may consider appropriate disclosures on the due diligence applied to ensure that it respects human rights and does not contribute to conflict.
- **Fair, balanced and understandable** – A company disclosing certain KPIs may increase transparency by providing information on purpose and link to the company strategy; definitions and methodology; sources of information, assumptions and limitations; scope of the activities concerned; benchmarks; targets; trends; changes in methodologies (if any); and qualitative explanations of past and expected performance.
- **Comprehensive but concise** – A company may summarize information, focus on material information, remove generic information, limit details, avoid elements that are no longer relevant, use cross-reference and signposting, and so on.
- **Strategic and forward-looking** – A company may disclose relevant information based on the expected impact of science-based climate change scenarios on its strategies and activities. Alternatively, it may disclose targets for reducing the number of occupational accidents or diseases.
- **Stakeholder orientated** – A company may disclose material information on its engagement with stakeholders, and explain how this influences its decisions, performance and the impact of its activities.
- **Consistent and coherent** – A company may identify relationships and linkages between its business model and corruption and bribery aspects.

Source: European Commission. 2017. "Information from European Union Institutions, Bodies, Offices and Agencies" *Official Journal of the European Union.*

Many SOEs have made significant improvements in their nonfinancial reporting. Some countries—such as India and South Africa as well as Chile, the Republic of Korea, Sweden, and other OECD countries—have SOE guidelines or requirements for disclosure that align with those for listed companies. Also, many large SOEs have released information on their own. Despite this, many SOEs may not disclose some key nonfinancial information, such as related-party transactions, the company's non-commercial objectives and policy commitments, ownership and governance structures, and risk exposure and risk management.

- **SOE objectives and social and policy obligations*:*** Non-commercial objectives often form an important part of the rationale for the existence of SOEs. These objectives may be tied to non-commercial obligations and their associated activities that may have large repercussions for an individual SOE's performance and viability and even for the longer-term fiscal position of the government. When SOEs have non-commercial objectives, they should be well defined and explicitly presented to the public, whether in the SOE's articles or statutes, in performance management documents, or elsewhere.
- **Ownership and corporate governance structure*:*** For SOEs wholly owned by the government, ownership structure and rights are not a significant issue. However, for partially privatized SOEs, public disclosure of any residual control rights retained by the government beyond its share ownership is important. Each SOE should issue a public corporate governance statement that sets out its governance structure, including board committees, and relevant policies. This statement can include making such instruments as company articles and bylaws available directly, and also, when required, through the SOE registrar or similar body.

Table 53 (on the next page) provides a list of the most commonly reported environment and social (E&S) metrics.

Box 58: Transparency and Disclosure in Korea – Recent updates

In Korea, as part of efforts to address the gender pay gap in the SOE sector, a change was made by an amendment to the 'Act on the Management of Public Institutions' on December 31, 2018, to require all SOEs and public institutions to disclose status of the wage difference between male and female executives/employees. With respect to board qualifications and selection processes, a new clause was added to the Act in 2016 to make meeting minutes of the Committee for recommending SOE CEOs publicly available for inspection by the public unless the case is judged to be exceptional. Also, the Committee is mandated to disclose eligibility criteria for CEOs taking into account specialties and requirements of the corresponding corporation or institution. Another Article was newly added to the Act in 2018 to require the Minister of Economy and Finance or the minister of the competent agency to subject an executive of an SOE to an aggravated punishment and public scrutiny through resolution if she/he is found guilty in connection with employment fraud or employment irregularities.

Source: OECD. 2020. *Implementing the OECD Guidelines on Corporate Governance of State-Owned Enterprises: Review of Recent Developments.* OECD Publishing, Paris. https://doi.org/10.1787/4caa0c3b-en

Table 53: Most Commonly Reported E&S Metrics

Topics	Sub-topics	Illustrative examples
Environment		
Resource Efficiency	GHG emissions	GHG emissions: Scope 1 and two (t), Scope three if relevant, intensity (GHG emissions/production of sales)
	Water use	Water used (m^3), percent recycled, percent in water stress areas, intensity (water use/sales)
	Energy efficiency and mix	Energy consumed (GW), percent grid electricity, percent renewables, intensity (energy/sales)
Pollution Prevention	Waste (water, solid, hazardous)	Waste from operations (t), percent hazardous, percent recycled, intensity (waste/sales)
	Air pollutants	Air pollutants (Tn): NOx (excl. N_2O), SOx, volatile organic compounds, particulate matter
	Pollution risks	Legal actions, community grievances, or public controversies involving past or ongoing pollution risks (for example, air or water emissions, soil or groundwater contamination, waste disposal) from the company/project. Describe corrective actions.
	Spills	Number and volume of significant spills
Biodiversity Conservation	Protection of habitat and biodiversity management	Statement, code, or policy on biodiversity management (y/n)
	Impact on endangered, vulnerable, or rare species	Company/project located in or near an area known to contain endangered, vulnerable, or rare species (y/n). Provide description and link
Climate Adaptation	Prevent or adapt to climate change	Steps to prevent and (if not preventable) adapt to the impact of climate change on the company's ability to operate profitably or the quality of its products and services
Labor and working conditions		
Workers Treatment	Forced and child labor in the company	Legal actions, employee grievances, or public controversies involving forced and child labor in the company's operations (#). Describe corrective actions.
	Wages	Average hourly wage and % of employees earning minimum wage
	Training	Hours of training per year per employee, broken down by gender
	Temporary workers	Temporary worker rate
Workers Relations	Collective bargaining agreements	% of the active workforce covered under collective bargaining agreements
	Turnover	Voluntary and involuntary employee turnover rate by major employee category
	Worker feedback and recourse	Worker grievance mechanism (y/n)
Diversity	Workforce composition	Workforce composition by gender and ethnicity
	Opportunities and fairness for all workers	Legal actions, employee grievances, or public controversies involving discrimination or equal remuneration. Describe corrective actions
	Gender pay ratio	Women/men pay ratio
Health and safety	Injury and fatality	Injury rate (Total Recordable incident Rate) and the fatality rate for direct and contract employees
	Lost Time Incident Rate	Lost Time Incident Rate for direct and contract workers (per 200,000 hours worked or per 100 full-time equivalent employees

Community		
Community	Human rights due diligence and management	Management of human rights in the value chain (codes, policies, prevention, and treatment)
	Security force impact on a community	Statement, policy, or code on security forces and interaction with the local community (y/n)
	Operations near indigenous people	Company/project in an area that indigenous peoples may live on, migrate through, or use (y/n)
	Human rights violations	Involvement in human rights violation
	Impact on indigenous peoples	Company/project in an area that indigenous peoples may live on, migrate through, or use (y/n)
Products		
Products	Impact consideration in product design	Integration of environmental and social consideration in products and services
	Energy/GHG intensity of products	Energy/fuel/GHGs efficiency of products during use-phase
	Data privacy policies	Policies and practices on the collection, use, and retention of customer information
	Packaging	Packaging weight (Tn), % from recycled or renewable materials, % recyclable or compostable
	Recalls	Product recalls: # of recalls, total units recalled
	Materials and chemicals of concern	The process to identify and manage emerging materials and chemicals of concern in products
	Incidents	Product safety fines and settlements (US$)
Ethics and government relations		
Ethics	Anticorruption	Management of anti-corruption in the value chain (codes, policies, prevention, and treatment); Fines and settlements for corruption or bribery (US$), description of major fines and corrective actions
	Political spending	Political spending, lobbying expenditures (including trade associations) (US$)
	Competitive behavior	Amount of legal and regulatory fines and settlements associated with anticompetitive practices
Sourcing		
Sourcing	Suppliers	Percent of suppliers selected and monitored according to social and environmental criteria
	Raw materials (recycled/renewables)	Percent of raw materials from 1) recycled content and 2) renewable resources
	Conflict minerals	Percent of tungsten, tin, tantalum, and gold smelters within the supply chain that are verified conflict-free
	Critical materials	Critical materials: % of materials cost

Source: Adapted from IFC 2019.

Topic two: Disclosure provisions under global guidelines

IFC's comprehensive and integrated approach to corporate reporting

IFC promotes a comprehensive and integrated approach to corporate reporting—one that supports the analysis of modern drivers of corporate value that is not always captured in typical annual reports. This approach presents strategic and corporate governance information together with financial results— providing investors with a better understanding of how the company is likely to perform in the future. It also calls for disclosure of the impact that environmental and social issues may have on the company's strategy, risk prole, and performance, and how key opportunities and risks are managed as part of the company's corporate governance. **IFC advocates for sustainability integrated into strategic, governance, and performance reporting as follows:**

- **Sustainability strategy.** In the strategy section of the annual report, companies should present an overview of key sustainability issues and their method for selecting those issues.
- **Sustainability governance.** Management and governance processes related to sustainability issues—whether considered strategic objectives or risks—should be disclosed in the governance section.
- **Sustainability performance.** In the performance section of the annual report, companies should report on their performance in managing the sustainability issues they have identified as material. This includes a discussion of performance and KPIs in the performance report as well as the disclosure of quantitative, comparable, and consistent sustainability metrics in the sustainability statements.

Table 54: IFC's Suggested Structure of Annual Report

Model Structure of Annual Report
Strategy
• Business Model and Environment
• Strategic Objectives
• Risk Analysis and Response
• Sustainability Opportunities and Risks
• Introducing Key Performance Indicators
Corporate Governance
• Leadership and Culture: Commitment to ESG
• Structure and Functioning of the Board of Directors
• Control Environment
• Treatment of Minority Shareholders
• Governance of Stakeholder Engagement
Financial Position and Performance
• Performance Report
• Financial Statements
• Sustainability Statements

Source: Adapted from IFC 2019.

This approach is in line with a recent international trend toward integrated reporting, which expands the scope of traditional financial reports and integrates nonfinancial information about such intangible factors as ESG considerations. Appendix A4.3A lists down a set of questions that the board of directors should ask when exercising oversight of the company's management and disclosure of ESG matters.

OECD guidelines on disclosure

High-quality international standards for most areas of transparency and disclosure have been adopted by many countries. Countries may choose to apply their tailor-made standards, which in principle, better reflect local needs than international standards do. However, significant costs can be associated with drawing up national standards, updating

them in response to changes in the business environment, and educating those responsible for implementing and using them. Adopting international standards avoids having to reinvent the wheel and reduces or avoids many of those costs entirely. It also prevents lack of local capacity from leading to lower-quality national standards.

The OECD guidelines on disclosure: The corporate governance framework should stipulate timely and accurate disclosure on all material matters, including the company's financial situation, performance, ownership, and governance. Disclosure should include, but not be limited to, material information on the following:

- SOE objectives
- Major share ownership and voting rights
- Remuneration policy for members of the board and key executives and information about board members, including their qualifications, the selection process, other company directorships, and whether the board regards them as independent
- Related-party transactions
- Foreseeable risk factors and measures are taken to manage them
- Issues regarding employees and other stakeholders
- Governance structures and policies, in particular, the content of any corporate governance code or policy and the process, by which it is implemented

SOEs should disclose material information on all matters described in the OECD's Principles of Corporate Governance, focusing on the areas of significant concern for the state as owner and the general public, namely,

- A clear statement to the public of the company's objectives and their fulfillment
- The ownership and voting structure of the company
- Any material risk factor and measure are taken to manage such risks
- Any financial assistance, including guarantees, received from the state and commitments made on behalf of the SOE
- Any material transaction with related entities

OECD guidelines on disclosure in public procurement

Public procurement has been increasingly used as a policy lever to further government action in many policy areas, ranging from protection of minorities, promoting small and medium enterprises (SMEs), privileging national production, to fostering responsible business conduct (RBC). Recognizing this role, the OECD Recommendation on Public Procurement calls on countries to ensure the strategic and holistic use of public procurement. Of all government activities, public procurement is also one of the most vulnerable to fraud and corruption. Bribery by international firms in OECD countries is more frequent in public procurement than in utilities, taxation, and judicial system, according to a survey of the World Economic Forum.

Weak governance in public procurement hinders market competition and raises the price paid by the administration for goods and services, directly affecting public expenditures, and therefore, taxpayers' resources.

Box 59: Bringing Information to Citizens in India
The Right to Information Act, 2005

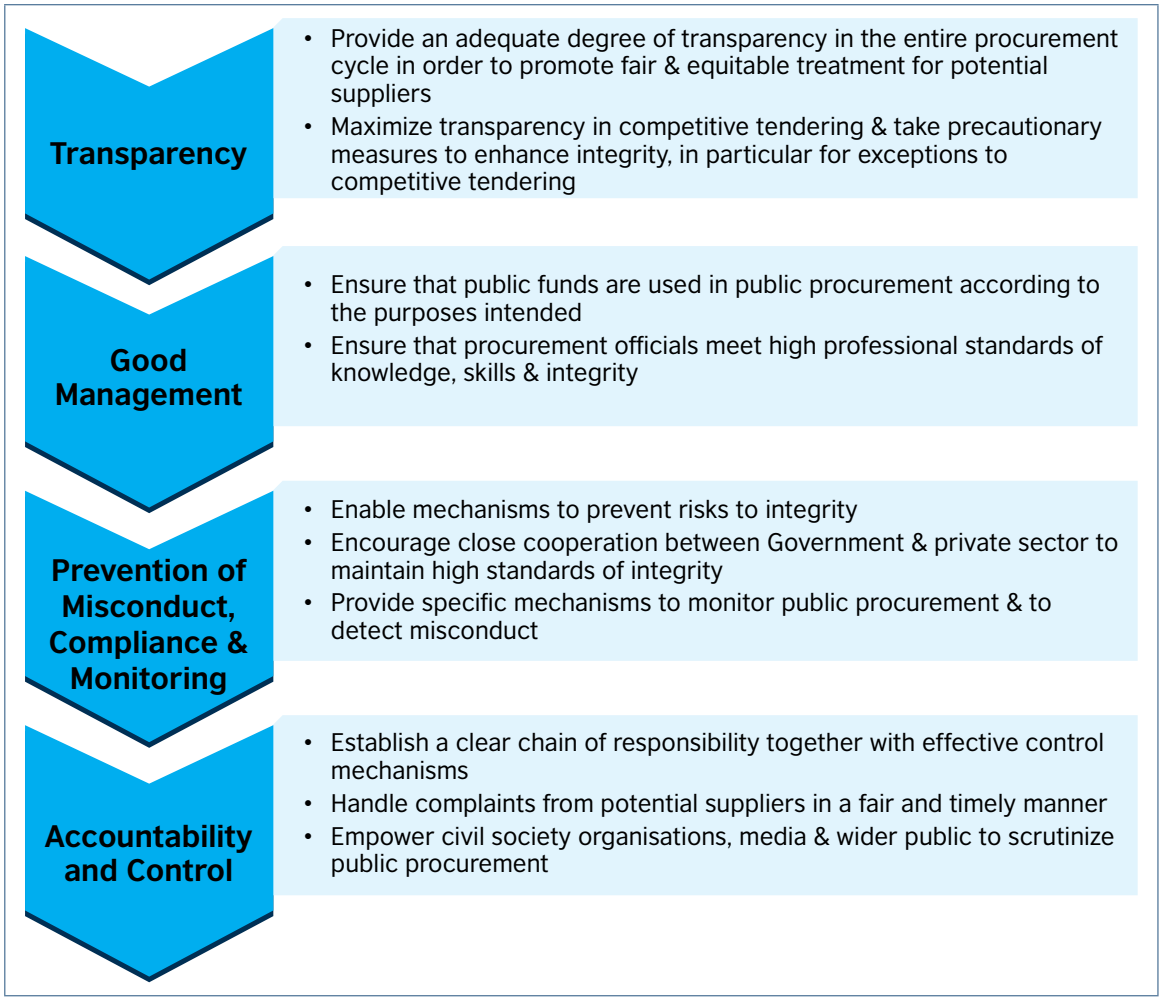
The basic object of the Right to Information Act is to empower the citizens, promote transparency and accountability in the working of the government, eradicate corruption, and ensure that the democracy works for the people in the real sense. It goes without saying that an informed citizen is better equipped to keep necessary vigil on the instruments of governance and make the government more accountable to the governed. The Act is a big step toward making the citizens informed about the activities of the government, including the SOEs.

Source: Right to Information. 2015. *An Initiative of Department of Personnel and Training, Government of India.*

The following principles have been developed by the OECD to ensure adequate disclosure in the public procurement process for SOEs.

SOEs must adhere to the principles illustrated in ensuring effective disclosure of nonfinancial information in the public procurement field.

Figure 47: OECD Principles for Disclosure on Public Procurement



Source: Adapted from OECD 2009.

Topic three: Sustainability reporting

In many markets, both in developed and developing countries, there is a growing call for increased transparency and accountability of organizations. Potential health and environmental risks posed by companies and the goods and services they produce are increasing pressure on them to generate, assess, and make information publicly available on their sustainability performance and impacts. In this sense, sustainability reporting represents a potential mechanism to generate data and measure progress and the contribution of SOEs toward global sustainable development objectives, as it can help companies and organizations measure their performance in all dimensions of sustainable development, set goals, and support the transition toward a low-carbon, resource-efficient, and inclusive green economy.

A sustainability report is a report published by an SOE about the economic, environmental, and social impacts caused by its everyday activities. A sustainability report also presents the SOE's values and governance model and demonstrates the link between its strategy and its commitment to a sustainable global economy.

Sustainability reporting can help organizations to measure, understand and communicate their economic, environmental, social, and governance performance, and then set goals, and manage change more effectively. A sustainability report is a key platform for communicating sustainability performance and impacts—whether positive or negative.

It can be considered as synonymous with other terms for nonfinancial reporting; triple bottom line reporting, corporate social responsibility (CSR) reporting, and more (refer Box 60 for example).

Importance of sustainability reporting

While sustainability reporting remains a voluntary practice, it holds several key benefits. In devising competitiveness for SOEs compared to their private sector counterparts, it is worth taking note of the value of sustainability reporting. The benefits of the exercise include

- Better reputation
- Meeting employee expectations more effectively
- Improved access to capital

Box 60: Contents of Sustainability Report of India's Largest State-Owned Natural Gas Processing and Distribution Company – GAIL Limited

1. Chairman and Managing Director's Message
2. Snapshot of the report
3. GAIL's story
4. Corporate governance
5. Risk Management
6. Sustainability at GAIL
7. Stakeholder engagement and materiality
8. Business growth
9. Operational excellence
10. Energy and environment
11. Health and safety
12. Public policy and advocacy
13. Human capital at core
14. Our corporate social responsibility
15. Customers
16. Suppliers
17. Performance snapshot
18. GRI content index
19. Linkages with NVG SEE principles
20. Linkages to American Petroleum Institute (API)/IPIECA, UNGC, ISO 26000 principles

Source: Gail India Limited. 2017. *Sustainability Report 2017–2018.*

- Increased efficiency and waste reduction
- Improved stakeholder relationships
- Improved risk management
- Improved investor relationships
- Ease in identifying new business areas to expand SOE scope

The following box (Box 61) outlines the difference between Sustainability and Corporate Social Responsibility (CSR).

Challenges to implementation

Developing countries are on a fast track to unprecedented economic growth in recent years, resulting in a growing demand for natural resources and has affected the environment as well. It has become impossible to have business success and economic growth without environmental sustainability. This is a major challenge for such fast-growing, emerging economies. At the Rio+20 conference too, this concept was given high priority.

Sustainability reporting demands a lot of organizational effort to gather and monitor data. This can make it a challenging, time-consuming and costly exercise. Another challenge is the need for independent verification and assurance of reports to provide comfort to stakeholders, management, and the board in mitigating the risks posed by sustainability issues. Only a fraction of the reports are independently assured; however, just like reporting itself, the trend is positive and gives rise to optimism.

To address these challenges, several providers of sustainability reporting have published guidelines. Any of these can be treated as a starting point to streamline activities toward comprehensive sustainability reporting. Table 55 presents their applicability and relative strength and weaknesses.

Box 61: Difference between Sustainability and Corporate Social Responsibility (CSR)

Sustainability is a term that is often synonymously used with corporate social responsibility and shared value. However, business sustainability is not related to CSR, rather, it is related to time.

The World Commission on Environment and Development defined sustainable development as development that "meets the needs of the present without compromising the ability of future generations to meet their own needs." Therefore, sustainability balances resource usage and supplies over time, thereby assuring intergenerational equity. For example, Norwegian Sovereign Wealth Fund, which puts aside royalties from natural resources for future generations and deploys the interest to meet current needs.

CSR, on the contrary, focuses on balancing current stakeholder interests. A socially responsible oil company would build local schools and hospitals to compensate communities for their resource extraction. However, such measures do not always acknowledge the long-term impact on the communities. Charitable donations that relieve social problems are responsible, but they are not sustainable if they do not resolve underlying issues.

By focusing on the 'sustaining' part of sustainability, businesses can build long-term relationships, innovate enduring designs and invest in long-lasting infrastructure. Not only will this help firms survive over the long term, it will help them thrive.

Source: Tima, Bansal and DesJardine, Mark. 2015. "Don't Confuse Sustainability with CSR." *IVY Business Journal.*

Table 55: Major Frameworks for Sustainability Management and Disclosure

Guidelines/ Framework	Objective	Strengths	Limitations	Best Use
Global Reporting Initiative (GRI)	To improve the sustainability of the organizations and support sustainable development. Guidelines are developed using a multi-stakeholder approach	Specific indicators for all companies. Sector-specific indicators for some industries	Used for stand-alone sustainability reports; more detailed information is not always relevant for strategic management and investment	Communicating a broad range of sustainability/ nonfinancial management practices to many different types of stakeholders; topics relevant for emerging markets; comprehensiveness limits smaller companies
Integrated Reporting	To increase long-term, integrated thinking within companies, and improve the allocation of financial capital; investor prioritized	Can help drive internal change, embedding environmental and social considerations in core operations	The principle-based framework does not offer specific KPIs for measuring and reporting performance	Reporting on value creation processes and explaining how sustainability issues are managed strategically. Approach relevant for emerging markets; sophistication limits smaller companies
European Commission	Large public interest entities (> 500 employees) should disclose policies, risks, and outcomes relating to environmental, social, and employee matters, human rights and anticorruption, and diversity in the board of directors	Mandatory reporting (or explain) with the flexibility to choose among the most widely used reporting frameworks	Limited to companies based or operating in the EU	Reporters with significant operations or markets in the EU
Sustainable Stock Exchange Initiative	Enhancing corporate transparency— and ultimately performance—on ESG issues, and encourage sustainable investment	Designed for both emerging and developed markets. Although designed for public companies, guidance can be used by private counterparts	Guidance geared primarily to stock exchanges in their efforts to issue reporting guidance to their members (indirect).	Topics and flexible framework relevant for emerging markets.
Sustainability Accounting Standards Board (SASB)	To democratize the availability of decision-useful sustainability information; the primary audience is investors.	Specific for each sector and subsector; fully embedded within financial reporting	For the US listed companies; integrating sustainability information and financial regulatory filings; not a user-friendly format	Explaining sustainability management and performance to investors; focus limited to the listed US companies.
UN Guiding Principles Reporting Framework	Improve transparency of human rights performance and adoption of the UN Guiding Principles on Business and Human Rights.	Focused on governance and management of salient human rights issues. Can be used with other guidelines or frameworks	Very process oriented; indicators are qualitative	Detailed communication regarding human rights management, adoption of UN Guiding Principles on Business and Human Rights ('Ruggie Framework'); topic relevant for emerging markets; sophistication limits smaller companies.

Carbon Disclosure Project (CDP)	CDP requests standardized climate change, water, and forest information through annual questionnaires sent on behalf of institutional investors	Provides comparable and aggregate information on key climate-related measures of corporate performance.	Stand-alone disclosure not integrated into annual reports; sophistication and comprehensiveness limits application to very large companies	Specialized disclosure to investors; industries with significant climate change impacts and/or those with the regulatory requirement to report on climate change. Focused on large listed companies
Climate Disclosure Standards Board	Providing information for investors on how climate change affects strategy, performance, and future prospects; intended for use with financial reporting	Harmonizes climate related disclosures and supplements financial statements, placing climate information in context for investors	Format may not be user-friendly for stakeholders other than investors	Integrated reporting; industries with significant climate change impacts and/or those with the regulatory requirement to report on climate change; focused on large listed companies
Task Force on Climate-related Financial Disclosures (TCFD)	Developing voluntary, consistent climate-related financial risk disclosures for use by companies in providing information to stakeholders	Comprehensive and integrated disclosure of climate risks, including governance, strategy, risk, and performance; includes scenario planning and industry-specific metrics	Sophistication and comprehensiveness limit application to very large companies	Integrated reporting; industries with significant climate change impacts and/or those with the regulatory requirement to report on climate change; focused on large listed companies

Source: Adapted from IFC 2018.

Topic four: Narrative reporting and methods of communication

'Narrative reporting' describes the nonfinancial information included in annual reports to provide a broad and meaningful picture of the SOE's business, its market position, strategy, performance, and prospects. This includes the strategic report, the directors' report, the chairman's statement, the directors' remuneration report, and corporate governance disclosures.

Narrative reporting offers a mechanism to support the creation of a more commercially attractive and differentiated picture of the business, which can lead to better investor understanding and improved stakeholder relationships. Furthermore, the underlying process necessary to produce this information can also enhance board effectiveness and improve governance.

Method of communication: Management commentary

In the private sector, it is now good international practice for companies to prepare an annual management commentary and a narrative report that provides context and explanation to the annual financial statements and focuses on forward-looking information.

A few OECD countries have adopted this practice for SOEs (refer Box 62).

Box 62: Country Case Study: Sweden's Narrative Reporting Practice

In Sweden, SOEs are required to issue detailed quarterly reports, including financial statements and a management discussion on operations and risks. In addition, some Swedish SOEs have organized 'capital market days', when external financial analysts and financial journalists can probe further.

Source: World Bank Group. 2014. *Corporate Governance of State-Owned Enterprises: A Toolkit.* Washington, DC: World Bank.

The IASB recently issued a practice statement on the management commentary.[17] The Management Commentary Practice Statement (MCPS) provides a broad, non-binding framework for the presentation of management commentary that relates to financial statements prepared, applying IFRS Standards. The MCPS focuses on what is relevant to the unique circumstances of the business. It does not prescribe detailed industry- or issue-specific disclosures.

Contents of management commentary: Figure 48 (on the next page) details the contents of a management commentary for an SOE. Based on a well-drafted management commentary, users can make better capital allocation decisions.

Narrative reporting illustration

An explanation of how the business generates value and the factors expected to materially affect this in the short and longer term in Table 56.

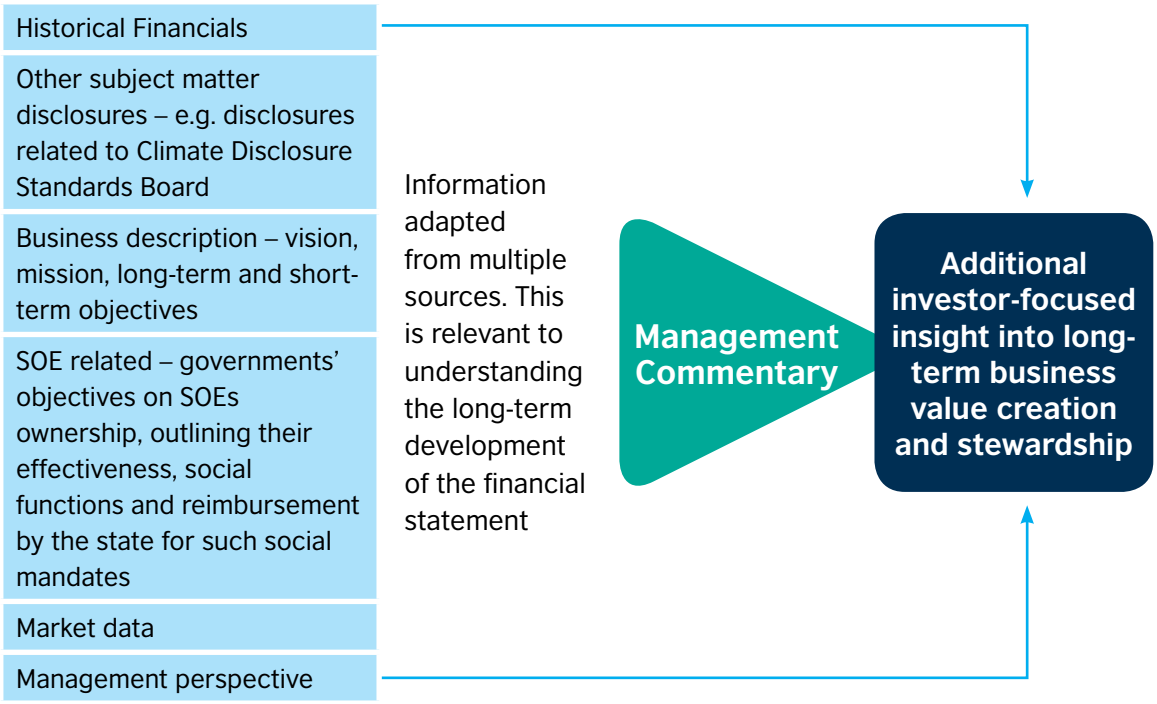
Table 56: Illustration on Narrative Reporting 1

Business model, risk, strategy, and operating environment Qualitative and quantitative information on • The operational position of the business • The factors affecting its future development	*Illustrations:* • '80% of our sales derive from existing relationships with lead contractors…' • '…to build on this, we plan to sell red widgets to all our blue widget customers' • 'Our competitive strength is in engineers' know-how. Their retention is a priority'

Source: Adapted from The International Financial Reporting Standards Foundation 2018.

Table 57 (on the next page) presents an illustration of interpretation and analysis of historical financial information.

Figure 48: Contents of Management Commentary



Source: Adapted from The International Financial Reporting Standards Foundation 2018.

Table 57: Illustration on Narrative Reporting 2

Current year financial analysis • Explanation of current year financial performance and position • Additional/non-GAAP financial analysis	*Illustrations:* • 'Total Capex includes US$ m to enhance existing stores' • 'Organic earnings growth was % after allowing for….' • 'Gross margin fell due to operational issues at….'

Source: Adapted from The International Financial Reporting Standards Foundation 2018.

Historical nonfinancial information relevant to an understanding of future financial performance and position in both the short and longer term:

Table 58: Illustration on Narrative Reporting 3

Nonfinancial information Pre-financial information and explanations that provide insight into: • Business progress • Implications for future financial performance Covers resources and relationships key to value creation	Illustrations: • Shorter-term: – Sales order-book; Headcount reductions • Longer term: – Customer wins and retention; Store upgrade progress; Product quality measures; R&D staff retention

Source: Adapted from The International Financial Reporting Standards Foundation 2018.

Management's view of future outcomes including the factors expected to drive them:

Table 59: Illustration on Narrative Reporting 4

Forward-looking statements Explaining statements of forecast and target financial and nonfinancial expectations	Illustrations: • Shorter term: Forecast sales growth % • Longer term: 'targets 20% penetration of the red widget market by 2020'; 'targeting a 50% reduction in carbon emissions to meet potential regulatory change'

Source: Adapted from The International Financial Reporting Standards Foundation 2018.

Narrative reporting risks

SOEs already provides a plethora of financial information in their annual report and other communications medium and support this information with varying degrees of detail around narrative and contextual information such as market dynamics, strategy, and CSR. Furthermore, by encouraging SOEs to provide information routinely used to manage their business, the guidance and legislation imply that the information should already be available. These demands raise many risks for companies.

Information gaps may be identified too late: Consideration of content at the last minute in the reporting process may highlight information gaps, which cannot be addressed in the time available. Even if the content of an SOE's communication is comprehensive, it may have the effect of highlighting strategic and operational weaknesses in its business that could have been identified, and actions could have been taken to address them earlier in the process.

Competitors may receive a first-mover advantage: The communication of narrative and contextual information will open new areas of corporate reputation to scrutiny and debate. Failure to paint a convincing picture on this broad canvas will expose companies to unjustified comparisons and difficult questions from investors and other groups who monitor business performance on behalf of society. If competitors, particularly from the private sector, gain a first-mover advantage, they will be able to help shape the information demanded by these investors and other groups. SOEs will then be encouraged, if not forced, to provide similar information, regardless of whether it is appropriate to their business model.

Failure to convey the right messages: By paying mere lip service to these demands, SOEs may approach the communication of narrative and contextual information with a tick-box mentality, simply bolting on additional content without taking a step back and considering the messages conveyed. This can often result in missing information, mixed messages, and a consequent misunderstanding by investors of what is important to the strategic success or critical information becoming lost in the detail.

Benefits of narrative reporting

Despite the risks detailed afore, narrative reporting as a task when done consciously yields significant benefits to organizations. These are particularly relevant in elevating the capacities and governance practices among SOEs.

Enhanced business understanding, improved governance, and board effectiveness: The process of responding to information demands can provide an opportunity for the boards to question the depth and breadth of information they use, and as a result, assess whether the limited time available in board meetings is being focused on the right issues. For example, Review if the board routinely receives lead performance indicators that go beyond traditional financial numbers and whether the time is devoted to strategy and activities critical to value creation. Over time, the challenge of responding to these demands will provide the boards with a more comprehensive picture of the corporate performance of the SOE, one with new insights into the health and sustainability of the business.

Enhanced investor understanding and improved relationships with key stakeholders: An SOE with effective narrative reporting will give investors and other stakeholders deeper and clearer insights into what drives value in its business, and clearly demonstrate why its chosen strategy is the right one to take the business forward.

Aligned reporting and communication strategy: Corporate reporting is going through a period of unprecedented change. As reported earnings become more volatile, corporate governance guidelines become more extensive, and socially responsible investment indices become more challenging, the discipline of reporting narrative and contextual information consistently offers companies a framework for providing insights into their underlying performance over time and across mediums. Internally, the challenge of collating a coherent set of narrative and contextual information provides companies with an opportunity to reassess the practical aspects of how information is channeled into the outside world both in terms of the messages being given, and also the costs incurred by various groups (from corporate communications, investor relations, environmental and social reporting, employee communications, and so on).

Steps to effective narrative reporting and communication

Set out below are 10 key steps that SOEs may practically undertake to successfully respond to these demands while avoiding the pitfalls:

Adopt the right mindset: The first step lies in adopting a 'communication mindset'—one that is quite distinct from the compliance-based approach usually taken with traditional financial reporting. The communication mindset has three major components. It involves seeking out, ensuring that there is enough comfort over the reliability of, and reporting information that is

- Seen through the eyes of the board of directors;
- Focused on matters that are important for investors; and
- Forward-looking in its implications for the business.

This approach, when applied consistently across all the areas of the business, will enable SOEs to produce an annual report, which fulfils the demand for narrative reporting. SOEs will also need to consider the degree to which they respond to these demands. Will they be a leader, a follower, or simply take the middle ground? Given the risks and benefits highlighted earlier, this is not a decision that should be taken lightly. The answer will not negate the need to follow the steps set out below, but it will impact the degree to which they are followed.

Obtain board sponsorship and buy-in: Addressing information demands needs to be treated as a project in its own right, with sponsorship from a member of the board and ownership clearly taken by the board or a board sub-committee. Whoever takes responsibility, will need to oversee a planned and transparent process. A first step should be to nominate an individual with the responsibility for understanding the implications of these demands for the annual report's development. This individual should then brief the board on what the implications are for their SOE. It will also be important at this stage to identify the relevant 'information owners', who may be required to contribute to the annual report. Some individuals may not have contributed to it, or worked together, before, some may have alternative agendas. It is, therefore, important that this individual should be of adequate authority to manage the variety of influences and personalities which may exist among the contributors.

Develop a picture of possible content: Having formed a view on the level of ambition, SOEs should consider applying an objective framework, as a basis for developing a broad picture of possible content for the annual report. However, it will need to be tailored to reflect the unique dynamics of SOE's industry and business.

Build a blueprint report: The next step is to calibrate the content by applying a strategy filter to determine what information is critical to assess the existing strategy and the potential for that strategy to succeed. This filtered picture should then act as the blueprint, against which the content of the annual report being developed, should be constantly compared and challenged. The blueprint should not be a static tool, but something that can be flexed to accommodate changes in the companies' circumstances and developments in the availability of internal information.

Benchmark the blueprint: The blueprint should now be compared against the information currently reported externally. In performing such a comparison, companies factor all mediums of communication used to report information internally and externally, including website, corporate responsibility report, investor/analyst briefings, and marketing publications. In building up a comprehensive picture of current reporting, consideration should also be given to assessing where SOEs stand with competitors, industry norms, and good practice and the extent to which they wish to align themselves with these benchmarks.

Identify information gaps: An output from the benchmarking exercise should be an analysis of the gaps between current reporting, competitors, and the broader information set required for the annual report. Some gaps may simply point to information that is available, but not reported. Other gaps may relate to more fundamental issues such as data quality, or where information is simply not produced within the existing systems or consistently across business units. Creating a gap analysis will be very revealing and should provide the basis for developing an implementation plan for both the short and medium term.

Assess the adequacy of supporting systems and procedures: Once the blueprint has been developed, an assessment of the supporting systems and procedures should be undertaken to determine whether they could provide the relevant information and whether it is sufficiently robust to achieve board comfort and publish externally. A useful first step is to start at the top of the organization and consider the scope, and nature, of the information being presented to the board in routine meetings, and the degree of process, control, and assurance applied to it, in its journey up the organization. Where this analysis highlights shortcomings, consideration should be given to the actions that are necessary to remedy the situation, ranging from rethinking the board's agenda, to establishing robust and reliable systems and controls.

Determine the level of accuracy and reliability: SOEs must determine the level of accuracy and reliability they wish to achieve for the information to be included within the annual report. This may vary depending on the strategic importance, nature, or source of the different information provided. When forming a view, SOEs must balance the risk of publishing valuable information, which may be difficult to obtain with complete accuracy, with remaining silent. In reaching a decision, it will also be important to consider the margin of error SOEs are willing to accept and to what extent that might differ depending on the nature of the information reported.

Create cohesion and clarity: Narrative reporting provides a real opportunity for SOEs to consider what impact it will have on the existing structure of the annual report. Further, it helps to know whether the historical format traditionally used allows for the effective communication of the company's strategy, management activity, and performance, and alternatively, whether it simply results in excessive repetition, increased length, and an unclear story.

Develop an implementation plan: Following steps 1 to 9, SOEs will be able to develop a short/medium-term implementation plan to address the gaps identified and deliver on their overall objective for the annual report. For information that is currently unavailable, SOEs need to consider whether to seek to obtain the information and, if so, to provide disclosure of their intent to report on these matters in future reporting cycles. For information that is available, but not sufficiently robust and comparable to publish, SOEs must determine how they obtain the appropriate level of comfort on the reliability of the information. This may range from the development of new internal controls and processes to independent verification.

Appendix A4.3A: Questions the board should ask on ESG management and disclosure

Below is a set of questions that the board of directors should ask when exercising oversight of the company's management and disclosure of ESG matters.

Strategy

- Is there an integrated corporate strategy that includes goals and targets for financial and E&S performance? If not, and there are two separate strategies, how are these strategies linked internally? How is the link explained in corporate reporting?
- What are the key sustainability factors or E&S factors that affect the company strategy regarding risks and opportunities? Which factors affect the company's short-term financial performance? Is there a long-term value-creation process in place?
- Does the company have a documented method for assessing material E&S issues?
- Is the strategy consistent with the information that the company has identified as material—including E&S information? Does the strategy include measurable targets and KPIs? Are sustainability objectives reviewed by the board?
- Is E&S information integrated into the risk management framework? Does it provide insight into emerging risks that may not be captured by traditional areas of risk management (operational, financial, and so on)?

Governance

- Are key areas of corporate governance addressed in the report, including the commitment to corporate governance, culture and leadership, board composition and functioning, compliance, risk appetite, executive compensation, controlling shareholders, and stakeholder engagement?
- How are E&S issues integrated into governance structures and processes, including risk management, control environment, compliance, board composition, disclosures?
- Is there an internal audit function and a process to ensure the accuracy of financial information? Does it include E&S information?

Stakeholder Engagement

- Who are the company's key stakeholders? What is the process to identify them? Does the board recognize its responsibilities to stakeholders beyond shareholders?
- Is there a mechanism for stakeholder engagement and grievance redressal?
- Are the process and results of stakeholder engagement disclosed publicly? Is relevant information disclosed to affected communities in an understandable format and language?

Performance

- How does the company's performance compare with its peers, including on the management of critical ESG issues?
- How does the reported performance compare with the company's internal management dashboard?
- Does the reported ESG information align with material issues and priorities for the company?
- Are the links between ESG and financial performance explained?

Disclosure and Transparency

- Who is the primary audience for reporting? What information do they need? Does company disclosure meet their information needs?
- What framework should be used (and why) to report sustainability information: GRI, IIRC, SASB? Should it be reported together with financial information?

Notes:

17 IFRS Foundation. 2018. *IASB Agenda ref 15A, Management Commentary Practice Statement, Education session.* https://www.ifrs.org/-/media/feature/meetings/2018/march/iasb/ap15a-mc.pdf.

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Control environment, transparency, and disclosure

Leadership Training Toolkit for SOEs

Part IV Module 4
SOE procurement

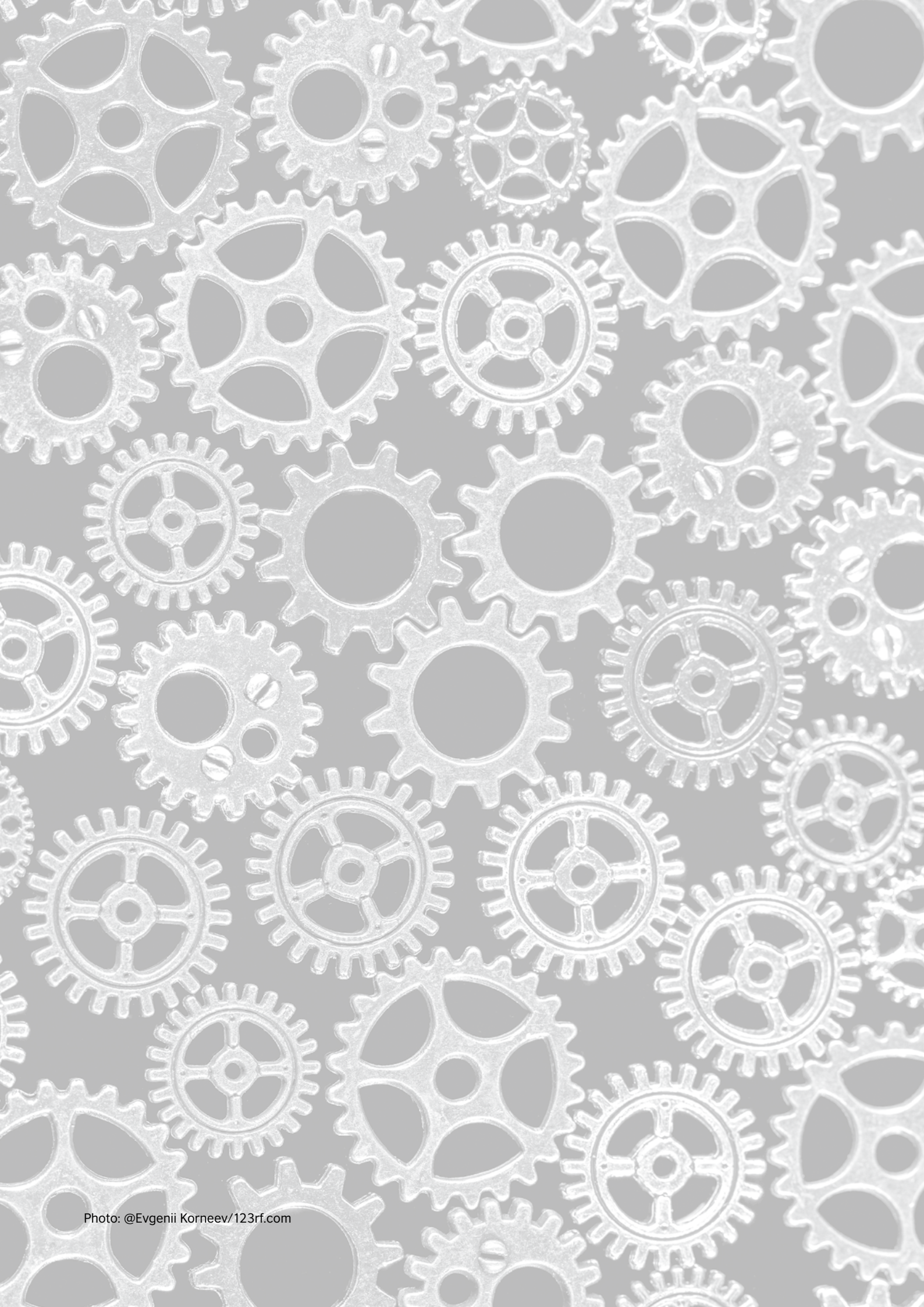


Photo: @Evgenii Korneev/123rf.com

Module 4: SOE procurement

This session (module) covers the following topics:

1 Good procurement principles and standards for SOEs



2 Procurement strategy and plan development



3 Efficient procurement processes and competencies

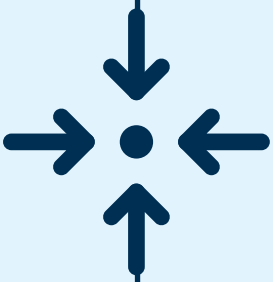


4 Transparency and integrity of SOE procurement



Learning objectives

By the end of this module, the participants will be able to



- **Explain good procurement principles and standards for SOEs**
- **Explain competitive neutrality in SOE procurement**
- **Develop a procurement strategy and plan based on market assessment**
- **Discuss efficient procurement processes and competencies**
- **Understand the concept of transparency and integrity in SOE procurement**

Agenda

Total time: 2 hours

Time	Topic
30 min	Good procurement principles and standards for SOEs
30 min	Developing a procurement strategy and plan based on market assessment
30 min	Efficient procurement processes and competencies
30 min	Transparency and integrity of SOE procurement

Introduction to the module: SOE procurement

As per the annotations to Chapter III: State-Owned Enterprises in the Marketplace in the OECD Guidelines on Corporate Governance of State-Owned Enterprises, the participation of SOEs in public procurement processes has been an area of concern for governments committed to a level playing field. Designing bidding regimes that in principle do not favor any category of a bidder is uncomplicated. Accordingly, this is embedded in the legislation of a growing number of jurisdictions. However, implementation in practice may be more complicated in different countries by whether such rules are limited to procurement by the general government or also extend to procurement by SOEs. When SOEs engage in public procurement, whether as bidder or procurer, the procedures involved should be transparent, competitive, non-discriminatory, and safeguarded by appropriate standards of transparency. Generally, the activities of SOEs can be divided into two parts: activities that are for commercial sale or resale and activities to fulfil a governmental purpose. In cases, where an SOE is fulfilling a governmental purpose, or to the extent that a particular activity allows an SOE to fulfil such a purpose, the SOE should adopt government procurement guidelines that ensure a level playing field for all competitors, state-owned or otherwise. State-owned monopolies should follow the same procurement rules applicable to the general government sector.

WHEN SOEs ENGAGE IN PUBLIC PROCUREMENT, WHETHER AS BIDDER OR PROCURER, THE PROCEDURES INVOLVED SHOULD BE TRANSPARENT, COMPETITIVE, NON-DISCRIMINATORY, AND SAFEGUARDED BY APPROPRIATE STANDARDS OF TRANSPARENCY.

SOEs in many countries are bound by public procurement laws to guard against corruption and misuse of public funds. Such rules can be cumbersome and pose a constraint on the ability of SOEs to operate and invest promptly to meet the competition. Complex, time-consuming procedures that are not commercially oriented can have a significant negative impact, especially when SOEs are purchasing commodities from world markets, where speed and flexibility are paramount. In recognition of these factors, and with increasing competition between SOEs and the private sector, the European Union is drafting new procurement rules for transport, energy, water, and postal sectors, where SOEs are prevalent.

During the preparation of the mentioned toolkit, these rules were not yet finalized. Short of reforming public sector procurement laws more broadly, some countries such as Turkey exempt SOEs from the procurement law for purchases below a certain threshold, although such thresholds are so low that they cover only a fraction of total SOE procurement.

SOE procurement creates scope for corruption when institutions are weak and monitoring lax. Thus, a careful assessment of the procurement regulations and practices of SOEs should be carried out since any inefficiencies will directly affect their governance arrangements and their ability to procure in an efficient, timely, and transparent manner. The weaknesses can then be addressed either through SOE laws, through separate procurement laws for SOEs, or improvements in the existing procurement law.

Topic one: Good procurement principles and standards for SOEs

Introduction

The OECD Recommendation of the Council on Public Procurement states that [18]

"Public procurement is a crucial pillar of strategic governance and services delivery for governments. Because of the sheer volume of spending it represents, well-governed public procurement can and must play a major role in fostering public sector efficiency and establishing citizen's trust. Well-designed public procurement systems also contribute to achieving pressing policy goals such as environmental protection, innovation, job creation and the development of small and medium enterprises."

In 2015, the Council of the OECD adopted a Recommendation on Public Procurement, composed of 12 integrated principles (see below), that ensure the strategic and holistic use of public procurement. It is a reference for modernizing procurement systems and can be applied across all levels of government and SOEs. It addresses the entire procurement cycle while integrating public procurement with other elements of strategic governance such as budgeting, financial management, and additional forms of service delivery (refer Figure 49).

The 12 principles of the OECD recommendation

1. TRANSPARENCY

- Recommendation: An adequate degree of transparency of the public procurement system in all stages of the procurement cycle should be ensured.
- Components: Transparency can be strengthened by following the proposed steps below (steps A to C, aligned with the Recommendation), while also improving other principles that are closely linked to transparency, such as, integrity, access, participation, efficiency, e-procurement, accountability, and integration.

Figure 50 outlines steps to improve transparency.

Figure 50: Steps to Improve Transparency

Step A: Promote fair and equitable treatment for potential suppliers by providing an adequate and timely degree of transparency in each phase of the public procurement cycle
Step B: Allow free access, through an online portal, for all stakeholders, including potential domestic and foreign suppliers, civil society and the general public, to public procurement information
Step C: Ensure visibility of the flow of public funds, from the beginning of the budgeting process throughout the public procurement cycle

Source: Adapted from OECD 2015.

Figure 49: The 12 Principles of the OECD Recommendation



Source: Adapted from OECD 2015.

Box 63 provides a case study on the disclosure of information through the central procurement system in Mexico.

Box 63: Disclosure of Information Through the Central Procurement System CompraNet in Mexico

- Pre-solicitation documents
- Solicitation documents
- Minutes resulting from the clarification meetings
- Electronic submission of bids
- Award decisions and supporting information
- Contract modifications
- Statistics and database related to past procurement
- Payment information Registry of suppliers not allowed to be awarded contracts
- Social witness testimony
- Possibility to file a formal complaint against procurement procedures
- Documentation associated with formal complaints

Source: OECD. 2015. *Compendium of Good Practices for Integrity in Public Procurement.*

2. INTEGRITY

- **Recommendation:** The integrity of the public procurement system through general standards and procurement-specific safeguards should be preserved.
- **Components:** Integrity can be strengthened by following the proposed steps below (steps A to D, aligned with the Recommendation), while also improving other principles that are closely linked to integrity, such as, transparency, access, balance, participation, efficiency, e-procurement, capacity, risk management, accountability, and integration.

Figure 51 outlines steps to improve integrity in the procurement process.

3. ACCESS

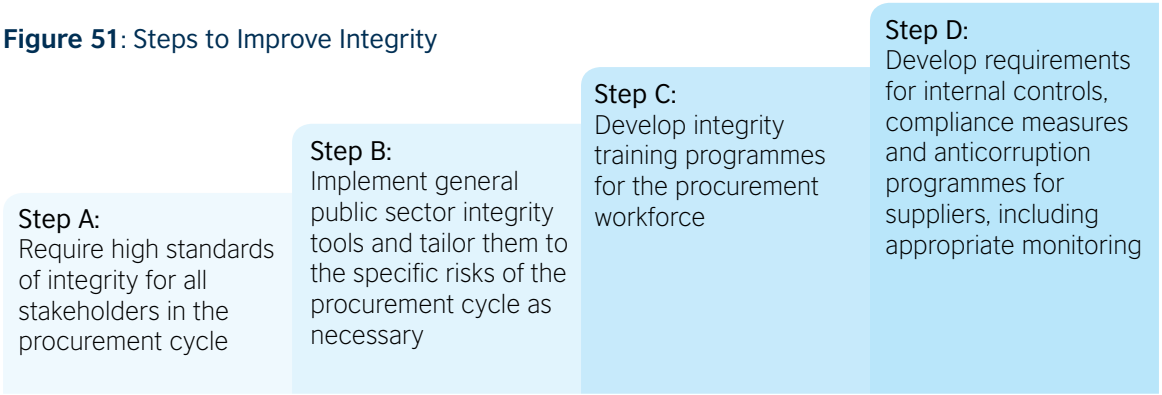
- **Recommendation:** Access to procurement opportunities for potential competitors of all sizes should be facilitated.
- **Components:** Access can be strengthened by following the proposed steps below (steps A to C, aligned with the Recommendation), while also improving other principles that are closely linked to access, such as, transparency, integrity, balance, participation, efficiency, e-procurement, capacity, and accountability.

Figure 52 (on the next page) outlines steps to strengthen access to procurement opportunities.

4. BALANCE

- **Recommendation:** It should be recognized that any use of the public procurement system to pursue secondary policy objectives should be balanced against the primary procurement objective.
- **Components:** The 'balance' principle highlights that a well-designed system can contribute to achieving pressing policy goals, which can be balanced against the

Figure 51: Steps to Improve Integrity



Source: Adapted from OECD 2015.

Figure 52: Steps to Strengthen Access

A	B	C
Coherent and stable institutional, legal, and regulatory frameworks	**Clear and integrated tender documentation**	**Use competitive tendering**
Essential to increase participation in doing business with the public sector Framework should be clear and simple Avoid duplication with other regulations Ensure equitable treatment of suppliers	Inform buyers' expectations (including contract as well as payment terms) and binding information about evaluation and award criteria and their weights Extent and complexity of information required in tender documentation and the time allotted for suppliers to respond is proportionate to the size and complexity of the procurement	Limit the use of exceptions and single-source procurement Use of single-source procurement should be limited, pre-defined and should require appropriate justification when employed

Source: : Adapted from OECD 2015.

primary objective of public procurement, namely, to achieve value for money. Balance can be strengthened by following the proposed steps below (steps A to C, aligned with the Recommendation), while also improving other principles that are closely linked to balance, such as, access, participation, e-procurement, capacity, and evaluation.

Figure 53 outlines steps to strengthen the balance between primary and secondary procurement objectives.

Figure 53: Steps to Strengthen Balance

Step A: Evaluate the use of public procurement as one method of pursuing secondary policy objectives in accordance with clear national priorities

Step B: Develop an appropriate strategy for the integration of secondary policy objectives in public procurement systems

Step C: Employ appropriate impact assessment methodology to measure the effectiveness of procurement in achieving secondary policy objectives

Source: Adapted from OECD 2015.

5. PARTICIPATION

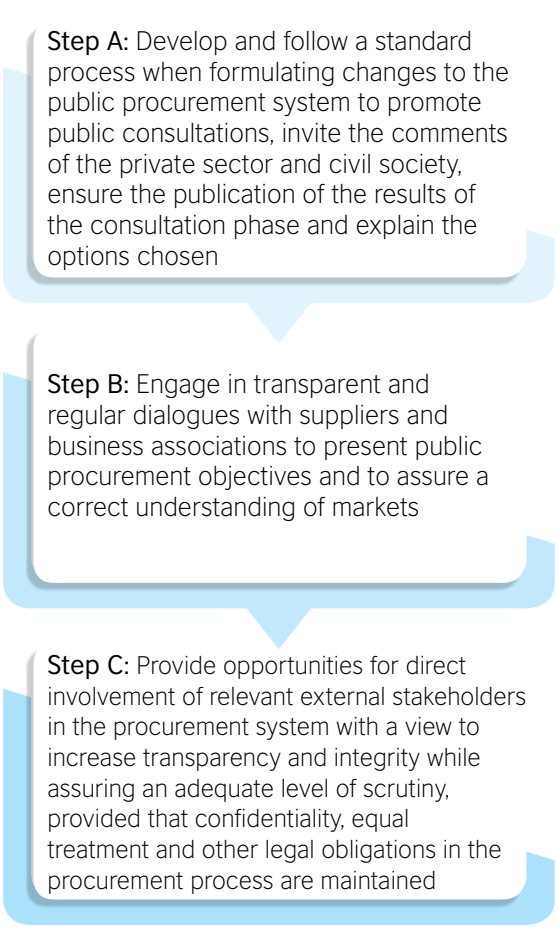
- **Recommendation:** Foster transparent and effective stakeholder participation.
- **Components:** Participation of all stakeholders is crucial for the success of the procurement process. Effective communication should be conducted to provide potential vendors with a better understanding of the country's needs, and government buyers with information to develop more realistic and effective tender specifications by better understanding market capabilities. Participation can be strengthened by following the proposed steps below (steps A to C, aligned with the Recommendation), while also improving other principles that are closely linked to participation, such as transparency, integrity, access, balance, efficiency, e-procurement, and accountability.

Figure 54 (on the next page) outlines steps to strengthen participation in public procurement.

6. EFFICIENCY

- **Recommendation:** Develop processes to drive efficiency throughout the public procurement cycle in satisfying the needs of the government and its citizens.
- **Components:** Public procurement accounts for a substantial portion of

Figure 54: Steps to Strengthen Participation



Source: Adapted from OECD 2015.

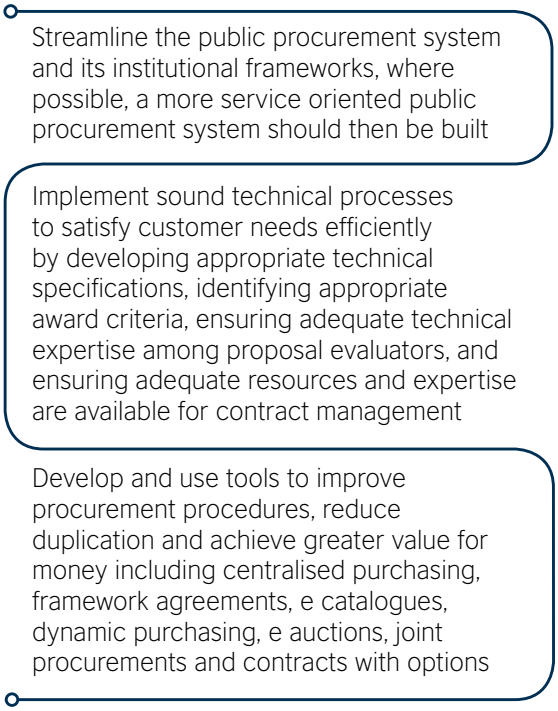
taxpayers' money and of government expenditures. Thus, governments are expected to carry out procurement efficiently to ensure value for money and high quality of service delivery. Efficiency can be strengthened by following the proposed steps below (steps A to C, aligned with the Recommendation), while also improving other principles that are closely linked to access, such as transparency, integrity, access, participation, e-procurement, capacity, evaluation, risk management, and integration.

Figure 55 outlines steps to strengthen efficiency in public procurement.

7. E-PROCUREMENT

- **Recommendation:** Improve the public procurement system by harnessing the use of digital technologies to support

Figure 55: Steps to Strengthen Efficiency



Source: Adapted from OECD 2015.

appropriate e-procurement innovation throughout the procurement cycle.

- **Components:** E-procurement is defined as the use of information and communications technologies in public procurement. It not only increases efficiency by facilitating access to public tenders, but also improves transparency by holding public authorities more accountable. E-procurement can be strengthened by following the proposed steps below (steps A to B, aligned with the Recommendation), while also improving other principles that are closely linked to transparency, integrity, access, balance, participation, efficiency, capacity, evaluation, accountability, and integration.

Figure 56 (on the next page) outlines steps to strengthen e-procurement.

8. CAPACITY

- **Recommendation:** A procurement workforce should be developed with the capacity to continually deliver the value or money efficiently and effectively.
- **Components:** Effective implementation of procurement reforms and specific

Figure 56: Steps to strengthen e-procurement

Step A

Employ recent digital technology developments that allow integrated e procurement solutions covering the public procurement cycle

Step B

Pursue state of the art e procurement tools that are modular, flexible, scalable and secure in order to assure business continuity, privacy and integrity, provide fair treatment and protect sensitive data, while supplying the core capabilities and functions that allow business innovation

Source: Adapted from OECD 2015.

Figure 57: Steps to Strengthen Capacity of Procurement Workforce

Step A	Ensure that procurement officials meet high professional standards for knowledge, practical implementation, and integrity by providing a dedicated and regularly updated set of tools
Step B	Provide attractive, competitive, and merit based career options for procurement officials
Step C	Promote collaborative approaches with knowledge centres such as universities, think tanks, or policy centres to improve skills and competences of the procurement workforce

Source: Adapted from OECD 2015.

procurement practices requires a properly trained public procurement workforce. It not only promotes the effectiveness of the system but also its integrity. Capacity can be strengthened by following the proposed steps below (steps A to C, aligned with the Recommendation), while also improving other principles that are closely linked to capacities, such as integrity, access, balance, efficiency, e-procurement, evaluation, risk management, and accountability.

The following figure 57 outlines steps to strengthen the capacity of the procurement workforce.

9. EVALUATION

- **Recommendation:** Drive performance improvements through evaluation of the effectiveness of the public procurement system from individual procurements to the system as a whole, at all levels of government where feasible and appropriate.
- **Components:** The overriding objective of a state's public procurement system is to deliver efficiency and 'value for money' in the use of public funds. Evaluation is about seeking to answer the fundamental question of whether the procurement system and operations ultimately deliver per per the main objectives set (primary and secondary policy objectives). Evaluation can be strengthened by following the proposed steps below (steps A to B, aligned with the Recommendation), while also improving other principles that are closely linked to evaluation, such as balance, efficiency, e-procurement, capacity, and accountability.

Figure 58 outlines steps to strengthen the evaluation of public procurement.

Figure 58: Steps to Strengthen Evaluation

Step A: Public procurement systems should collect consistent, up-to-date, and reliable information and use data on prior procurements, particularly regarding price and overall costs, in structuring new needs assessments, as they provide a valuable source of insight and could guide future procurement decisions

Step B: Develop indicators to measure performance, effectiveness and savings of the public procurement system for benchmarking and to support strategic policy making on public procurement

Source: Adapted from OECD 2015.

10. RISK MANAGEMENT

- **Recommendation:** Integrate risk management strategies for mapping, detection, and mitigation throughout the public procurement cycle.
- **Components:** Risk management encompasses risk assessment (including an assessment of the nature, causes and potential consequences of risks) and risk mitigation. It involves the contracting authority as well as the contractor. Risk management can be strengthened by following the proposed steps below (steps A to B, aligned with the Recommendation), while also improving other principles that are closely linked to risk management, such as integrity, efficiency, e-procurement, capacity, and integration.

Figure 59 outlines the steps to strengthen risk management of the procurement function.

Figure 59: Steps to Strengthen the Risk Management of Procurement Function



Source: Adapted from OECD 2015.

11. ACCOUNTABILITY

- **Recommendation:** Apply oversight and control mechanisms to support accountability throughout the public procurement cycle, including appropriate complaint and sanctions processes.
- **Components:** Public procurement is an activity particularly vulnerable to fraud and corruption. Oversight and control mechanisms help to support accountability throughout the public procurement process. Accountability can be strengthened by following the proposed steps below (steps A to D, aligned with the Recommendation), while also improving other principles that are closely linked to accountability, such as transparency, integrity, access, participation, e-procurement, capacity, and evaluation.

Figure 60 outlines the steps to strengthen accountability in public procurement.

Figure 60: Steps to Strengthen Accountability



Source: Adapted from OECD 2015.

12. INTEGRATION

- **Recommendation:** Integration of public procurement into overall public finance management should be supported. This recommendation is principally applicable for government organizations such as line ministries and sub-national governments, and hence, is not discussed elaborately in this curriculum.

Competitive neutrality in public procurement

Competitive neutrality occurs, where no entity operating in an economic market is subject to undue competitive advantages or disadvantages. Public procurement considers whether government procurement rules consider competitive neutrality and whether such rules apply to SOEs and in-house or intragovernmental procurement.[19] It also considers whether incumbency advantages have been alleged, and if so, whether compensatory payments have been made based on these advantages. Often these alleged advantages include a stronger position to pre-qualify or bid for contracts, where a given SOE has already established a track record; information advantages concerning service levels and costs; and lower start-up and transition costs compared with potential entrants, especially where contracts are of limited duration.

Box 64 outlines case studies of preferential procurement practices for SOEs.

The main components of competitive neutrality in public procurement entail the following:[20]

- **Public procurement should be a competitive process**: The SOE guidelines (OECD, 2005a) promote the use of general procurement rules for SOEs just as they would apply to other companies (Guideline 1.A.); a level playing field is encouraged, where the consistent application of rules applies to both public and private companies. Furthermore, the SOE guidelines call for the removal of legal and non-legal barriers to fair procurement and promoting ethics in the procurement process.
- **Ensure transparency and equitable treatment in procurement policies and procedures:** Procurement policies and procedures should ensure clear selection criteria in advance, and fair and equitable treatment in the selection of suppliers. Any unfair barrier is recommended to be removed to ensure fair and non-discriminatory selection processes. Where discriminatory preferences exist, OECD

Box 64: Preferential SOE Procurement Practices in Select Countries

Iraq: Government of Iraq entities are required to give preferential treatment to SOEs under multiple laws:

- Under Article 16 of the 2008 Regulations for Implementing Government Contracts (Law No. 1), SOEs are exempt from bid bond and performance bond requirements.
- A 2009 Council of Ministers' decision requires all Iraqi government agencies to procure goods from SOEs, unless the SOE cannot fulfil the quality and quantity requirements of the tender.
- A Board of Supreme Audit decision requires government agencies to award SOEs tenders if the SOE's bid is no more than 10 percent higher than other bids.

- Furthermore, some Government of Iraq entities, including the Ministry of Industry and Minerals (MIM), have also issued their own internal regulations requiring tenders to select Iraqi SOEs, unless the Iraqi SOE states that it cannot fulfill the order.

- SOEs receive research and development subsidies.

- The foreign firm must form a partnership with an Iraqi firm to fulfill tenders promulgated by SOEs.

- In addition to subsidized or free credit, SOEs can receive indirect subsidies through state purchasing of their goods and services at above-market prices.

Jordan: In Jordan, there is a 15 percent (by value) preference to national enterprises, as per Article No. 12/1 of Act 32 (1993).

Lebanon: Procurement of SOEs is governed by separate regulations but under the same terms and conditions as public procurement. SOEs and public institutions benefit from certain tax exemptions. The procurement regulations being loose arrangements whereby SOEs procure services from companies owned by ministers or other high-level officials can be found.

Even though the SAI theoretically can investigate SOEs, in practice it does not do so due to a lack of political support. The efficacy of SAIs, including in relation to SOEs, lie in their reporting relationship with the executive party, their political backing and the scope of their mandate.

Source: World Bank 2014.

recommends that these should be made transparent and shared with potential bidders in advance.

- **All public entities, including in-house bidders, participating in a bidding process should operate according to the standards of competitive neutrality**. In-house bids should be treated the same as outside bids, and neutrality should be safeguarded between private and public providers.
- **Integrity and ethics are essential in the procurement process**. This applies to SOEs as public purchasers and organizers of tenders.

For a government committed to competitive neutrality, the following considerations are required in public procurement: (i) ensure that public procurers compare bids on a like-for-like basis; (ii) reflect and take differences between bidders into account; and (iii) establish complaints mechanisms and reconciliation measures.

Some concrete examples in implementing these options are described below:

- **Ensure public procurers compare bids on a like-for-like basis**. In general, economic operators are subject to the following principles in public procurement procedures: equal treatment, non-discrimination, transparency, proportionality, and mutual recognition. All these principles are consistent with competitive neutrality. These principles are reflected in most national policies, which are also embedded in World Trade Organization (WTO) rules. To fulfil these criteria, in some economies, the state sector is outright discouraged from participation in public procurement processes to avoid the risk of indirect preferences and other neutrality issues, which may arise out of their participation in managed competitions. In other cases, jurisdictions have issued specific rules on the terms that govern public participation in managed competitions and how specifically the issue of in-house procurement should be treated (refer Box 65 on country case study).
- **Reflect and take differences between bidders into account**. Practically, procurers must be equipped with the right tools to ensure competitive neutrality among bidders in managed competitions. One way is to ensure that bidding processes are fair and that bids (from the public, private, or third sector) reflect and take differences between bidders into account before the awarding of public contracts. This approach was followed by the UK Ministry of Justice, which developed a set of Principles of Competition designed to remove any advantage that applies to bidders because of their ownership in the provision of custodial services to prisons (refer Box 66 on the next page).
- **Ex post complaints mechanisms and correcting measures.** In most countries, specific mechanisms have been set up to receive complaints in cases of non-neutrality after a public procurement process has been initiated. For the EU member states, specific review procedures

Box 65: Toolkit: Ensuring Competitive Neutrality in Managed Competitions – Australia

The Commonwealth Procurement Rules (CPRs) articulate the policy framework and rules, which govern agencies procurement activities. Potential suppliers must be treated equitably based on legal, commercial, technical, and financial abilities in respect to their ability to provide the product or service. The CPRs do not allow for discrimination based on origin or government ownership. This ensures that all organizations are not disadvantaged based on their organizational structure when agencies are procuring goods and/or services. According to the Australian Competitive Neutrality Guidelines (2004), all agencies conducting a tendering process must include a requirement for public sector bidders to declare that their tenders are compliant with competitive neutrality principles. Should a public sector bid be successful, the business activity would need to assess the application of competitive neutrality in accordance with the Guidelines.

Source: OECD. 2012. *Competitive Neutrality: Maintaining a Level Playing Field between Public and Private Business.*

Box 66: Six Principles of Competition in the United Kingdom

Process: Regulatory, commissions, procurement, and bidding functions into different departments to avoid any conflict of interests that arise when assessing bids (public, private, and third sector) should be separated. All relevant information should be provided in a timely manner and any incumbency advantage should be reduced.

Costing: A formula is given and applied to all public sector bids to reflect the allocation of indirect costs.

Grant funding: All bidders must declare grant funding, including any received by subcontractors. Bidders must attest that grant funding will not be used to subsidize their bid, including indirect costs.

Pensions: Pensions transfer, or treatment of public sector pensions should be addressed. Guidance on the broader issue of the treatment of staff who are transferred from the public sector should be provided. All public sector bids from incumbents must apply any uplift of 3 percent per year to all payroll costs.

Risk: A list of risks that are considered insurable is given and the principles require that each bid includes a limit of liability for each of the listed risks irrespective of the bidder. Any public sector bidder is required to obtain a quote for commercial insurance coverage. Bidders must evaluate all other risks and clearly attribute their commercial value.

Tax: Although the evaluation of bids excludes Value Added Tax (VAT) and corporate taxes, bidders are required to provide information on the expected liabilities for both.

Source: Office of Fair Trading, 2010. "Competition in Mixed Markets: Ensuring Competitive Neutrality." Working Paper OFT1242.

set out in EC Directive 2007/66/EC are aimed at improving the effectiveness of review procedures concerning the award of public contracts. EU rules require that a sufficient amount of time is factored into the procurement process before the signature of the contract, to ensure the possibility for a review process and for tenderers or candidates to make an effective review of the decision to award a contract. This so-called 'standstill' period provides an opportunity for tenderers or candidates (who may not have been awarded the contract in question) to request adequate information, to review the decision, and to bring forward review proceedings, if necessary. Where procedure or awarding of the contract constitutes an infringement, eligible authorities can take corrective measures.

Checklist for implementing the OECD recommendation of the council on public procurement

The Checklist for Supporting the Implementation of the 2015 OECD Recommendation of the Council on Public Procurement has been developed to guide and support public procurement practitioners in reviewing, developing and updating their procurement framework, according to the 12 principles of the Recommendation.

The 'checklist' format aims at encouraging self-assessment and providing a starting-point for implementing the recommendation. The 'checklist' does not provide a compulsory list of elements the countries/SOEs have to comply with but offers information that is rather more detailed and guidance for each of the 12 principles as well as actions that can be taken to improve the strategic and holistic use of public procurement.

This checklist may be used by SOEs to ensure adherence to the OECD Recommendations by incorporating the same in their procurement manuals. This manual can then be used to train the procurement officials in the SOE. The checklist can be accessed here: http://www.oecd.org/governance/procurement/toolbox/search/checklist-implementation-oecd-recommendation.pdf

Box 67 on the next page outlines provisions on green public procurement that can be adopted by SOEs.

Box 67: Cross-Cutting Theme: Green Public Procurement (GPP)

Green public procurement (GPP), that is, public purchasing of products and services that are less environmentally damaging[21] when taking their whole life cycle into account,[22] is increasingly used by countries to achieve policy objectives in the area of environmental protection.

For successful GPP implementation, six dimensions need to be referred to:

- Setting a GPP legal and policy framework to assist buying entities in incorporating GPP in their procurement procedures – with understandable definitions, targets and priorities in helping public entities achieve their goals.
- Planning GPP, including understanding market capacity and available technical solutions as well as assessing GPP costs and benefits – consulting with stakeholders and suppliers is crucial to assess available green solutions and gauge supply capacity.
- Introducing environmental standards in the technical specifications, procurement selection and award criteria as well as in contract performance clauses – performance-based contracting and payment provide incentives for innovative green solutions. Credible standards determining what products or services count as green, such as, for example, eco-labels, are core conditions to reach environmental goals including paperless procurement procedures.
- Professionalizing GPP and increasing know-how and skills - GPP requires specialized knowledge and skilled multidisciplinary teams.
- Raising awareness on GPP solutions and their benefits with buyers, businesses and the civil society. A focused effort on getting the right messages across to government procurement officials and the general public can have a significant impact on the success of GPP.
- Monitoring the results of GPP and providing a feedback loop into policy and regulation.

Source: OECD. 2015, *Going Green: Best Practices for Sustainable Procurement.*

Topic two: Procurement strategy and plan development

Procurement planning (stage 1)

The goal of procurement planning is a coordinated and integrated action to fulfil a need for goods, services, or works promptly and at a reasonable cost. Early and accurate planning is essential to avoid last-minute, emergency, or ill-planned procurement, which is contrary to open, efficient, and effective—and consequently transparent—procurement. Additionally, most potential savings in the procurement process are achieved by improvements in the planning stages. Even in situations, where planning is difficult, such as emergencies, proactive measures can be taken to ensure contingency planning and be better prepared to address upcoming procurement requests. For example:

- Advance identification of suitable suppliers of potential products frequently requested in emergency operations, including confirmation by suppliers on willingness to respond on short notice.
- Development of standard specifications/ terms of reference (TOR)/scope of work (SOW) for products/services/works requested in emergency operations

There are two types of procurement planning:

- Consolidated procurement plans
- Individual procurement plans

Consolidated procurement plans

Consolidated procurement plans are often developed for the whole organization, but depending on the structure and level of decentralization, these may be developed at the corporate, divisional, country office, or business unit level, or even at a number of

these levels. At the organizational level, the responsibility for preparing the plan would normally lie with the authority responsible for procurement policy and planning, but in smaller business units, it may lie with the procurement officer. Consolidated procurement plans would normally be prepared annually, but in some environments, where the needs are more difficult to define, these may be done more frequently, though not normally more than quarterly. It is a good practice to publish these consolidated procurement plans, for example, on the organization's website. This provides advanced information to the outside world of upcoming procurement activities and advances the key principle of transparency in procurement.

Individual procurement plans

Once a requisition or project plan is received determining an actual requirement, the procurement officer is then responsible for developing the individual procurement plan. The scope of the individual procurement plan will depend on the complexity of the requirement. While it is good practice to always plan, in the case of low-risk/low-spend requirements, the plan should be simple with an overview of the necessary steps of the process and associated timeline. At the other end of the scale, managing the procurement of an extremely high-risk/high-spend requirement needs project management and should entail a thorough and comprehensive planning process.

Development of the procurement plan

The first step in the planning process is to identify the desired outcomes and objectives of the procurement. However, the process is not necessarily linear. In some cases, information obtained in the informational gathering stage will also have an impact on the identification of objectives. For example, an analysis of the supply market shows that there are limited sources of supply, which means that a key objective is to identify suppliers, who can develop alternative products. This, in turn, will have an impact on the requirement definition stage of the process.

The information-gathering stage relates to collecting and analyzing two types of information:

- Definition of requirement (stage 2)
- Supply market

The information gathered in both cases will provide input into the identification of the objectives and outcomes and development of the procurement plan.

Once the objectives have been set and the relevant information on the requirement definition and the supply market has been gathered, the next stage is to develop the procurement plan. A key element of this is the selection of the procurement method. This is covered in detail under the procurement strategy.

Once the procurement method has been selected, the procurement plan can be elaborated, often in collaboration with key stakeholders such as the client, requisitionister, or technical experts. **Typically, the procurement plan would include the following information:**

- Procurement objectives and performance indicators
- Breakdown of activities under the selected procurement method
- Identification of responsible party for each activity
- Timeline and milestones taking into consideration the procurement method and required clearances
- All appropriate administrative requirements (relevant codes, budget allotments, and so on)

Procurement planning and sourcing based on market assessment

The market assessment aims at collecting and analyzing information about capabilities within the market to satisfy the organization's requirements, such as, obtaining updated cost information, determining the appropriate technology and alternative products, as well as identifying appropriate supplier qualification criteria. It is also referred to as sourcing.

A thorough sourcing process, leading to identification and invitation of relevant suppliers, ensures maximized competition, by allowing the most relevant and suitable

companies to compete. Sourcing also leads to a better understanding of the market. This knowledge helps to

- Assist in a make, buy, or lease decision;
- Determine when to buy;
- Establish realistic delivery schedules;
- Review sole/single-source justifications;
- Identify price and non-price evaluation factors;
- Identify special terms and conditions for the solicitation and resulting contract that are customary in special markets; and
- Establish realistic budgets, pricing arrangements, and economic ordering quantities.

Sourcing is often conducted in parallel with the requirement definition. An issue procurement officers should keep in mind is that while requisitioners are preparing specifications/ TORs/SOW, they are informally performing technical market research by discussing the forthcoming procurement action with prospective suppliers. This communication, although an important part of the needs assessment process, is sensitive, as it can give rise to biased specifications or perception of favoritism. Procurement officers should advise the requisitioner on the risk associated and should explain that it is important that no supplier be given an advantage through upfront information and that care should be taken to ensure that no supplier gets the impression that they have an increased opportunity to be awarded a contract.

Figure 61 outlines the stages in the sourcing process.

Figure 61: Stages in the Sourcing Process (stage 3)

Step 1: Market research

Step 2: Establishment and signature of short list

Step 3: Supplier management

Source: Adapted from OECD 2009.

Step 1:
Market research should identify relevant suppliers and products that could meet the needs of the organization. For small standard procurement activities, research may be limited to searching existing rosters and previous contracts. For larger or more complex procurement, extensive market analysis is required. Procurement activities should be made widely known to all potential suppliers. This can be achieved through various means, for example, by advertising the following:

- Procurement plans, information on specifications for standard products, specifications of sole-source products, and so on, in order to provide suppliers with the opportunity to express interest
- Request for expression of interest, request for information, pre-qualification exercises
- Open tenders as means to reach out to the supplier community broadly

Step 2:
Unless a rule prescribes or a decision is made to proceed with an open tender, or market research justifies a waiver of competitive bidding, a shortlist of suppliers to be invited should be prepared based on the market research findings. Shortlisting criteria can include the following:

- The monetary value of the procurement activity; the higher the value, the higher number of companies that should be shortlisted. Most organizations have specific requirements in this regard.
- Share of potential markets and geographic distribution.
- Specific requirements for the procurement action (for example, International Organization for Standarization (ISO certification/quality standards, representation of supplier in the recipient country, and/or donor-specific requirements as per the agreement with donor).
- Legislative requirements (for example, registration under existing regulation in the supplier's country, registration with a professional body, required insurances, and so on).

- Technical capacity and experience (that is, relevant experience, experience from the geographic area in question, availability of after sales-service, availability of required equipment, and so on).
- Appropriate financial capacity compared to the value of the contract; in general, if information about the supplier is insufficient, they should be contacted and asked for further information, and if the procurement officer is not confident that the supplier can meet the requested needs, the supplier should not be invited.

Step 3:
This may encompass the use of pre-qualification as a strategic tool, which is the most useful, in particular, for products/services bought regularly. Another way is by the use of rosters that provides easily accessible information on suppliers and the goods and services they provide. To promote economical and efficient procurement, the performance of existing suppliers should be evaluated on an ongoing basis. Data should be recorded, and non-performance should be flagged in existing rosters/information systems.

Box 68 outlines initiatives and practices to encourage SME participation in public procurement in China.

Selection of a procurement strategy (Step 4)

The purpose of identifying and selecting an appropriate procurement strategy is to find the best way to obtain the solution/result to satisfy the needs of the end-user for goods, works and services. This is done by obtaining the most advantageous pricing and contractual conditions through a competitive process that will best deliver what is required promptly while ensuring achievement of the UN guiding procurement principles.

The process of identifying and selecting the appropriate procurement strategy can best be described as a series of decisions, rather than sequential stages that need to be followed in a strict order. Normally, the procurement officer would only complete the most relevant stages based on organizational practice, and the procurement officer's experience.

Table 60 on the next page outlines the process of selecting a procurement strategy.

Box 68: Encouraging SME Participation in Public Procurement in China

The Chinese government has been conscious of the impact of public procurement on SMEs since the beginning of its government procurement reforms. The first comprehensive government procurement code, Government Procurement Law 2002 (GPL), provides in Article 9 Government procurement that shall be conducted in such a manner as to facilitate achievement of the economic and social development policy goals of the state, including but not limited to environmental protection, assistance of underdeveloped or ethnic minority regions, and development of SMEs. In addition, Law on Promotion of Small and Medium-sized Enterprises 2002, which was adopted by the National People's Congress on the same day, provides in Article 34 "[I]n government procurement, preference shall be arranged to goods or services originated from small and medium-sized enterprises."

In addition, the 2011 Interim Measure on Facilitating the Development of SMEs in Government Procurement adopted jointly by Ministry of Finance (MOF) and Ministry of Industry and Information Technology (MIIT) provide that 30 percent of government procurement budget shall be set aside to purchase goods and services from the SMEs and 60 percent of such reserved contracts shall be awarded to small or micro enterprises. Furthermore, small and micro enterprises participating in procurement not reserved for SMEs shall be granted a price preference in the range of 6–10 percent, with the exact margin to be determined by the relevant procuring entity or its agent. The Interim Measure also encourages big companies to use SMEs as subcontractors, to form consortia with SMEs, and encourages financial institutions to provide credits/guarantees for SMEs to pay deposits and perform the contract.

Finally, it is compulsory for the procuring entities to report their implementation of the measure and the data gathered shall be published on the official government procurement media (website: www.ccgp.gov.cn; newspaper: Chinese Finance and Economy; and magazine: Chinese Government Procurement, China State Finance).

Source: Ministry of Finance, People's Republic of China. 2016. *Public Procurement Toolbox -Treasury two Government Procurement Management Division.*

Table 60: Process of Selecting a Procurement Strategy

Steps	Description
Step 1: Analysis of the requisition	During the analysis of the requisition, each of the actions below should be considered to determine the nature of the requirement, the specifications, and the expected value of the procurement action. • Identify crucial information in the requisition as well as the requirement definition, which could have an impact on the procurement strategy (e.g., urgency, specific local requirements, which must be met, target arrival date, and so on). • Identify generic versus branded specifications. • Double-check that the technical specifications provide a sufficiently high minimum level such that any product meeting the requirements is acceptable. • Ascertain the feasibility of the requested delivery date and provide feedback on lead times to the requisitioner. • Determine whether factors other than technical compliance should be included in the evaluation. • Determine whether technical and other factors are all suitable for 'yes/no' threshold conditions or whether any should be given weight. • Consider the expected value of the requisition, with relevant financial thresholds for procedures and delegations. • Consider whether requisition can be packaged with other similar requests awaiting procurement or identified during the organization-wide needs analysis.
Step 2: Selection of responsible unit	The framework, the structure, and the delegations of authority will determine who should respond to the end-user requirements within an organization. This decision may depend in part on whether the supply is expected to be available locally/regionally. Central and decentralized units are sometimes authorized to operate in different markets, depending on the organization. The capacity of each unit might also be considered.
Step 3: Consideration of not-buy options	It is important to consider options other than buying, including: • Make versus buy • Lease versus buy • Incorporate in other procurement versus buy The decision to make, buy, lease or incorporate in other procurement should be made jointly by the procurement officer and the requisitionist.
Step 4: Consideration of indirect buy options	Some indirect buy options that should be considered are as follows: • Use existing long-term agreements (LTAs) • Use other organization's LTAs • Develop new LTA • Buy from other organizations • Incorporate in other procurement.
Step 5: Choice of a solicitation method	There are the following three main solicitation methods used in the United Nations: • Request for Quotations–RFQ • Invitation to Bid–ITB • Request for Proposals–RFP The selection of the appropriate method is determined by the expected cost of the procurement action, the feasibility of preparing complete specifications at the outset of the requirement definition, and whether price alone or price plus other criteria such as quality should determine the selection among qualified suppliers.

Steps	Description
Step 6: Selecting the type of competition	Depending on the value of the procurement, the market conditions as well as knowledge of the market, various types of competition can be used. A choice must be made whether to use 'open competition', where any supplier can participate, or have 'limited/restricted competition', where a shortlist and specific invitation are provided to selected suppliers. Further, a decision should be made on geographic sourcing and whether international competition is to be used, or whether to limit competition to local or regional suppliers.
Step 7: Decision on type of contract to be signed	One crucial element to address during the strategy phase is to determine the type of contract to be used, in particular, whether it should be a purchase order (PO), contract for services or contract for works. Other issues such as whether the contract should be fixed price (lump sum) or cost-reimbursable are also considered at this stage. The type of contracts and availability of standard contracts vary between organizations.

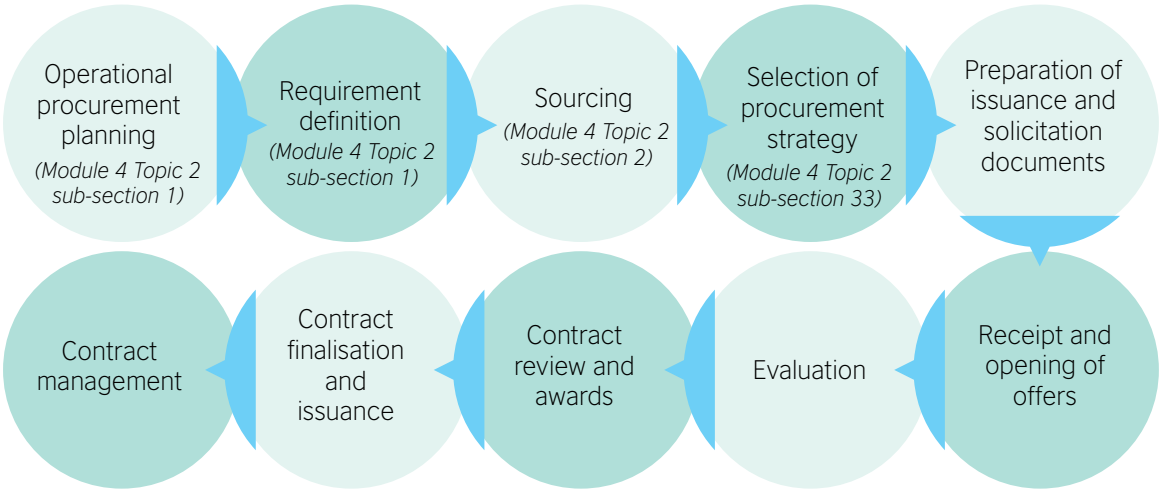
Source: Adapted from OECD 2009.

Topic three: Efficient procurement processes and competencies

Introduction

As per the United Nations Procurement Practitioners' Handbook,[23] the flowchart in Figure 62 shows each of the stages in the procurement process. In the previous section, it has already been discussed till the fourth stage, that is, the selection of procurement strategy (refer to Module 4, Topic 2). Therefore, this section talks about the stages thereafter.

Figure 62: Stages in the Procurement Process

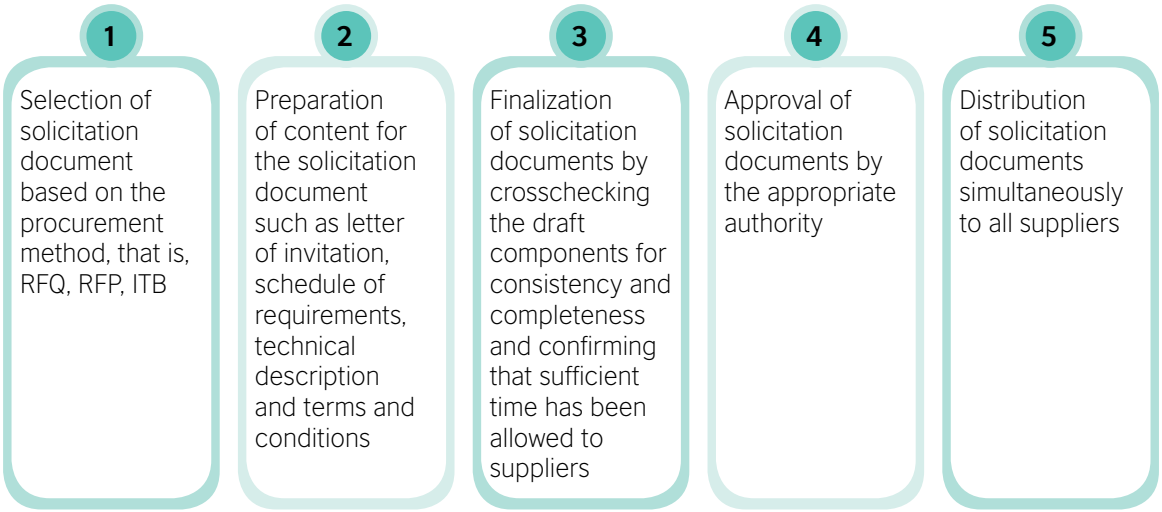


Source: Adapted from OECD 2009.

The procurement process

Stage 5: Preparation of issuance and solicitation documents (refer Figure 63)

Figure 63: Step-by-Step Breakdown of Preparation of Issuance and Solicitation Documents



Source: Adapted from OECD 2009.

Stage 6: Receipt and opening of bids
The purpose of this formal process is to ensure that offers are received, handled and opened according to the instructions provided in the solicitation documents and that transparency and confidentiality are maintained as specified in the relevant regulations, rules, and procedures of the organization.

Stage 7: Evaluation
Upon the receipt and opening of offers, an evaluation must be conducted according to the set of evaluation criteria and method, which have been established during the preparation of the solicitation documents. Evaluation criteria can be divided into the following categories:

- **Formal** – Offers are checked for their compliance with any formal criterion stated in the solicitation documents. Offers not meeting the formal criteria are rejected. Examples of formal criteria are
  - Offers have been properly signed
  - Offers are accompanied by the required securities, if applicable
  - Supplier is eligible, for example, duly registered if pre-registration is a requirement
  - Offers are accompanied by the required documentation
  - Offers are complete, and so on
- **Technical** – Technical evaluation criteria are derived from the specifications, TOR, or SOW. Technical criteria can also include requirements to the supplier, such as
  - Previous experience in a similar field and with the same type of requirements
  - Experience from the region
  - Available capacity and equipment to undertake the assignment
  - Qualification and experience of proposed personnel
- **Financial** – Price is an important evaluation criterion but the weight of the price depends on the chosen evaluation methodology.

Stage 8: Contract review and award
It provides for independent written advice on the acceptability of the procurement process undertaken, and the proposed commitment of funds by the highest-level procurement authority or officer with the appropriate delegated authority, through contracts or purchase orders (awarding authority).

The award is the formal decision and approval to establish a contract, for example, a service contract or purchase order, or an LTA with a successful supplier, based on an independent review of the procurement process within the limits of awarding authority. The award phase marks the

- The successful conclusion of the procurement process; and
- The starting point for contract finalization and execution

Stage 9: Contract finalization and issuance (refer Figure 64)

Figure 64: Step-by-Step breakdown of Contract Finalization and Issuance

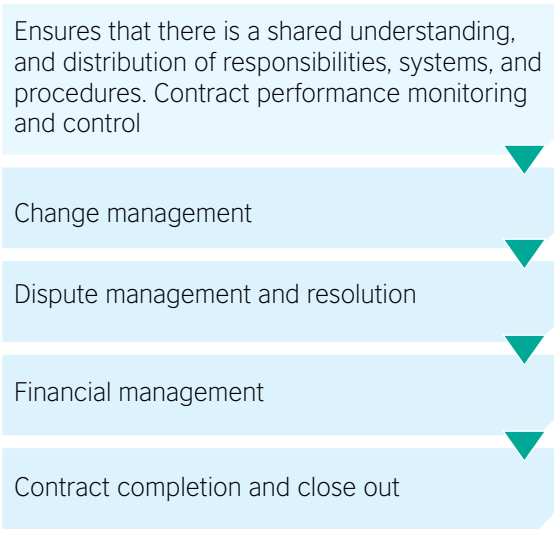


Source: Adapted from OECD 2009.

Stage 10: Contract management

The purpose of contract management is to ensure that all the parties to the contract fully meet their respective obligations as efficiently and effectively as possible, delivering the business and operational outputs required from the contract and providing value for money. It also protects the rights of SOEs and ensures required performance when circumstances change. Contract management includes monitoring and documenting performance. Depending on the organization and goods or services procured, daily/regular monitoring of the contract may be primarily the responsibility of the requisitioner (refer Figure 65).

Figure 65: Step-by-Step Breakdown of Contract Management



Source: Adapted from OECD 2009.

Procurement competencies

In the area of public procurement, the expected positive outcomes of a sound public capacity strategy have been described as follows: "The benefits that organizations and its officials will reap from applying this priority will be extensive and will include economies in resources, good management information, sound disciplines and, of course, cost savings in externally procured expenditure" (The Scottish Government, 2006).

Building a learning culture in public procurement with all stakeholders is essential. A procurement capacity strategy will explore and select the best options for addressing procurement gaps and bottlenecks. Thus, a strategy is a planning exercise, and establishing a step-by-step roadmap forces the prioritization of objectives and expected outputs. It is also important to recognize that building a sustainable procurement workforce is a long-term effort, mobilizing time and resources; the key to this is to appropriately build the political will and stakeholder expectations to support this effort.

An identified task force, or steering committee, would be very useful to anchor the strategy. A formalized steering committee could be useful to demonstrate to the government and the procurement community that building sustainable capacity requires more than short-term training of procurement staff by consultants. Involving local training institutions and well-known universities or professional

schools, for example, schools of engineers, law schools, or business schools, should be strongly encouraged when developing a procurement capacity strategy for an SOE. Training of trainers may also be explored as an option for doing the capacity-building exercise on a pilot basis.

Under-professionalization of procurement staff, absence of career perspectives, and lack of incentives for individuals penalize the success of the reforms and prevent their expected shift toward the implementation of strategic procurement. On the side of the SOEs, under-professionalization is reflected in under-performance of services, lack of clarity of responsibilities, costly mistakes during the planning process, and high levels of complaints and litigation. To create a sustainable environment fostering a performing workforce, the strategy must address all these issues in parallel. Adequate capacity is, therefore, a crucial component of a sound public procurement system, empowering the successful development of the other components.

Topic four: Transparency and integrity of SOE procurement

Public procurement is one of the SOE activities that is the most vulnerable to corruption. In addition to the volume of transactions and the financial interests at stake, corruption risks are exacerbated by the complexity of the process, the close interaction between public officials and businesses, and the multitude of stakeholders. Various types of corrupt acts may exploit these vulnerabilities, such as embezzlement, undue influence in the needs assessment, bribery of public officials involved in the award process, or fraud in bid evaluations, invoices, or contractual obligations. The OECD Foreign Bribery Report provides additional evidence that public procurement is vulnerable to corruption as more than half of foreign bribery cases occurred to obtain a public procurement contract.[24] The direct costs of corruption include loss of public funds through misallocations or higher expenses and lower quality of goods, services, and works. In terms of indirect costs, corruption in SOE procurement leads to distortion of competition, limited market access, and reduced business appetite for foreign investors.

Integrity risks along the SOE procurement cycle

Integrity risks occur in every stage of the procurement process, from the needs assessment over the bidding phase to the contract execution and payment.

The nature of the integrity risk may differ for each step, and red flags include undue influence, conflict of interest, and various kinds of fraud risks (refer Table 61 on the next page).

Enhance integrity and transparency to curb corruption

Integrity refers to upholding ethical standards and moral values of honesty, professionalism, and righteousness, and it is a cornerstone for ensuring fairness, non-discrimination, and compliance in the public procurement process. Therefore, safeguarding integrity is at the basis of any effort to curb corruption in public procurement.

SOEs may develop an overarching **code of conduct** for the entire company as such. However, some SOEs introduce specific codes of conduct for procurement officials, often together with specific guides and training, to help procurement officials apply these standards in their daily practice. The standards for procurement officials, particularly specific restrictions and prohibitions, aim to ensure that the officials' private interests do not improperly influence the performance of

their public duties and responsibilities. Most common conflict of interest situations are related to personal, family, or business interests and activities, gifts and hospitality, disclosure of confidential information, and future employment. Consequently, the additional standards can include provisions on asset declaration requirements, whistle-blowing procedures, and protection measures for whistle-blowers. **Disclosure of assets**, previous employment, and paid positions outside the public service may be effective at detecting potential conflict of interests and possible illicit enrichment. The conflict-of-interest rules needs to leave flexibility to relevant authorities to attract competent and experienced employees while ensuring impartiality of the procurement process.

Table 61: Integrity Risks Across the Procurement Process

Phase	Activity	Integrity risk
Pre-tendering phase	Needs assessment and market analysis	• Lack of adequate needs assessment; • Influence of external actors on officials' decisions; • Informal agreement on the contract.
	Planning and budgeting	• Poor procurement planning; • Procurement not aligned with overall investment decision-making process; • Failure to budget realistically or deficiency in the budget.
	Development of specifications/ requirements	• Technical specifications are tailored for a specific SOE; • Selection criterion is not objectively defined and not established in advance; • Requesting unnecessary samples of goods and services; • Buying information on the project specifications.
	Choice of the procurement procedure	• Lack of proper justification for the use of non-competitive procedures; • Abuse of non-competitive procedures based on legal exceptions: contract splitting, abuse of extreme urgency, non-supported modifications.
Tendering phase	Request for proposal/bid	• Absence of public notice for the invitation to bid; • Evaluation and award criteria are not announced; • Procurement information is not disclosed and is not made public.
	Bid submission	Lack of competition or cases of collusive bidding (cover bidding, bid suppression, bid rotation, market allocation)
	Bid evaluation	• Conflict of interest and corruption in the evaluation process through (a) Familiarity with bidders over time, (b) Personal interests such as gifts or future/additional employment.
	Contract award	• Vendors fail to disclose accurate cost or pricing data in their price proposals, resulting in an increased contract price (i.e., invoice mark-ups, channel stuffing); • Conflict of interest and corruption in the approval process (i.e., no effective separation of financial, contractual and project authorities); • Lack of access to records on the procedure.
Post-award phase	Contract management/ performance	Abuses of the supplier in performing the contract, in particular with its quality, price and timing: • A substantial change in contract conditions to allow more time and/or higher prices for the bidder • Product substitution or sub-standard work or service not meeting contract specifications • Theft of new assets before delivery to end-user or before being recorded • Deficient supervision from public officials and/or collusion between contractors and supervising officials
	Order and payment	• Deficient separation of financial duties and/or lack of supervision of public officials leading to false accounting and cost misallocation or cost migration between contracts or late payments of invoices; • False or duplicate invoicing for good and services not supplied and for interim payment in advance entitlement.

Source: Adapted from OECD 2009.

Box 69 provides a generic code of conduct for procurement practitioners.

Box 70 on the next page provides an outline of the code of conduct for procurement officials in Canada.

Transparency in public procurement not only promotes accountability and ensures access to information; it also serves an important role in leveling the playing field for SOEs and allowing small and medium enterprises to participate on an equal footing. Although transparency is strongly related to integrity and anti-corruption, the relationship is not automatic. Several conditional factors need to be in place for effective accountability. For citizens and civil society organizations to fulfil an oversight role, as a so-called watchdog, data availability needs to be paired with timeliness, data quality, processing capacity, effective reporting, and whistle-blower channels.

Box 71 on the next page provides an outline of integrity pacts in India.

Adequate and timely information may be provided about upcoming contracts as well as contract notices and information about the status of ongoing procurement processes. Additional information such as the average procurement duration, justification of exceptions, and specific overview records by type of bidding procedure may further enable external parties to scrutinize public procurement practice. To provide an appropriate degree of information, governments need to strike a balance between ensuring accountability and competition on the one hand, and on the other hand, protecting trade secrets and respecting the confidentiality of information that can be used by interested suppliers to distort competition, in current or future procurement processes.

Box: 69 Code of Conduct for Procurement Practitioners

A generic code of conduct for procurement officials may include the following:

- **Serving the public interest:** Procurement officials are expected to maintain and strengthen the public's trust and confidence in SOEs, by demonstrating the highest standards of professional competence, efficiency, and effectiveness, upholding the laws, and seeking to advance the public good at all times.
- **Transparency and accountability:** Procurement officials are expected to use power and resources for the public good, in accordance with the law and government policy. They should be prepared to be accountable for the decisions they make and to justify their official decisions and actions to a relevant authority, or publicly, as appropriate in the circumstances.
- **Integrity:** Procurement officials are expected to make decisions and act without consideration of their private interests. Public service, being a public trust, the improper use of a public service position for private advantage is regarded as a serious breach of professional integrity
- **Legitimacy:** Procurement officials are required to administer the laws and government policy, and to exercise legitimate administrative authority under delegation. That power and authority should be exercised impartially and without fear or favour, for its proper public purpose as determined by the legislature or the official's organization as appropriate in the circumstances.
- **Fairness:** Procurement officials should make official decisions and act in a fair and equitable manner, without being affected by bias or personal prejudice, taking only the merits of the matter into account, and respecting the rights of affected citizens.
- **Responsiveness:** Procurement officials are required to serve the legitimate interests and needs of the government, public organizations, other civil servants, and citizens in a timely manner, with appropriate care, respect and courtesy.
- **Efficiency and effectiveness:** Procurement officials are required to obtain the best value in expenditure of public funds, and efficient use of assets deployed in or through public management, and to avoid waste and extravagance in the use of resources in public programmes and official activities.

Source: OECD. 2009, *Public Procurement Toolbox, Tool: Code of Conduct for Procurement Practitioners.*

Transparency can be further enhanced by ensuring **visibility of the flow of public funds** throughout the public financial management cycle. It allows the stakeholders to understand SOE priorities and spending and policy-makers to organize procurement strategically. Box 72 outlines the practice of establishing a procurement ombudsman in Canada.

Box 70: Code of Conduct for Procurement in Canada

The Government of Canada spends billions of dollars a year on the procurement of goods and services. The government has a responsibility to maintain the confidence of the vendor community and the Canadian public in the procurement system by conducting procurement in an accountable, ethical, and transparent manner.

The Code of Conduct for Procurement provides all those involved in the procurement process—public servants and vendors alike—with a clear statement of mutual expectations to ensure a common basic understanding among all the participants in procurement.

The Code reflects the policy of the Government of Canada and is framed by the principles set out in the Financial Administration Act and the Federal Accountability Act. It consolidates the federal government's measures on conflict of interest, and anti-corruption as well as other legislative and policy requirements relating specifically to procurement. This Code is intended to summarize existing law by providing a single point of reference to key responsibilities and obligations for both public servants and vendors. In addition, it describes Vendor Complaints and Procedural Safeguards.

The government expects that all those involved in the procurement process will abide by the provisions of this Code.

Source: Government of Canada. 2019. *Public Services and Procurement Canada.*

Box 71: Integrity Pacts in India

In the recent past, the Central Vigilance Commission (CVC) has taken commendable initiatives in terms of promoting electronic solutions and Integrity Pacts. Integrity Pacts in procurement help governments, businesses, and civil society to fight corruption in the field of public contracting via an agreement on no corruption between the procurement agency and all bidders for a public sector contract. In India, Integrity Pacts hold additional relevance for the following reasons:

- Low rating in the Corruption Perception Index;
- History of scandals and delays in public procurement;
- Existing anti-corruption regulations have had limited success.

Thirty-nine public sector companies are using Integrity Pacts in their procurement process. According to a Transparency International – India document, 96 percent of Integrity Pact Compliant Public Sector Undertakings feel that the Integrity Pact has helped in making procurement process more transparent and 100 percent feel that the procurement process will not be better off without Integrity Pacts.

Source:

Central Vigilance Commission. 2010. *National Anti-corruption Strategy.*

Transparency International. 2019. *Assessment of Integrity Pact (IP) in IP Compliant Public Sector Undertakings.*

Box 72: Procurement Ombudsman in Canada

A Procurement Ombudsman was set up in 2008 to increase the effectiveness and transparency of business practices in relation to procurement. This was part of a series of reforms to implement the Federal Accountability Action Plan to help strengthen accountability and increase transparency and oversight in federal government operations.

Source: OECD. 2014. *Compendium of Good Practices for Integrity in Public Procurement: Meeting of the Leading Practitioners in Procurement.* Paris: OECD.

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18 OECD. 2015. *OECD Recommendation of the Council on Public Procurement, Directorate for Public Governance and Territorial Development.* http://www.oecd.org/gov/public-procurement/recommendation/OECD-Recommendation-on-Public-Procurement.pdf

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23 UN Procurement Practitioner's Handbook. 2012. "Chapter 3: Procurement Process." https://www.ungm.org/Areas/Public/pph/ch03.html#chapter3

24 OECD Foreign Bribery Report. 2014. *An Analysis of the Crime of Bribery of Foreign Public Officials*. http://dx.doi.org/10.1787/9789264226616-en

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Control environment, transparency, and disclosure

Leadership Training Toolkit for SOEs

Part IV
Caselets

CASE STUDIES

1. The control environment – Whistle-blowing

Learning objective

Evaluate the company's whistle-blowing policy and its place in corporate governance.

Introduction

Whistle-blowing involves the act of reporting wrongdoing within an organization to internal or external parties. This case examines a board-approved whistle-blower policy. Participants review the new policy and assess its strengths, weaknesses, and effectiveness. The discussions should cover

- Key components of a whistle-blower policy
- Company's commitment—demonstrating the 'tone at the top'
- The importance of educating employees, others about the policy

Trainer's note

- In preparation, distribute the case background and Handout H4.1A (Case Study: The control environment – Whistle-blowing)
- To begin, refresh participants' knowledge about the case and explain the learning objectives
- Ask participants to review the board-approved whistle-blower policy for Organic Company Limited; engage the entire group in a discussion of the merits and weaknesses of the policy; ask one participant to list the points made on a flip chart

Questions to focus the discussion

- What are the strengths of this policy?
- What are the weaknesses of this policy?
- Does the commitment of the company come through strongly and clearly?
- Would a whistle-blower feel confident that they would be protected? What about the section cautioning that the company may have to report the information to law enforcement officers or a court?
- Are the procedures clear for how a whistle-blower should lodge a complaint?
- Is it clear how the company will handle the investigation?
- Does the policy convey a reasonable tone to guard against frivolous, unfounded complaints?
- Are protections of employees who are the subject of an investigation sufficiently and clearly explained?
- It can be said that the 'tone' of the organization, its culture, and its commitment determine the effectiveness of a whistle-blower policy. What are some examples of how this tone can be established?

The necessity of a whistle-blower program
Studies show that fraud in US companies, for example, amounts to 6 percent of annual revenues and that nearly one-third of the employees have witnessed unethical or illegal conduct in their workplace but did nothing about it. This is why effective whistle-blower programs are key to a company's commitment to delivering value to shareholders.

Tone at the top
Strong commitment by the board and senior management, in words and actions, is important to the policy's effectiveness. Part of this effort entails a widespread education program that explains the policy and assures whistle-blowers of their protection against retaliation while guarding against the filing of unfounded complaints. Accessibility is another key component as is the company's culture and its emphasis on open communications.

Follow-up procedures

When complaints are filed, a sound and efficient process is needed to investigate the complaint's validity and how the company should respond.

These questions may include the following:

- Is this a fraud?
- Has it been substantiated?
- Is the condition ongoing?
- Who is involved?
- What are the risks?
- How was the fraud discovered?
- What are the legal considerations?
- Are their factors requiring an immediate response and resolution?
- Does the company have the tools and expertise?
- Who should the compliance officer be accountable to?

2. Board director demands greater transparency through a disclosure policy

Learning objective

Explain the best practices for transparency and disclosure requirements and why these are core principles of corporate governance.

Introduction

Company ABC Ltd. only discloses what the requirement as per the laws and regulations are for privately held companies. The one independent board director, **Ivan,** has been demanding more disclosures and greater transparency. Some directors support his request given their skepticism about related-party transactions. Other directors oppose greater disclosure, citing competitive pressures, privacy, administrative burdens, liability, and other reasons. Participants debate the merits of greater disclosures and enhanced transparency.

Trainers notes

In preparation, distribute Handout H4.2C (Case Study - Board director demands greater transparency through a disclosure policy).

To begin, refresh participants' knowledge about the case and explain the learning objectives.

Divide participants into two groups:

- One side aligns with the non-executive director **Ivan** and favors greater transparency for related-party transactions and financial statement disclosures.
- The other aligns with the founders and opposes greater disclosures.

Ask each group to list five reasons for their support or opposition to the board's adoption of disclosure practices. Each group designates one person to present their recommendations. After 10 minutes, bring the two groups together to make their presentations. Focus discussion on the benefits and risks of disclosure and the components of a model disclosure policy.

Questions to focus the discussion

- What is transparency? What are the benefits?
- What is meant by timely and accurate disclosures?
- Is disclosure of related-party transactions a good idea or a bad one? Why is it so?
- If the company plans to go public, what disclosure standards must it adhere to? What are the best practices?
- What should a disclosure policy look like?

Discussion points

Review the best practices of transparency and financial disclosure for an SOE. From the IFC matrix, these include the following:

Level One: Understanding the Need

- Adequate accounting and auditing systems in place
- Accounting and reporting are performed per the highest national standards
  - o Quarterly financial reports prepared by internal accounting and approved by the board
  - o Annual financial statements audited by independent external auditors and approved by shareowners' meeting

Level Two: First Concrete Steps

- Accounting, reporting, and auditing systems meet the highest international standards
- An annual audit is performed by a recognized accounting firm following the highest national standards
- Internal audit and internal control with highest national standards

Level Three: Implementation

- Accounting, reporting, and auditing systems are consistent with the highest international standards
- Internal audit and control systems are consistent with the highest international standards

State and explain the reasons for, and benefits of, a company providing timely, accurate disclosures and the necessity of doing so if a company goes public. Also discuss the consequences of inadequate disclosure of financial information.

Notes

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