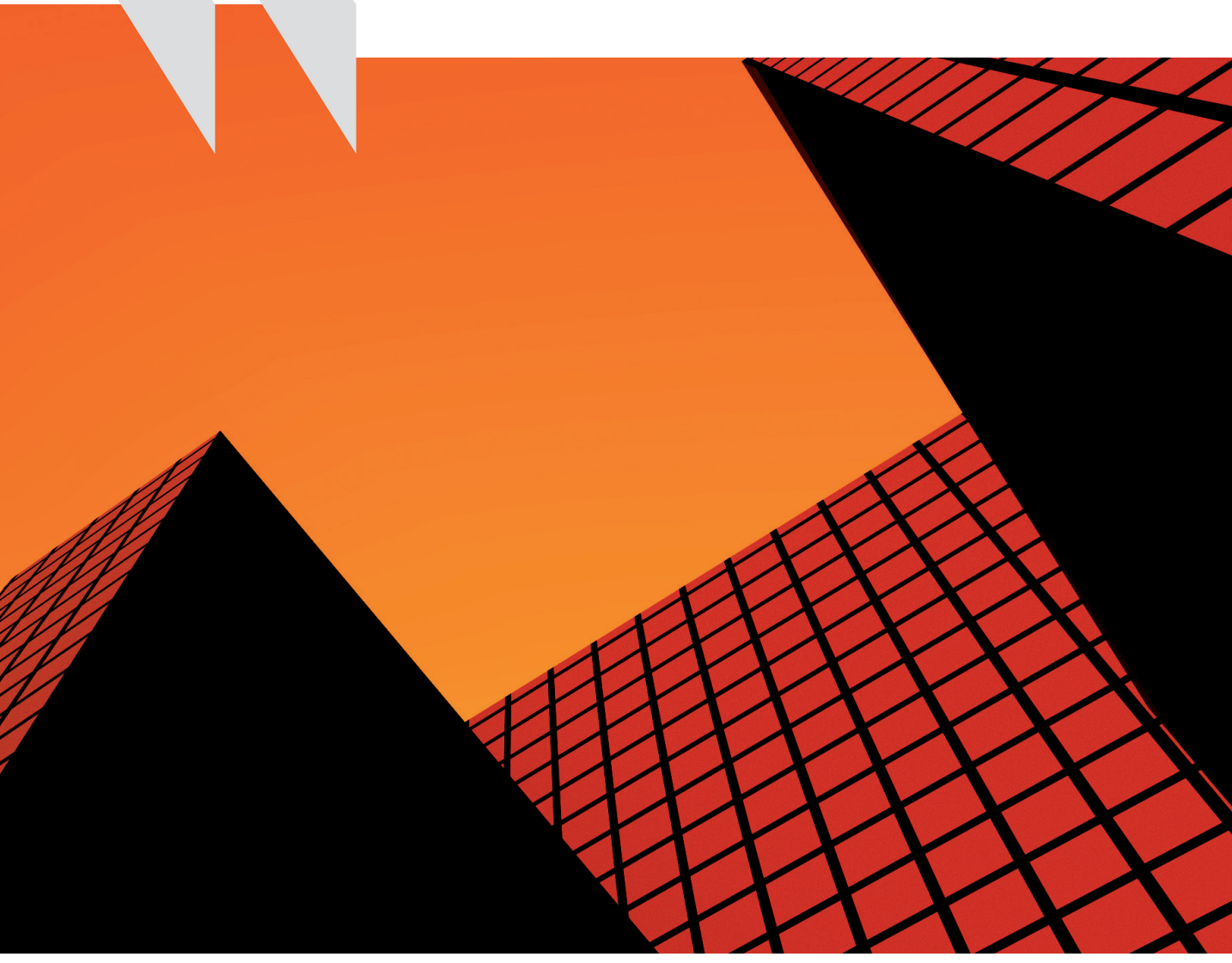
Corporate Governance

Accountability and Transparency

A GUIDE FOR STATE OWNERSHIP



OECD

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Foreword

State-owned enterprises (SOEs) play an important role in the ownership landscape and in global markets. How well these state-owned enterprises are governed will have a significant impact on their performance and value, as well as on public finances, economic growth and competitiveness.

Governments face complex challenges in improving the governance of state-owned enterprises. To help governments face these challenges, the OECD adopted in 2005 the OECD Guidelines on Corporate Governance of State-Owned Enterprises *(www.oecd.org/daf/corporate-affairs/soe/guidelines). These Guidelines have been widely endorsed and warmly welcomed by OECD and non-OECD governments. They now serve as a global benchmark for countries introducing governance reforms in the state-owned sector. Regional networks in Asia and Africa are discussing how to implement the Guidelines in their specific contexts. A Global Network was launched in 2008 to share experiences and provide a means for better understanding of emerging new issues and trends in state ownership, and review priorities and approaches for implementing the Guidelines.*

One priority in implementing the OECD Guidelines is to ensure a high quality of transparency and accountability. These are the very basis of any sound corporate governance regime and a central recommendation of the OECD Guidelines. Ensuring transparency and accountability gives substance to shareholders' rights by providing the information essential to their exercise. They are the remedy of choice for fraud and market manipulation. Finally, they are the prerequisites and underpin public trust. Transparency and accountability entail complex challenges but are efficient entry points for further reforms, as they are politically feasible, suitable for gradual implementation and effective in mobilizing support for further reform.

This Guide is intended to facilitate the practical implementation of the OECD Guidelines in the area of transparency and accountability. It aims to help evaluate existing practices and support reforms. It provides viable policy-options and a "roadmap" of the practical steps that might be taken to implement the Guidelines, pointing at typical difficulties, risks and hurdles that may be encountered during the implementation process. It also provides examples of good practices that illustrate the implementation of provisions and can serve as references and inspiration to governments that are confronted with similar challenges. The OECD will use this Guide to continue to promote good governance of SOEs through policy dialogue with OECD and non-OECD countries.

This Guide has been developed by and is published under the authority of the OECD Working Group on Privatisation and Corporate Governance of State-Owned Assets. It benefited from discussions with representatives from the TUAC (Trade Union Advisory Committee to the OECD) and BIAC (Business and Industry Advisory Committee). It also benefited greatly from public consultations and consultations with experts, SOE directors and senior executives, as well as policy makers from a number of non-OECD economies, within the framework of the Global Network on Corporate Governance of SOEs which was launched this year.

Note to the Reader

by

Lars-Johan Cederlund,
Chair of the OECD Working Group on Privatisation and
Corporate Governance of SOEs

Governments face complex challenges in improving the governance of state-owned enterprises. Having worked for the Swedish government handling state ownership for more than 15 years, I have firsthand experience as a practitioner on how the governments struggle to improve the governance of SOEs. One of the main challenges in doing so is to put in place appropriate accountability and transparency processes. It is only with such systems that the state as an owner will be able to act as an informed owner, without interfering in day-to-day management, two essential recommendations of the OECD Guidelines. The Swedish government, having been an advocate of reforms, has been able to appreciate how useful it is to put lights on the performance of SOEs and on how the state exercises its ownership function. Greater transparency is usually very effective in triggering further support for reforms.

After having driven the development and successful adoption of the OECD Guidelines, the Working Group has been positively surprised by the keen interest they received and by how much demand was raised to discuss and implement them in different economic, legal and political contexts. To face such a strong demand, we decided to develop some guidance on how to implement the Guidelines. The first topic which we thought would be the most relevant was transparency and disclosure… hence this Guide. What I think will be particularly useful for governments in this Guide are the policy options described in a very organised and systematic way, as well as specific examples provided to illustrate the more generic recommendations.

To develop this Guide, all members of the OECD *Working Group on Privatisation and Corporate Governance of State-Owned Assets* provided us with their country experience, sharing their successes as well as their difficulties. Their dedicated and collective expertise made this project a success. Appreciation should be given in particular to the group's bureau members, who have served as an active sounding board for successive drafts of this document, namely Mr. Morten Kallevig, Mr. Pekka Timonen, Mr. Arto Honkaniemi, Ms. Lucie Muniesa, Mr. Aimilios Stasinakis, Mr. Kyung-Ho Choo and Mr. Petr Musil.

The OECD's advisory bodies, the Business and Industry Advisory Committee (BIAC) and the Trade Union Advisory Committee (TUAC) participated in the process and provided invaluable inputs. The Global Corporate Governance Forum and the World Bank have also made essential contributions to this work, and our joint projects in non-OECD regions,

including Asia and Africa, have allowed us to fine tune our thoughts with regards to how to implement the OECD Guidelines in often weaker institutional environments. In this regard, I would like to give special thanks to all officials, experts and practitioners from around the world who participated in our consultation within the framework of the OECD Global Network in Paris in March 2008. Among these, Mr. John Lim, Chair of the Asia SOE Network, deserves a special appreciation for leading our work in Asia. But all other participants (see list in Annex B) provided us with relevant comments and useful suggestions on how to improve the Guide and make it fully relevant for governments around the globe. In addition, the work has benefited from comments and inputs from experts from the African Development Bank, the Asia Development Bank and the INTOSAI (International Organisation of State Audit Institutions)'s Working Group on Privatisation.

A final thank to Ms. Mathilde Mesnard, Economist in the Corporate Affairs Division, who has served the Working Group since the development of the OECD Guidelines and developed the various drafts of this Guide under the supervision of Mr. Mats Isaksson, Head of Division.

Paris, 30 September 2008,



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Chapter 1

Setting Objectives

Accountability requires benchmarking performance against clearly defined objectives. The fist step is thus to define objectives at different levels: firstly, for the state as an owner, with the "ownership policy" for high-level and long-term objectives and then specific yearly targets; secondly, for the SOEs themselves, with their high-level mandates, then their yearly objectives with specific performance indicators. This chapter will cover how to develop an ownership policy for the state as an owner, then how to develop specific yearly targets for the state ownership entity(ies). It will also describe how to define and review SOEs' mandates, i.e. *simple and brief descriptions of the high-level objectives and missions of the individual SOEs in the long run. It will then discuss how to identify SOEs' public services and other special obligations, decide on their relevance, evaluate their cost and fund them transparently, which is a fundamental prerequisite to decide on SOEs' objectives and targets. Finally, it will review how to develop an objective documents and specific performance indicators for individual SOEs.*

1.1. Overview

Accountability requires benchmarking of performance against clearly defined objectives. Since state ownership is often characterised by vague, complex or contradictory objectives, improvement in this area is typically the very first step towards better accountability. This chapter provides guidance on how to formulate and communicate clear objectives at all relevant levels. It also gives suggestions on how to build up useful performance indicators for benchmarking performance against these objectives.

At the most aggregate level, the government should define its overall objectives and ownership practices. An effective way of doing this is by developing an **ownership policy**, as recommended in the Guidelines (Guideline II.A): "*The government should develop and issue an ownership policy that defines the overall objectives of state ownership, the state's role in the corporate governance of SOEs, and how it will implement its ownership policy.*"

An ownership policy has a number of advantages:

- It helps governments to avoid the usual pitfalls of passive ownership and excessive interference, which often follow from multiple and contradictory objectives: "*It is often the multiple and contradictory objectives of state ownership that lead to either a very passive conduct of ownership functions, or conversely results in the state's excessive intervention in matters or decisions which should be left to the company and its governance organs*" (Annotations, p. 23).
- The ownership policy also serves as an effective tool for public communication and provides companies, the market and the general public with a clear understanding of the state's objectives as an owner and its long-term commitments. It thus helps the state to clearly position itself as a predictable and long-term owner.

Based on the general objectives that are formulated in the ownership policy, it is useful to identify more specific **targets for the ownership entity**. This step should aim at "operationalising" the objectives formulated in the ownership policy. Doing this also allows communication and evaluation of the ownership entity's performance, as called for in Guideline II.E: "*The ownership entity should report on its performance in exercising state ownership and in achieving the state objectives in this regard*" (Annotations p. 27).

In fully owned companies, the state should also **define and review the company mandate**. This mandate is intended to be valid over a long period of time and updated only in the event of fundamental change of the company's overall mission.

Based on their overall mandate, the companies should also be given a set of **company-specific objectives and targets.** These objectives and targets will help at the operational level and provide board members with important guidance (Guideline VI.A): "*SOE boards should carry out their functions of monitoring of management and strategic guidance, subject to the objectives set by the government and the ownership entity.*"

When the company is not fully state-owned and listed, the task of formulating the mandate, company-specific objectives and targets differs significantly. The process and framework for objective setting is different and primarily exercised through participation in the annual meeting.

When the Guide discusses objective setting at the company level, the distinction between different kinds of companies will be made whenever relevant.

When formulating company-specific objectives, it is essential to clearly **identify any public services and other special obligations.** The Guidelines recognise that such "*obligations and responsibilities that an SOE is required to undertake in terms of public services beyond the generally accepted norm*" do exist in many cases. The Guidelines therefore have three important requirements: firstly, that such special obligations are "clearly mandated by laws or regulations"; secondly, that they are "disclosed to the general public"; and finally, that their "related costs (are) covered in a transparent manner" (Guideline I.C). It is also required to disclose "*any financial assistance, including guarantee, received from the state*" (Guideline V.E.4). Effective implementation of these Guidelines is essential to ensure a level playing field between the state and the private sector. To fulfil these requirements, a specific work of mapping, *i.e.* identifying these "special obligations" has to be performed. In addition, the cost of these obligations needs to be evaluated, along with their sources of funding.

Besides identifying special obligations, another central but technical difficulty is to **develop relevant performance indicators**. This is not specific to SOEs, and a lot of work and guidance is available in this regard both for private sector companies and for the public sector in general. As it is at the core of defining SOE objectives, some useful guidance might be provided and this topic will be covered in a specific session.

These topics will be covered in the following pages. For each topic, guidance will be provided on possible processes to fulfill these tasks and on specific steps which could be undertaken by the state as an owner to ensure appropriate implementation of the Guidelines in this area. Distinction between partially and fully owned SOEs will be made when necessary.

1.2. Developing an ownership policy

The ownership policy should be a short but high-level policy document providing **a clear statement of the state's overall objectives as an owner and** summarizing the most important elements of all other documents related to the state's overall objectives and strategy *vis-à-vis* SOEs. Box 1.1 below provides examples of how these general objectives have been formulated in different countries.

In addition to stating the overall objectives, it is useful if the ownership policy also defines (see Box 1.2 for the Norwegian example):

- **The mandate given to the ownership entity** in exercising the state ownership rights.
- The **main functions** fulfilled by the ownership entity(ies).
- The **organisation of the ownership function** within the state administration and its evolution.
- The **main principles followed or policies implemented** by the ownership entity regarding the exercise of ownership rights. Issues covered could include directions on the nomination of SOE boards, the role of general meetings, the role and functioning of boards, the appointment of external auditors, the remuneration of management, etc.

It is also useful for the ownership policy to include a brief overview of provisions that aim at ensuring a level playing field with the private sector.

In order to document the different elements that influence ownership policy, it could also provide a **summary of the main reference documents** that define or frame the exercise of ownership rights by the state. Examples of such useful references include:

- Specific provisions of the Constitution, relevant Parliament acts, specific laws, including the Company Act, resolutions and regulatory documents, defining the respective roles and

Box 1.1. **Examples of ownership objectives**

- In Sweden, "The Government's overall objective is creating value for the owners" (*State Ownership Policy*, 2006).
- In France, the overall objective is "to contribute to a better valorisation of state shares in SOE". (*Loi Organique sur les Lois de Finance* (LOLF), 2006, p. 131).
- In the UK, the overall objective of the Shareholder Executive is "to ensure that Government's shareholdings deliver sustained, positive returns and return their cost of capital over time within the policy, regulatory and customer parameters set by Government, by acting as an effective and intelligent shareholder".
- In Finland, the core purpose of state ownership is defined as follows: "The State seeks to achieve an economic and societal overall result that is as good as possible" (*2004 Decision in Principle on State's Corporate Ownership Policy)*. What this means in practice is then clarified: "The economic overall result is the sum of the development in value of the shares owned and their annual dividend yield" (*State Shareholdings in Finland*, 2005, p. 4).
- In Norway, "The purpose of state ownership is to attend to the common good. As an owner, the State also expects these companies to take corporate responsibility and to uphold our basic values in an exemplary manner" (*The State Ownership Report,* 2005, p. 5).

Source: 10 Challenges in Setting Objectives and Reviewing Performance of State Owned Enterprises, OECD, 2007.

Overarching goals of state ownership in New Zealand

In New Zealand, the long-term hold policy has four overarching goals:

- to be clearer with SOE boards about shareholding ministers' expectations of the companies;
- to provide shareholding ministers with a greater understanding of, and therefore confidence in, the performance of SOEs, through enhanced benchmarking;
- to develop appropriate capital structures which impose financial disciplines on SOEs while ensuring they have sufficient capital to make operational investment decisions without recourse to the Crown; and
- to ensure that requests for capital are considered in line with the business needs of the SOE, while recognizing the Crown's preference that major investments are considered relative to other demands for capital across the Crown by incorporating SOE requests for equity for significant investments into the normal budget process.

Source: CCMAU, "*Owner's Expectations Manual for State-Owned Enterprises*", 29 October 2007.

explaining the delegation of authority among the Parliament, the government, the ownership entity, the SOE boards, etc.

- Non-binding principles or codes that the government wants to adhere to, including internationally recognised standards, such as the OECD Guidelines and the OECD Principles.
- A list of all the statutory laws dealing with specific SOEs.
- Focused guidelines adopted by the ownership entity on specific aspects of ownership supervision.

Developing an ownership policy is often an iterative process that may involve several parties and consultations. If successful an appropriate degree of inclusiveness will improve the relevance and credibility of the document.

Box 1.2. **Example of the content of an ownership policy in Norway**

1. FOREWORD

2. THE GOVERNMENT'S OBJECTIVES FOR STATE OWNERSHIP

- 2.1. Scope
- 2.2. The Soria Loria Declaration
- 2.3. A national base
- 2.4. Ensuring national ownership and control of and revenues from our natural resources
- 2.5. Securing other important political goals

3. THE STATE'S EXPECTATIONS OF THE COMPANIES

- 3.1. Important sector-independent considerations that companies must take into account
- 3.2. Division into categories
- 3.3. objectives for the ownership of the individual companies

4. REQUIREMENTS OF THE COMPANIES

- 4.1. Companies with commercial objectives – required rate of return
- 4.2. The capital asset pricing model
- 4.3. Companies with sectoral policy goals
- 4.4. Dividend
- 4.5. Repurchase of shares
- 4.6. The companies' reporting

5. THE GOVERNMENT'S POLICY ON THE REMUNERATION OF LEADING PERSONNEL

6. THE DIVISION OF ROBLES IN THE STATE ADMINISTRATION

- 6.1. The purpose of distinguishing between roles
- 6.2. On the administration of ownership in the individual ministries

7. THE FRAMEWORK FOR THE STATE'S ADMINISTRATION OF ITS OWNERSHIP

- 7.1. The constitutional framework
- 7.2. Companies legislation
- 7.3. Equal treatment with respect to information and rules for inside information
- 7.4. Public subsidies
- 7.5. Freedom of information
- 7.6. The state's financial management regulations
- 7.7. Corporate governance principles
- 7.8. Transparency about ownership and predictability

8. THE RELATIONSHIP BETWEEN THE BOARD OF DIRECTORS, THE MANAGEMENT AND THE SHAREHOLDERS

- 8.1. Contact with companies
- 8.2. The board of directors' responsibilities
- 8.3. The election of the board of directors
- 8.4. Period of office and remuneration

9. APPENDIX

10. REFERENCES

Source: The *Government's Ownership Policy*, Norwegian Ministry of Trade and Industry, 2006.

While a long-term document, the ownership policy should nevertheless, when necessary, be reviewed and updated. This could be considered as reviewing the overall ownership mandate, similar to mandate reviews made for individual SOEs.

The following table presents the main steps in developing an ownership policy:

Table 1.1. **Main steps in developing an ownership policy**

Main steps	Brief description
Survey existing documents	In order to develop an ownership policy, the ownership entity could first **survey existing documents**, including legal or regulatory texts, official declarations, internal policies, codes, etc., related to the exercise of ownership rights. The ownership entity should also review the effective implementation of these provisions.
Receive directions from the government	The ownership entity could also **receive directions** from the government on the ownership objectives. This is particularly the case where there is a change in government or a change in overall governmental policy.
Develop a draft document	Based on instructions received from the government and existing relevant documents, the ownership entity could develop a draft document for discussion, summarizing the main elements of existing policies or practices and **identifying potential main elements to be included in the ownership policy**. This draft document should also allow identification of areas where there are some contradictions among existing documents, or where there is a need for clarification in terms of specific objectives.
Consultation with all concerned parties	The ownership entity should consult with all concerned government entities and discuss actively the main elements of the ownership policy. This could be done, for example, through a specific Working Group comprising representatives from the ownership entity, the relevant Parliamentary committees, other concerned ministries, the state audit institution, relevant regulators, etc. The objective is to ensure broad understanding and support by all concerned entities on general objectives and practices of the state as an owner, and thus on the functions and responsibilities of the ownership entity.
Consult broadly and early	It could be fruitful to **consult** even more broadly with selected board members and management of SOEs, and even to integrate them into the Working Group. In the same vein, representatives from the private sector, including investors and market service providers, as well as representatives from the trade unions could be included early in the consultation process. This would increase the level of acceptance of this ownership policy by key stakeholders and market participants. More generally, making appropriate use of public consultation will be instrumental in testing the market and political reaction.

Table 1.1. **Main steps in developing an ownership policy** *(cont.)*

Main steps	Brief description
Obtain and demonstrate high-level political approval	If the ownership policy was not initiated at the political level, it is important, as it is further developed, to **get and demonstrate high-level political approval**. This is especially the case when no clear instructions from the government had been received prior to the development of the draft ownership policy. Clear and high-level political approval will reinforce the credibility of state ownership policy and position the state as a predictable owner. This high-level political approval could be provided through an introduction or foreword signed by the minister in charge of state ownership or the prime minister. Another way is to organise a high-level political event to "launch" the ownership policy with the participation of appropriate ministers, inviting all relevant stakeholders including market participants and ensuring adequate press coverage.
Endorsement by relevant public servants	To make the ownership policy even more credible, it could also be **endorsed by relevant public servants**, particularly the ones working for the ownership entity. Official endorsement by civil servants will strengthen the state's credibility in "walking the talk", thus in implementing effectively its announced policy.
Public disclosure	Another key aspect of the ownership policy is its **public disclosure**. "The ownership policy and associated company objectives should be public documents accessible to the general public and widely circulated amongst the relevant ministries, agencies, SOE boards, management and the legislature" (Guidelines Annotations, p. 24). To ensure large public disclosure, the ownership policy could be: ● Launched in a high-level public event largely covered by the media. ● Posted on the ownership entity website. ● Included in the Aggregate Annual Reports, at least for its most important elements. ● And printed copies could be sent to all relevant government organs, SOE boards and management as well as market participants.
Adapt if needed, keeping core elements stable	SOEs face continuing changes in their economic, market and in some cases political environment. The state as an owner will thus need to **adapt** its ownership policy on a regular basis. However, the main elements should be as stable as possible and not subject to frequent changes. The objective is to give a clear picture of the behaviour of the state as an owner, and one important aspect of this is to bolster the perception that it is a predictable owner. Consequently, "*the state should strive to be consistent in its ownership policy and avoid modifying the overall objectives too often*" (Annotation, p. 23).

1.3. Setting specific targets for the ownership entity

Targets for the ownership entity should consist of a limited number of objectives that will allow assessing its performance in executing the state's ownership policy.

These targets have to be agreed by the ownership entity and the entities or institutions to which it reports. The process for formulating them may vary depending on the institutional setting and the organisation of the ownership function. For example, the ownership entity might propose a series of targets for approval either by the relevant Parliamentary committee, or the relevant ministry. Regardless of the exact process it is essential that all institutions that have a say *ex post* in evaluating the ownership entity's performance be included somehow in discussing its objectives *ex ante*. This may include the Parliament, relevant ministries, state audit agencies, etc.

Targets could be both quantitative and qualitative. An important part of the ownership entities' work is process-driven, and dependent on the quality of the relationship it manages to establish with SOEs and their boards. Qualitative targets could therefore relate to their ability to retrieve and process adequate and timely information and feedback on SOE performance. Other targets could cover the quality of SOE boards and the ownership entity's performance in the board nomination process. The ownership entity could also be held accountable for the effective implementation by SOEs of specific governance instruments or codes, etc. (compare Box 1.3).

Box 1.3. **Implementation of the "Charter on Relationships Between SOEs and the State Shareholder" in France**

The ownership entity in France, the APE (Agence des Participations d'État) has developed a "Charter on relationships between SOEs and the state shareholder". The APE follows each year how effectively this charter is implemented, based on a specific evaluation done by APE representatives in SOE boards. The APE comments on the results of this evaluation each year in its annual report.

An improvement in the implementation of the Charter is one of the objectives of the APE. This is a qualitative objective. The evaluation gives rise to percentages of a "targeted" full implementation, as it evaluates to which point specific processes have been put in place. These processes cover, for example, the competencies of the boards, the quality and effective functioning of the audit and strategy committees and the general relationship with the APE.

Using this evaluation as a basis for evaluating the performance of the APE might, however, be slightly biased. It is based on an evaluation done by some APE executives nominated in SOE boards. Consequently, it might be considered as an indirect self-evaluation. Nevertheless, this constitutes an evaluation of how the processes decided by the ownership entity regarding the governance of SOEs are effectively implemented.

There is an increased focus on quantitative and financial targets covering the whole state portfolio (see Box 1.4). In order to measure performance in this respect it can be useful to identify a number of different indicators, which will be computed for the overall state portfolio or a significant portion of the portfolio (for example, the publicly traded SOEs if these represent the bulk of SOEs in terms of value). These indicators would include financial indicators, such as operational and financial profitability, debt-ratio and sustainable dividend levels.

In order to make sure that the indicators actually reflect the performance of the ownership entity rather than the SOE performance and the economic and business environment, it is important that appropriate benchmarking with market performance be provided.

Box 1.4. **Specific indicators to assess performance of state ownership in France**

Objective 1: Ensure the increase in State shares' value.

- Indicator 1: Operational profitability of capital (operational result/assets).
- Indicator 2: Financial profitability (net result/equity).
- Indicator 3: Operational margin (operational results/turnover).
- Indicator 4: Indebtedness sustainability (EBITDA/net debt).

Objective 2: Ensure the success of selling transactions.

- Indicator 1: Difference between receipts from sales and intrinsic or stock values of sold shares (based on valuations made by the Commission on Participations and Transfers).
- Indicator 2: Level of fees and commissions paid to advisers.

Objective 3: Contribute to the decrease in state debt.

- Indicator 1: Decrease in debt and interest charges of entities in public administration except the state.
- Indicator 2: Decrease in debt and interest charges of the state.

Another useful target is the combined value of the state SOE portfolio, which is used in a growing number of countries. Changes in the value of the state portfolio could be reported and commented on in an annual report. When defining value targets there are several options:

- An aggregate **unique target** to increase the value of the total state portfolio or of a significant portion of it by a certain per cent over a specified time. This option is appealing in terms of simplicity and as an efficient communication tool. However, it has some inherent limitations (compare Box 1.5). The overall increase in value might be highly dependent on the performance of a single company and heavily influenced by factors other than the performance of the ownership entity.
- Sub-targets for the most important SOEs in addition to an overall portfolio target. The objective would be to achieve at least a portion of these sub-targets, with appropriate weight in place to reflect the significance of the different SOEs in the overall state portfolio.

When using value as a target, the economic value-added concept (EVA) could be a useful tool for calculating the change in value of the state portfolio. Economic value added is an absolute measure that allows accounting for the cost of capital and risk. This gives a good idea of the scale of value creation. It is well-established, widely used and applicable to a wide range of industries consistently (see Box 2.8 in Chapter 2).

Whatever the targets chosen, they will always represent imperfectly the real performance of the ownership entity. When discussing targets, the ownership entities and other institutions involved should thus strive to focus on their relevance, ensuring that they have a close link with the overall objective of state ownership, and building them so that they effectively reflect the performance of the ownership entity, with due consideration for market and business environment.

Box 1.5. **Case Study: Pros and cons of a unique target for the ownership entity in the UK**

The advantages of a unique target

The Shareholder Executive agreed on a specific and quantified objective to increase the value of six main businesses in the government's portfolio, representing 76% of total sales in its overall portfolio: "*To increase by £1 billion in the three years to 2007 the value of the core portfolio of businesses owned by government, within a framework of clearly defined policy, customer and regulatory objectives*" (a).

This quantitative and clear-cut objective allows improved communication about meaningful targets. It is considered an important "educational" tool to highlight the concept of value creation and focus on it. It is also instrumental in making SOEs and the general public understand that capital is not free. "*The target will help embed the concept of managing the businesses for value in the government's objectives*" (a). "*The Executive's target (…) has brought greater attention to shareholder value within public businesses*."

Critics of the unique target by the National Audit Office

"*Going forward, however, there are limitations with the target that will need to be addressed. It is difficult to link the achievement of the target with the Executive's own performance in managing the shareholding on behalf of the government. Furthermore, the earnings of these target businesses can potentially be volatile and the performance of a single one can have a decisive influence on whether or not the financial target is achieved. Continuing with a single, portfolio-level target alone is, therefore, inappropriate.*"

The Shareholder Executive should set individual business-level targets alongside with aggregate portfolio-level targets. These targets must take into account the challenges facing each individual business. "*The Executive could be required to meet an overall portfolio-level target which could be broken into a series of individual business-level targets… The Executive would, over a given reporting period, have to meet a certain proportion of these business-level targets – suitably weighted towards the larger businesses to avoid a loss of focus on overall value.*"

Critics of the unique target by the Committee of Public Accounts

"The target of increasing the value of six of its 27 businesses by £I billion is not an adequate test of the Executive's effectiveness. One or two large businesses, potentially affected by market conditions, can influence whether the Executive meets its target, regardless of the Executive's underlying performance. Its performance management regime needs to include wider measures that are based on the results of individual businesses, alongside an aggregated portfolio-level target."

Source: "The Shareholder Executive and Public Sector Businesses", National Audit Office, 28 February 2007/House of Commons, Committee of Public Accounts, "*The Shareholder Executive and Public Sector Businesses*", 27 June 2007.

The following table describes main steps in setting specific targets for the ownership entity:

Table 1.2. **Main steps in setting specific targets for the ownership entity**

Main steps	Brief description
Identifying potential targets	A useful step for the ownership entity is to identify a large series of potential targets which could reflect/correspond to the overall objectives of the ownership entity in exercising the state's ownership rights, as described in the ownership policy. If such objective is value creation, one obvious target is the increase in the value of the state portfolio, or a series of specific increases in the values of each or the main SOEs. Other potential targets at the aggregate portfolio level are usual financial indicators such as profitability, indebtedness, dividend distribution, etc. More qualitative targets could also be considered, based for example on the processes that the ownership entity puts in place to exercise efficiently its ownership rights. Targets could cover how effectively the recommended processes are implemented. The overall set of targets should, of course, remain outcome-oriented and not too heavily process-based. Besides reflecting the overall objectives as described by the ownership entity, targets must reflect as far as possible the performance of the ownership entity itself in exercising the state's ownership rights. Obviously, a number of overall targets will also reflect other conditions, such as the performance of SOE management, the overall or sector specific economic or market environment, etc. In this case, targets should take into account the overall market, business and general economic environment and conditions.
Checking target's characteristics	Selecting meaningful targets to reflect the global performance of the ownership entity is complex, involving multiple challenges. In addition to reflecting the performance of the ownership entity, targets should have the following characteristics: ● Be specific enough and time bound. ● Be measurable, possibly at the portfolio level. This will in many cases entail some significant aggregation difficulties (see below). ● Be at the same time realistic and challenging, in order to play a positive incentive/motivational role. Additional guidance on selecting appropriate targets and performance indicators is provided in Section 1.7. Having looked at all the potential targets under these different perspectives, the ownership entity might select a number of appropriate targets.

Table 1.2. **Main steps in setting specific targets for the ownership entity** *(cont.)*

Main steps	Brief description
Select an appropriate mix	There is a trade-off to be made regarding the number of targets. In addition to the usual difficulties encountered in specifying targets for a complex organisation such as a business corporation, SOEs could have a more complex set of objectives, involving commercial as well as policy ones, including public services and other special obligations as discussed in Section 1.5. Moreover, the state as an owner may have another complex set of objectives, and setting targets at the portfolio level might entail specific size/aggregation effects. Having multiple targets might give a more complete perspective on the performance of the state as an owner. However, having a **limited number of well-selected overall targets** will make it easier to communicate and report on them and may be useful in enhancing strategic focus. There is a balance to be found between completeness and focus.
Consider aggregation challenges	Besides the difficulties in selecting meaningful indicators, there are also a number of more technical difficulties in computing aggregate indicators for the overall state portfolio, which tends to be well diversified. Attention should also be brought to the weight that one or several large SOEs' results might have on the overall performance of the state portfolio.
Test targets on past performance	Before agreeing on a final set of targets, it could be useful to test them on past performance and check if their achievement would have appropriately reflected performance based on similar objectives.
Discuss targets internally and externally	To be effective in terms of motivation, targets have to be adhered to, thus considered to be relevant and fair. It could therefore be useful to discuss widely the set of targets internally to the ownership entity in order to figure out more realistically the impacts they might have on the individual civil servants' motivation and behavior. In the same vein, it could be useful to discuss potential targets for the ownership entity with SOEs' boards and management, to figure more clearly the impact they might also have at SOE level.
Agree on targets with government and other relevant institutions	It is also necessary to agree on the ownership entity's targets with all the institutions to which the ownership reports or which will be involved one way or the other in assessing its performance. This might include supervising ministries, the government, the relevant Parliamentary committees and the state audit institution. This agreement on targets might be instrumental in ensuring that targets do cover all the important dimensions of the ownership entity's performance, and are set at an appropriate level. This *ex ante* dialogue will also ensure a smoother review of performance *ex post* and align expectations regarding the ownership entity's performance. Final targets should be clearly and formally agreed between the ownership entity and the government. It might also be advisable that relevant Parliamentary commissions clearly adhere to the agreed upon set of targets for the ownership entity.

Table 1.2. **Main steps in setting specific targets for the ownership entity** *(cont.)*

Main steps	Brief description
Disclose overall targets	The overall targets of the ownership entities, as agreed with the government, should be clearly disclosed. This will include a clear indication on the ownership website, a reference to the initial targets in the aggregate reports and regular communication during the year by the ownership entity.

1.4. Defining and reviewing SOE mandates

SOE mandates are simple and brief descriptions of the high-level objectives and missions of an SOE in the long run. SOE mandates might be described in their articles of association or relevant statutory laws. SOE mandates are relevant mostly in the case of fully owned SOEs. In the case of partially owned SOEs, the state might not be in a position to formally "mandate" the SOE to achieve specific objectives or fulfill missions. It might give some direction, but as a significant shareholder and through the usual mechanisms of shareholder "voice". This section thus concerns mostly fully owned SOEs.

SOE mandates usually define the main line of business. They also provide some generic indication regarding the ambition in terms of market leadership, quality of service or innovation (see Box 1.6). They could also set some broad goals or constraints in terms of financial sustainability and sometimes include some form of public services and social obligations or commitments, such as relates to employment issues. SOE mandates thus quite often clearly show a mix of commercial and policy objectives.

Box 1.6. **Examples of mandates or overall objectives for similar soes (post) in different OECD countries**

Canada Post Corporation/Canada. Mandate: To operate Canada's postal service on a self-sustaining basis with a standard of service that meets the needs of Canadians. Vision: To be a world leader in providing innovative physical and electronic delivery solutions, creating value for customers, employees and all Canadians (*Crown Corporations Annual Report to Parliament,* 2005, p. 161).

Posten Norge AS/Norway. Norway Post aims to fulfil its societal and operational obligations in a sound, cost-effective manner, and with these parameters effectively administer the state's assets and promote good commercial growth of the company (*The State Ownership Report,* 2005, p. 81).

Posti/Finland. The group aims to develop its business towards integrated information and material flow management, enabling versatile messaging and logistics solutions (*State Shareholding in Finland*, 2004, p. 22).

Posten AB/Sweden. Posten's profitability target is 10 per cent of net profit in relation to average shareholders' equity, assuming an equity/assets ratio of 25% (*Annual Report State-Owned Companies,* 2004, p. 61).

Royal Mail/UK. Vision: To ensure the universal provision of postal services in the UK. Within that to ensure a publicly owned Royal Mail Group, fully restored to good health, providing excellent quality service to customers and rewarding employment to its people. Objectives: Royal Mail to be best in class postal service provider with robust long-term, sustainable business health. The delivery of government and other services effectively through an efficient and fit-for-purpose Post Office RO branch network. (*Annual Report 2004-2005*, Shareholder Executive, p. 47).

These mandates or missions are valid over a long period and are updated only in case of fundamental change of mission (see Box 1.7).

Box 1.7. **Description of a mandate review**

In its 2000 report, the Auditor-General of Canada noted that "only two Crown corporations had been subject to mandatory and systematic mandate reviews. Other carried out such reviews on a generally *ad hoc* basis, and many reviews did not engage the Treasury Board, the responsible minister, and Parliament or address all significant issues." The report thus recommended the government to develop guidelines for conducting mandate reviews.

In its 2005 review of progress made, the Auditor-General shows that "Crown corporations that undergo mandate reviews are still the exception, and the reviews are still usually carried out on an *ad hoc* basis" and that no guidelines have been developed.

The 2004 report to Parliament commented on an example of a company having changed its activities without adequate and corresponding mandate review.

Defining clearly the mandate of each (fully owned) SOE is necessary to build up appropriate accountability, to define and limit the scope of public services or other special obligations and as a basis for discussing more specific targets for the company's operations.

These mandates and overall objectives should be disclosed, as asked for in the Guideline V.E.1: "*SOEs should disclose material information on all matters described in the OECD Principles of Corporate Governance and in addition focus on areas of significant concern for the state as an owner and the general public. Examples of such information include: a clear statement to the public of the company objectives and their fulfillment.*"

Table 1.3. **The main steps in defining and reviewing SOE mandates**

Main steps	Brief description
Checking existing documents	A first step to clearly define SOE mandates is to **check existing legal documents** which either define the missions of SOEs or provide the general framework to do so.
Drafting the mandate	Based on these legal documents, the ownership entity could work out an **appropriate formulation** or redefinition of fully owned SOEs' mandates. The SOEs themselves may provide the ownership entity with drafts of their mandates, especially when there are a large number of small SOEs. It should, however, remain the prerogative of the ownership entity to establish the final mandates and ensure that they are in line with state overall objectives. Regardless of the process, the mandate clarification or formulation should include an appropriate discussion with the SOE chair and should be discussed by the SOE board to ensure a common understanding.

Table 1.3. **The main steps in defining and reviewing SOE mandates** *(cont.)*

Main steps	Brief description
Drafting a statement of priorities	SOE mandates should also give some clear indication of how to articulate the trade-offs between commercial and policy objectives. To do so, ownership entities could draft "**statements of priorities**" (see the example of Canada, Box 1.8). These documents serve, for a fixed period, to clarify the SOE mandate and potential conflicts on objectives, to inform the SOE on overall government strategic priorities and to ensure their implementation at the individual SOE level. They could be instrumental in ensuring mutual understanding between the ownership entity and the SOE board on a set of high-level expectations. They should also provide the framework for the development of more specific corporate plans.
Public disclosure	SOE broad mandates should be **publicly disclosed**. They should be posted on the individual SOEs' websites and clearly stated in their annual reports. They should also be integrated in the ownership entity's aggregate reports, at least in a summary form, in the section reporting on large individual SOEs. More specific documents such as "statements of priorities" or letters of agreement between the ownership entity and the board chair may remain undisclosed in cases involving commercially sensitive information.
Regular review	Mandates or broad objectives for each SOE will need to be **reviewed regularly** to maintain their relevance and consistency with the overall framework and economic environment. Boards and the Parliament should ensure that SOE mandates be kept relevant to the government's policy objectives (see the example of a call for Guidelines in Canada, Box 1.7). Mandate reviews could be done whenever a major change in the strategy, the market or political environment makes it necessary. Different types of mandate reviews could be done, varying in terms of depth, inclusiveness and costs: ● Some might be done internally, *i.e.* by the SOE and the ownership entity with limited public input. ● Others could be conducted by independent panels (appointed by the ownership entity) with full public input and contracted experts. ● In some rare cases relevant Parliamentary committees might carry out the mandate reviews. The choice between these different types of mandate reviews will be based on their relative advantages (in terms of depth and openness to public debate) and related costs. It is nevertheless necessary to ensure that these mandate reviews happen periodically and systematically to maintain the relevance of all SOEs' mandates, both as regards the corporation's operating environment and the government's policy objectives.

Table 1.3. **The main steps in defining and reviewing SOE mandates** *(cont.)*

Main steps	Brief description
Consultation with stakeholders concerned	Mandate reviews should be carried out by the ownership entity together with high-level officials from the SOE concerned. They should also review whether the SOE is doing what it is supposed to do and whether it needs to have new or changed objectives. In order to ensure that the mandate review will address all relevant issues, it is also good practice if the ownership entity engages in doing so with all **stakeholders concerned**, including the Parliament. Mandate reviews should be done in a transparent manner and their results reported to all concerned parties.

Box 1.8. **Example of a statement of priorities in Canada**

As a member of the International Trade Canada portfolio, EDC has a critical role to play in supporting the government's agenda. To that end, the minister of international trade has outlined for EDC the government's agenda in a statement of priorities. This statement, which follows on one of the measures announced in the report on Crown corporation governance, also articulates the minister's priorities for EDC.

EDC has been asked to support the government's international commerce agenda in the following priority areas:

- ***Securing Canada's Place in the US Market***.
- ***Developing Trade and Investment Links with China, India and Brazil***.

In addition, EDC has been asked to consider how it might expand the tools available for equity financing. Similarly, the government and EDC will consider how the corporation can assist Canadian business to develop promising technologies that will enhance Canada's position as an international technology and commercialization leader. Finally, the minister has asked that EDC make full use of its capital in support of these objectives, while at the same time continuing to manage its operations on a self-sustaining basis.

The business strategy that is presented in the corporate plan is aligned with these priorities, and will articulate how EDC can contribute to this agenda. As well, the business strategy will illustrate how EDC's continued co-operation with its government partners, both in the international trade portfolio and across the government of Canada, supports Canadian business. This collaboration is critical to ensure that Canadians get the full benefit of the suite of services provided by the government of Canada.

Source: EDC Corporate Plan Summary 2006-2010 (p. 13).

1.5. Identifying, costing and funding public services and other special obligations

The Guidelines recognise that "in some cases, SOEs are expected to fulfil special responsibilities and obligations for social and public policy purposes… (that) may go beyond the generally accepted norm for commercial activities" (Annotations Guideline I.C., p. 20).[1] The Guidelines require these obligations to be mandated by laws or regulations and disclosed to the general public. The related costs should be covered in a transparent manner and "any financial

assistance, including guarantee, received from the state" should be disclosed. The Guidelines' annotations also mention that compensation should be "structured in a way that avoids market distortion".[2]

It is important to clearly identify public services and other special obligations as they usually have a significant impact on SOEs' performance. Indeed, the cost of these "special obligations" might be high and they are often hidden or at least not easily identifiable. Disclosing "special obligations" should also increase transparency concerning various risk factors that the SOE may face. Clearly identifying "special obligations", costing them adequately and disclosing relevant information allows an informed public debate about their relevance, budgetary implications as well as distributional consequences.

This identification and costing of "special obligations" represents an important undertaking that requires time, method and a good deal of discussion and negotiation between the ownership entity, the SOEs themselves and in many cases also relevant stakeholders. It is, however, a necessary step to allow a clear discussion on SOE objectives and performance.

A preliminary exercise for the state as an owner is to agree on a definition of what constitutes a "special obligation". The one provided by the Guidelines ("*special responsibilities and obligations for social and public policy purposes… (that) may go beyond the generally accepted norm for commercial activities*") might need further elaboration to be operational in a specific country's economic and legal environment (see Box 1.9).

Box 1.9. **Definition of community service obligations in Australia**

"A Community Service Obligation arises when a government specifically requires a public enterprise to carry out activities relating to outputs or inputs which it would not elect to do on a commercial basis, and which the government does not require other businesses in the public or private sectors to generally undertake, or which it would only do commercially at higher prices."

Sources: "*Community Service Obligations: Some definitional, costing and funding issues*", 1994, Australian Industry Commission.

The ownership entity should then ask SOEs to identify existing "special obligations" based on the agreed definition.

SOEs should then provide information on the actual costs of existing "special obligations", based on a consistent methodology. It is necessary to develop a consistent approach to costing these "special obligations", as it will reduce inconsistencies in performance measures among SOEs, making benchmarking easier (see Box 1.10).

This mapping exercise is necessary to identify existing "special obligations". On this basis it is possible to have an informed discussion firstly between the Parliament and the ownership entity on the relevance of these "special obligations", and secondly between the ownership entity and the SOEs on their performance objectives. It is important to decide if the targeted objectives are still relevant. It is then necessary to take a step back and consider for each of these special obligations whether or not the objective could be achieved through other mechanisms having less impact in terms of market distortion or SOE efficiency, such as direct subsidies, procurements or regulatory

Box 1.10. **Methods for measuring the cost of "social obligations"**

There are four main methods to evaluate costs of "special obligations":

Marginal costs: Includes costs that increase as a result of increased production or service. In principle, short-run marginal costs should be used, as they do reflect the real opportunity cost of supplying the additional product or service. But there are a series of practical difficulties in estimating marginal costs, related for example to the treatment of common and joint costs, especially when the same enterprise produces a variety of goods or services, or to the determination of the appropriate marginal unit of production. The distinction between short-run and long-term marginal costs might also be difficult concerning depreciation, for example, or in cases where capacity is not in a long-run equilibrium. In addition, these marginal costs might vary significantly according to the demand level, not even mentioning issues related to congestion in some industries. These difficulties can make the estimation of marginal costs extremely costly and complex.

Fully distributed costs: The idea is to include average variable cost plus a mark-up to cover fixed costs. A practical way to achieve this is to distribute fully the total costs of the enterprise by allocating them to all its different products or services. There again a number of allocation methods could be used. Fully distributed costs are considered as "fair" but tend to overestimate costs. This method ignores the discrepancies that often exist between average and marginal costs in the case of infrastructure industries. It is appropriate when the cost functions approach constant returns to scale.

Avoidable costs: Includes all costs associated with an additional block of output, including variable and capital costs whenever additional capacity is required. Actual costs should be considered, even if they might differ from best practice. The evaluation also takes into consideration capacity utilization, with avoidable costs calculated at peak-load capacity to include capital costs incurred by the "additional" production or services deriving from the "special obligations". Avoidable costs increase with the size of the incremental level of output to be considered, as more capital costs might thus be considered as "avoidable". A distinction has thus to be made between short-run and long-run avoidable costs, the latter allowing incorporating additional capital costs. A related question arises with the estimation of capital costs and the appropriate rate of return to use for measuring the opportunity cost of capital. In some cases, a mark-up might also be added to avoidable costs to reflect a contribution to common costs.

Stand-alone costs: Costs incurred for producing an output in isolation. They by definition ignore economies of scale and scope. They result in significant over-estimation of the real cost of "special obligations".

Sources: "*Community Service Obligations: Some definitional, costing and funding issues*", 1994, Australian Industry Commission.

provisions. Discussion on funding mechanisms for these "special obligations" (as described below) could also lead to less distortive mechanisms.

In parallel to disclosing "special obligations" and related costs, the Guidelines also require disclosure of "any financial assistance, including guarantees, received from the state" (Guideline V.E.4). Dealing both with special obligations and special benefits or financial assistance is essential to ensure a "level playing field" with the private sector. It is also inferred from two other Guidelines, namely Guideline I.C, dealing with application of laws, and I.F, dealing with access to finance. This

may be done through the development and implementation of a "competitive neutrality principle" (see Box 1.11).

However, each step gives rise to some complex issues and trade-offs.[3]

Table 1.4. **Dealing with special obligations**

Main steps	Brief description
Agree on a definition of "special obligations"	Usually three main characteristics are required to qualify as a "special obligation": ● To be specifically required by the government. ● Not to be undertaken on the basis of a purely commercial decision. ● To achieve effectively a social or policy benefit. This still leaves a number of issues open and there is usually scope for interpretation when these criteria are applied to a practical case. Ambiguities will need to be solved, sometimes on a case-by-case basis. They relate for example to the following questions: Which directives from the government are to be considered? These directives have to be specific, explicit and public. They do not include general directives given to all companies in an industry or to all SOEs, or general regulatory directives. But they might include directives concerning inputs, including labour. What would be the decision of the SOE based on purely commercial grounds or, more appropriately, a commercial decision of a good corporate citizen? The answer is not necessarily clear-cut. For example, "special obligations" will not necessarily include all loss-making products or services, nor would it generally include corporate sponsorships or philanthropy. All can result from appropriate commercial decisions, based for example on marketing considerations or capacity utilization rationales. What constitutes an effective social or policy objective? This could include requirements aimed at fulfilling vertical equity objectives (such as targeting specific disadvantaged groups) or horizontal equity objectives (such as universal provision of services). "Special obligations" will thus typically include the requirement to provide a product or a service at an affordable or unified price below their effective cost, to grant specific price concessions to targeted groups for redistribution purposes, or to use specific inputs with constraints or conditions not applying to private sector firms.
Mapping existing "special obligations"	Based on the agreed upon definition, the ownership entity should, in co-operation with SOEs, map existing "special obligations". Agreement between the ownership entity and SOEs on what constitutes their "special obligations" is the first step towards ensuring an effective discussion on their objectives and performance (see the Public Service Agreements in Italy, Box 1.12).

Table 1.4. **Dealing with special obligations** *(cont.)*

Main steps	Brief description
	This is not a straightforward exercise and will in many cases require discussion, including with stakeholders. Some activities undertaken by SOEs might be considered as "special obligations" whereas they just result from traditions or established practices. The ownership entity might announce a timetable to complete the identification and review of "special obligations", providing an incentive for all concerned parties to complete the review process. A first step is for SOEs to submit to the ownership entity and related portfolio ministries a list of what they consider as "special obligations". The ownership entity then reviews the submissions and assesses which proposal will be accepted, *i.e.* fulfil all required criteria to qualify as a "special obligation". This review includes discussion with other concerned portfolio ministers. These latter might take the opportunity to evaluate the existing arrangements and review the specification and scope of these "special obligations". The government might also consider the extent to which these "special obligations" are still priorities within its policy and might decide in cases to discontinue some "special obligations". Appropriate consultation with stakeholders in this regard should take place, while avoiding giving rise to political bargaining. This is why a clear definition will need to be provided ahead of the process to provide a clear basis for the mapping exercise.
Evaluate costs of "special obligations"	Measuring the cost of "special obligations" is another complex but necessary exercise. It is trying to evaluate the opportunity cost of the resources used to fulfil these "special obligations". A commonly recommended method is "avoidable cost", as an approximation of marginal cost and a "practically achievable benchmark" (see Box 1.12). The ownership entity should ask each SOE to estimate the cost of its "special obligations", indicating which method has been used and providing enough information to justify the estimations. Alternatively, the ownership entity could mandate a costing methodology. In most cases, complexities arise and the method will have to be adapted on a case-by-case basis. Difficulties are linked especially to capacity levels with estimations being in principle based on peak-load capacity. Specific issues are also raised in industries characterised by long-run decreasing costs, which is often the case for SOEs in infrastructure industries.

Table 1.4. **Dealing with special obligations** *(cont.)*

Main steps	Brief description
	In practice, trade-offs will have to be made between precision and the time and resources used to evaluate these costs. The capacity of the accounting systems to disaggregate cost information has an impact on the precision and reliability of estimations. The difficulty of the exercise also depends on the clarity and precision of the directive received from the government, *i.e.* to which point they give rise to interpretation. Compromises will probably vary from one industry to another and criteria including administrative simplicity and efficiency implications will have to be considered. Therefore, an industry-by-industry approach to measuring the cost of "special obligations" could be developed. Where there are significant difficulties involved, such an exercise need not be undertaken every year, but could rather be undertaken every four or five years, with a simpler methodology adopted to roll forward the cost estimates in the intervening years.
Review existing obligations	Once existing special obligations and related costs have been identified, it is necessary to assess their relevance and effectiveness, in order to make an explicit political decision regarding these "special obligations". Such review would first aim at discussing whether the objectives are still relevant. It should also be assessed if the "special obligations" could be replaced by other mechanisms that would achieve the same objectives at a lesser cost, more effectively and/or without the same impact on market distortion and SOE efficiency. It could be the case that social objectives, for example, would be achieved more efficiently through a direct subsidy to the targeted population, procurement processes or other regulatory provisions. "Special obligations" must become the result of a rigorous process and explicit political and economic assessment, rather than a historic liability or "fait accompli".
Decide on funding mechanisms	The Guidelines recommend a transparent funding of "special obligations" to make their costs explicit. This allows an effective monitoring of SOE performance and an informed debate about their relevance. They also require that they be funded from the state budget, using mechanisms avoiding market distortions.

Table 1.4. **Dealing with special obligations** *(cont.)*

Main steps	Brief description
	Among different funding options, direct funding from the state budget provides the most transparency, makes the costs explicit and avoids distortions. It ensures that related costs be subject to public scrutiny and spreads the costs over all taxpayers.[4] It also creates the possibility for introducing competition between the SOE and alternative suppliers. In this case, the funding can go to a "purchasing ministry" which purchases the additional services that the SOE would not be able to provide on fully commercial terms. From the SOE perspective it turns the service provided from a non-commercial to a commercial one, with positive incentive-related consequences. From the ministry's perspective, it allows making the level of subsidisation needed to obtain certain societal objectives subject to a bidding process. Another common funding option, "accepting lower rates of returns",[5] seems equivalent to direct funding in terms of financial end-result, but basically takes the funding out of the budget process, so reduces accountability. Other funding options, such as levies on users, cash transfers or voucher systems, present different sets of pros and cons.[6] Cross-subsidies are to be avoided as they reduce transparency and as such might significantly impair public scrutiny over the relevance and cost of "special obligations". Moreover, they have negative efficiency effects and encourage cost-padding practices. They are only sustainable in a monopoly or non-competitive environment and so act as an impediment to competitive industry reform. In order to encourage more efficient delivery of "special obligations", consideration might be given to funding them on the basis of "best practice" instead of on real costs structures. Whenever possible, best practice cost levels should be established based on industry and/or international benchmarks. In order to administer this direct funding of "special obligations", a contractual system might be developed whereby the government specifies clearly the nature and extent of "special obligations", the indicators to assess related performance and funding mechanisms applied in compensating SOEs for related costs.
Monitoring "special obligations"	It is important for the state as an owner, as long as it asks SOEs to fulfil "special obligations" and compensate them for doing so, to monitor their effective fulfilment. This could be done through the overall process for setting objectives and reviewing of SOE performance (see the following sections). A specific review could also be carried out separately. Other concerned departments and stakeholders might be involved in this monitoring process.

Table 1.4. **Dealing with special obligations** *(cont.)*

Main steps	Brief description
	In case the funding is provided through a "purchasing ministry" (as described above), it removes the monitoring of the delivery of "special obligations" from the ownership entity that would have no particular interest or expertise in such matters to the concerned ministry.
Disclose special benefits or financial assistance	In parallel with disclosing and funding transparently "special obligations", it is also necessary that any financial assistance from the state to SOEs be fully disclosed. This double disclosure will allow an informed discussion on objectives. It is also necessary in order to promote a level playing field with the private sector.

Box 1.11. **Competitive neutrality in Australia**

In Australia, the concept of competitive neutrality seeks to deal with any "special benefits" as a single concept. The competitive neutrality principles were established under an agreement between all Australian governments signed in 1994, called the Competition Principles Agreement, administered by the national Competition Council.

1. The objective of competitive neutrality policy is the elimination of resource allocation distortions arising out of the public ownership of entities engaged in significant business activities: Government businesses should not enjoy any net competitive advantage simply as a result of their public sector ownership. These principles only apply to the business activities of publicly owned entities, not to the non-business, non-profit activities of these entities.
2. Each party is free to determine its own agenda for the implementation of competitive neutrality principles.
3. A party may seek assistance with the implementation of competitive neutrality principles from the Council. The Council may provide such assistance in accordance with the Council's work program.
4. Subject to sub-clause (6), for significant government business enterprises which are classified as "Public Trading Enterprises" and "Public Financial Enterprises" under the Government Financial Statistics Classification:
   a) the parties will, where appropriate, adopt a corporatisation model for these government business enterprises (noting that a possible approach to corporatisation is the model developed by the intergovernmental committee responsible for GTE National Performance Monitoring); and
   b) the parties will impose on the government business enterprise: *i)* full Commonwealth, state and territory taxes or tax equivalent systems; *ii)* debt guarantee fees directed towards offsetting the competitive advantages provided by government guarantees; and *iii)* those regulations to which private sector businesses are normally subject, such as those relating to the protection of the environment, and planning and approval processes, on an equivalent basis to private sector competitors.

Source: National Competition Council website: *www.ncc.gov.au/pdf/PIAg-004.pdf*.

Box 1.12. **Public services agreements in Italy**

Special obligations for SOEs providing services of general interest are usually set forth in the "Public Service Agreement"("*Contratto di programma*") signed by the company and the relevant ministry, in accordance with the ministry of economy, for a period of at least three years.

The agreement aims at ensuring that end-users may have safe, reliable services at reasonable prices and that market competition is always granted. An agreement must also define required standards with regard to:

- Characteristics and quality of services.
- Level of tariffs (usually using the price-cap method).
- Productivity targets.
- Production costs per unit.

The agreements have mostly achieved positive results in improving efficiency of public services.

Besides, the agreements define the services which have to be provided by each SOE, whose costs are not covered by tariffs, also setting up the related compensation by the state.

SOEs which receive state funds for providing public services and that have other activities at the same time are required to keep separate accounts in order to show the distinction between all activities, the associated costs and revenues and the methods of setting up and allocating costs and revenues.

This system, in accordance with EU laws, is required for enterprises operating both in monopolist and competitive markets to avoid cross-subsidies harming competition in the relevant sector.

1.6. Defining SOE objectives and specific targets

Objectives documents are fundamental for the accountability framework for SOEs. They should be relatively short documents clarifying high-level expectations and specific objectives agreed upon between the ownership entity and the SOE boards. In most cases, and particularly for partially owned SOEs, the objectives of the company will have to be duly approved by the general shareholder meeting. The state will have to exercise its shareholder rights but will not be more than a significant or controlling shareholder. In the case of listed SOEs, a light-handed touch is required as there is partial market for corporate control. Market mechanisms then apply, as well as listing regulation. This section thus concerns mostly fully owned SOEs.

It is crucial that the government's expectations of the SOE be formally, clearly and publicly communicated. These documents might be called "Statement of Corporate Intent", "Shareholders' Letters" or "Letters of Agreements", "Memorandum of Understanding", "Business or Corporate Plans", etc. They might have different legal status according to countries. They will typically contain the following information:

- A business description and a mission statement.
- Elements of the corporate vision and the overall objectives of the SOE.
- A statement of accountability (including reporting obligations).
- Based on the previous elements, broad expectations on financial and non-financial performance with related performance indicators.
- An estimation by the board of the company's value.

In most cases, objective documents and related specific targets will be developed on a yearly basis. However, another option is to set up targets into a two- to four-year frame, with control on performance still being done yearly (see Box 1.13 on Switzerland).

Box 1.13. **Setting objectives in Switzerland**

Principle No. 16: As owner, the Confederation sets higher medium-term (four-year) objectives in order to provide strategic direction for independent entities. Through these strategic objectives, which have been broadly standardised, it influences the development of the entities, whether bodies or enterprises ("enterprise-related directives") and their tasks ("task-related directives") based on this overall approach. How much guidance is given at task level varies depending on whether the performance of the task delegated: *a)* is described only in broad outline in the legislation and is barely regulated by the market; *b)* is largely financed by general fiscal revenues; or *c)* could entail high risk for the Confederation.

Comment on the above principle: In its capacity as owner, the Federal Council must manage all of the independent entities by setting medium-term objectives and maintaining a broad overview… It is not possible for the Confederation to manage the development of its independent entities by legislation alone, since legislation regulates the main points over the longer term. It needs an instrument that will enable it to influence the independent entity and the performance of its tasks in the medium term, with the aim of safeguarding its higher interests.

From now on, the Federal Council, in its role as owner, should manage all independent entities by setting strategic objectives… Strategic objectives may relate to the development of the entities through *enterprise-related* directives, and the outsourced tasks, through *task-related* directives… Enterprise-related directives define, among other things, commercial policy priorities and aim to consolidate or increase the value of the enterprise. Task-related directives establish priorities for the performance of tasks or the use of any indemnities paid.

At present, the Federal Council already approves strategic objectives for enterprises active on the market without consulting Parliament… Parliament will no longer have direct influence over the strategic objectives as a general rule; the aim here is to ensure proper separation of powers and responsibilities of the legislative and the executive.

As a general rule, strategic objectives are binding on the board of directors of public institutions and public joint-stock companies to the extent when the organisation act of the entity expressly so provides. They are also binding in practice, though not legally so, on the board of directors of independent entities set up as joint-stock companies subject to private law: the board of directors cannot afford to ignore the intentions of the principal or majority shareholder, otherwise it risks being removed from office or not appointed a second time.

Source: Corporate Governance Report, 2007.

The quality and usefulness of objective documents might vary a lot according to the quality of the objective described and the relevance of the performance indicators agreed upon (see Section 1.7). Financial objectives and related performance indicators allow measuring, following-up and assessing SOEs' profitability, efficiency and risk level. The financial objectives are aimed at replicating the discipline that market mechanisms, including the threat of a takeover, would exert over the CEO and board members of a firm in the private sector, and to build a competitive neutral environment (see Box 1.14).

Among financial objectives, many objectives documents include (sustainable)[7] dividend objectives. The level of proposed dividends aims at achieving the company's optimal capital

Box 1.14. **Purpose of financial targets for SOEs in Sweden**

The purpose of financial targets from the perspective of the owner is to:

- Secure the creation of value by the board and executive management working towards ambitious, long-term targets.
- Achieve efficient use of capital by clarifying the cost of capital.
- Keep the company's risk at a reasonable level.
- Assure the owner sustainable and predictable dividends taking into consideration the company's future capital requirements and financial position.
- Make possible and facilitate measurement, follow-up and assessment of the company's profitability, efficiency and risk level.

Source: *Annual Report State Owned Companies 2005*, Government Offices, p. 30.

structure within an agreed time frame. It should thus be based on or driven by the optimal capital structure, the level of current profitability and any planned future capital expenditure. A possible avenue to define the targeted or optimal capital structure is to use a credit rating benchmark. The optimal capital structure is the one that provides for an appropriate credit rating, while at the same time imposing a discipline on the SOE to optimise efficiency (see Box 1.15).

Box 1.15. **Credit rating benchmark in New Zealand**

The government has a credit rating benchmark policy whereby SOEs are expected to have a capital structure consistent with a BBB (flat) credit rating (unless the SOE can demonstrate good reasons for an alternative benchmark). This is to ensure that all SOEs have appropriate financial discipline to manage capital efficiently at similar risk levels. The application of this credit rating benchmark may involve moving to a higher gearing ratio. … Ministers expect boards to use their best endeavours to negotiate prudent levels of borrowing to closer reflect shareholder preferences, and if necessary explore alternative banking arrangements. Shareholding ministers additionally expect boards to report on the likely timing for a change in gearing levels, to better align with the BBB (flat) benchmark.

Source: CCMAU, Owner's *Expectations Manual for State-Owned Enterprises*, 29 October 2007.

It is also useful for the objective document to include estimation by the board of the company value. This estimation should be provided with relevant information on the methodology used for the assessment and on the basis for any assumptions made. A recommended methodology is the one based on discounted cash flows. The value assessment could also be done or reviewed by an external advisor with specialised valuation expertise. It would nevertheless have to be endorsed by the board, as it is expected to "have an ongoing understanding of company value; what value drivers are and the effect in terms of enterprise value".[8] However, the value estimation should not necessarily be published. This could be sensitive information, especially if the ownership entity is considering carrying out a share sale in the near future.

Objective documents also increasingly include performance indicators for non-financial and public policy objectives, including public services and other special obligations. These are more

difficult to define clearly and tend to be underemphasised. Instead of clear non-financial objectives with related indicators, some objective documents provide only strategic directions.

Some more "structural" objectives, related to the quality of the company's governance or management, could also be added. These could, for example, cover the quality and effectiveness of boards, the existence and effective work of audit and risk committees, the quality of the human resources policy, etc. Specific objectives given in this regard could support an overall and gradual improvement in SOEs' governance in the medium term.

Finally, along with objective documents, SOEs could be asked by the ownership entity to submit their long-term plans. These long-term plans will provide the basis and the framework for discussing their strategy and yearly objective documents.

The objective documents are shared documents between the ownership entity and the SOE board. They are based on the corporate plans, which are purely board documents. In some cases the objective documents might be the corporate plans themselves. Where they contain commercially sensitive information, a publicly available version should also be prepared that excludes the commercial-in-confidence material. This sensitive information could include estimation of the SOE value.

The development of an objective document/annual targets/corporate plan is usually the main instrument for conveying objectives to the corporation. It is generally a collaborative process with ongoing communication between the SOE itself (its board and CEO) and the ownership entity. The Guidelines recommend that the board be involved in this process, as it is accountable for the SOE performance (Guideline VI.A) and should carry out its function of strategic guidance, subject to the objectives set by the government and the ownership entity (Guideline VI.B).

It is useful to formalise the process of developing objectives documents through legislation, regulation and/or a protocol (see the New Zealand process in Box 1.16). This is instrumental in clarifying the requirements in terms of content, time frame and respective responsibilities and powers. One important question which has to be decided upon in such a formal document is who has the final word in case of disagreement.

Developing objective documents is a complex task which requires industry knowledge as well as strong financial modelling skills. It also requires a certain level of operational experience to determine the key levers of performance and the time frame in which it is reasonable to expect results. The combination of this industry knowledge, financial capability and operational experience should be present in SOE boards, and reflected also within the ownership entity to allow informed and balanced dialogue on the development of objective documents. To negotiate as an informed owner, the ownership entity should develop appropriate knowledge of the industry, based on research and analysis as well as the history of dialogue with, and feedback from, the SOE boards. It could also seek inputs from consultants or other experts (see Box 1.17).

Box 1.16. **Negotiation of corporate objectives in New Zealand**

The main steps in the business planning cycle are:

- Shareholding ministers write to each Crown company board before the beginning of each planning round to detail the information requirements, the timing (milestone dates) and any special issues the company is to address during the planning round.
- Boards are then required to: assess their business environment; reassess their strategic direction; provide a detailed plan for the immediate year; and provide financial projections for the following 2 to 4 years.
- Following the delivery of the boards' outlook and business plans to the shareholding ministers, advisors then prepare a report on these documents for the shareholding ministers' consideration. Draft SCIs are delivered together with the business plans. The SOE Act, the CRI Act and other relevant company-specific legislation require boards to deliver their draft SCIs to shareholding ministers at least one month before the end of each financial year.
- Shareholding ministers may then, through their advisors, seek further information.
- Shareholding ministers then consult with boards on any issues or concerns they have with the business plans and draft SCIs. This occurs either by letter or, more often, meetings between shareholding ministers, advisors and the board (referred to as the business planning meeting).
- Following the business planning meeting (if held) shareholding ministers write to boards outlining their understanding of the main outcomes and issues discussed.
- Boards then consider the outcomes from business planning meetings and the shareholding ministers' written comments, and if necessary, revise their business plans and SCIs. Boards then deliver to shareholding ministers finalised business plans and SCIs.
- Shareholding ministers table the finalised SCIs in the Parliament.

Sources: Corporate Governance of State-Owned Enterprises, A Survey of OECD Countries, OECD, 2005. *Reporting Requirements of Crown Companies, Owner's Expectation Manual,* Section 4.1, New Zealand CCMAU (*www.comu.govt.nz/pdfs/OEM-Final-Version-310502.pdf*).

Box 1.17. **Reviewing and challenging soe corporate plans in Canada**

Based on 1996-2000 reviews, the review of the governance of SOEs by the Auditor-General advises the government to review and challenge the corporate plans by asking itself a series of typical questions, as follows:

- Has the corporation properly interpreted its mandate?
- Are the corporation's objectives, strategies and targets appropriate and do its performance indicators provide a strong basis for holding it in account?
- Are the trade-offs the corporation has made between its commercial objectives and its public policy objectives reasonable?
- Do its performance targets sufficiently "stretch" the corporation?
- Has the plan taken government priorities into account?
- Is the corporation capitalised appropriately, and are targets for dividends and return on equity appropriate?
- Has the corporation met its past performance targets?
- Is there a need to assess whether the corporation's mandate is still relevant?

Box 1.17. **Reviewing and challenging soe corporate plans in Canada** *(cont.)*

In **Canada**, the review of the governance of SOEs by the Auditor-General found that there were significant deficiencies in 38% of approved corporate plans, and less serious problems in a further 28%:

> "*Many deficient corporate plans are approved, and the government has limited capacity to challenge them. Problems included any or all of the following: Absence of long term plans; Unclear or non-existent corporate objectives, targets, goals and business strategies, as well as weak action plans; Little information by which to judge whether the corporation is achieving its objectives.*"*

However, this represents a significant improvement from previous rounds of special examinations carried out by the Auditor-General, as: *i)* 62% of SOEs had significant deficiencies in corporate and strategic planning and/or performance measurement and reporting in 1984-90; *ii)* 78% had significant deficiencies in this area in 1990-96.

A review of progress made since the 2000 report of the Auditor-General showed that in 2005:

> "*Feedback from the government on corporate plans is still limited. Neither the Treasury Board Secretariat nor the applicable departments have clearly defined their respective roles in the process for reviewing and approving corporate plans or assessed the capacity and skills needed to fulfill their roles.*" "*Many Crown corporations still are not setting clear goals and indicators of performance for their public policy objectives. Some deficient corporate plans are still being approved.*"

* *Report of the Auditor-General of Canada, Chapter* 18, "Governance of Crown Corporations", p. 22.

Source: 2000 *Report of the Auditor-General of Canada*, Chapter 18, "Governance of Crown Corporations", p. 22; 2005 *Report of the Auditor-General of Canada*, Chapter 7, "Governance of Crown Corporations", p. 10-11.

The whole process of defining and agreeing on objectives raises also important questions about the respective roles of the board and the ownership entities. The fact that objectives have to be officially approved, and that in some cases boards might not even have the final say in case of disagreement, can be perceived by the boards, and rightly so, as an usurpation of their authority. This could also lead to reduced accountability by the board, especially when strategic issues are addressed. It is thus critical to ensure an appropriate definition of respective roles in the process of defining objectives and ensure that it will maintain appropriate board accountability.

Box 1.18. **Letters of expectations in British Columbia**

In the British Columbia model, the minister responsible for the Crown corporation, as the representative of the government, communicates broad strategic direction and expectations as determined by the cabinet. This direction and formal expectations for the corporation are communicated annually in a "letter of expectations" that is also signed by the Crown corporation board's chair and made public. This letter also identifies actions the government will take to assist the Crown corporation in achieving mandate and operational objectives. The minister responsible for the corporation is the voice of the government. By playing a role in establishing the corporation's direction and the government's expectations of it, the minister is reflecting the expectations of the owners and there is a basis for accountability for the corporation's actions. In this model, the minister does not take over the role of the board but communicates formally and publicly the performance that the government expects from the corporation. The board is responsible for governing the corporation within that framework.

Source: Office of the Premier, Province of British Columbia, Exhibit 7.3 in Chapter 7, p. 13, *Report of the Auditor-General of Canada* – February 2006.

The following table describes main steps in developing objectives documents.

Table 1.5. **The main steps in developing objectives documents**

Main steps	Brief description
Communication of high-level expectations	To clarify the relationship between the corporation and the responsible minister, it could be useful for the government to communicate on broad strategic direction and expectations for the year. This could be under the form of an annual "letter of expectations", to be signed by the board's chair and made public (see the example of British Columbia, Box 1.18).
Interpretation of high-level expectations into main objectives	The draft objective document is developed by the SOE board (with senior management) based on high-level objectives defined in the SOE mandate and communicated by the ownership entity. The ownership entity will define priorities and interpret policy priorities. SOE boards will have to seek clarification and question the ownership entity if needed. The SOE board should determine the main and specific objectives allowing the fulfillment of the SOE mandate as well as government policy priorities and high-level expectations.
Develop relevant performance indicators	Please refer to Section 1.7. for more precise guidance.
Put in place appropriate information systems	Appropriate information systems should be put in place to collect accurate and reliable data necessary for calculating the indicators. Automatic extraction from existing management applications is a useful way of cutting the costs while increasing reliability.
Develop a draft objective documents	SOE boards will develop a draft objective document describing main objectives for the SOE, key performance indicators and specific, often yearly, targets. It is useful that the stated objectives be accompanied by comments allowing to: ● justify the choice of indicators associated with it; ● comment on previous results; ● explain the choice of a target; ● mention the main levers of action to achieve the objectives. The first draft is submitted to the ownership entity.
Informal negotiation of the draft	Boards are expected to enter into a process of dialogue with the ownership entity to arrive at an appropriate understanding of the company's objectives based on the government's policy priorities. This specific dialogue between SOE boards and the state shareowner is not possible or strictly regulated in case of partially owned SOEs, as this would breach the principle of equitable treatment of shareholders.

Table 1.5. **The main steps in developing objectives documents** *(cont.)*

Main steps	Brief description
	This informal negotiation could be done at different stages of the draft development. The process will be mostly informal and cannot be defined precisely, but it necessarily involves intensive contacts and information sharing between the ownership entities and SOE boards. There could be a round of discussion and negotiation through one or more meetings to discuss high-level summaries and more developed detailed documents with the ownership entity. This informal negotiation is key to building consensus and ensuring clarity about the SOE mission. The boards are driving this process on the SOE side. It is their responsibility to seek clarification from the ownership entity and/or play a challenging function. Both the ownership entity and the SOE need to ensure that statements of objectives are specific enough and provide clear and relevant targets to be achieved. A second draft is then agreed both by the SOE concerned and the ownership entity.
Formal comments	It is important that the ownership entity provides relevant comments on the draft objectives document received from the SOE. This should be done either directly by the ownership entity or by the minister, who would have been informed on key aspects of the plan by the ownership entity. This could allow the minister adjusting the document to better reflect government policies and priorities. SOEs should receive formal feedback on their draft objective documents within a defined time limit. However, this obligation for the ownership entity to provide formal feedback should not lead to focusing on minor issues which would derail the attention from the main aspects and most strategic questions (refer to advice on how to review and challenge SOE corporate plans in Canada, Box 1.17). The absence of comments might send an unclear message. Either the ownership entity effectively understands and agrees with the draft document, or it is unable or unwilling to comment on it. Reasons for weak feedback from the ownership entity may include the lack of knowledge about the commercial dimension of SOEs, a lack of understanding of their competitive environment, lack of time and resources to develop informed comments, or even incapacity to read and interpret properly financial documents.

Table 1.5. **The main steps in developing objectives documents** *(cont.)*

Main steps	Brief description
Official approval	Once agreed between the SOE and the ownership entity informally, the objective document might be approved formally on both sides: ● on the SOE side, the objective document will have to be duly approved by the general shareholder meeting; ● on the state side, the objective document might either be approved at official level or by the minister in charge. The shareholder minister should also ensure that the objective document is consistent with the government's policy and might have the final say on approving it. In some cases other ministries, and primarily the Ministry of Finance, might also have to approve the objective document or parts of it. This could be the case, for example, when the levels of dividends or borrowing plans might impact the state budget.
Clear endorsement	In addition to being approved by the general shareholders meeting (if it exists), and in order to give it more weight, the objective document could also be formally endorsed by the board and senior management.
Tabling in Parliament	According to different legal and administrative frameworks, objective documents might also have to be tabled in Parliaments within a specific timeframe. Objective documents might be tabled in Parliaments as such when they are simple and relatively short documents. When they are full-fledged corporate plans, only summaries might be submitted for confidentiality concerns (see the example in Canada, Box 1.19). In this case, there is a trade-off to be made between *ex ante* accountability and competitive concerns.
Public disclosure	Objective documents could be disclosed on the SOE websites as well as on the ownership entities' websites.

Box 1.19. **Confidentiality issue regarding corporate plans in Canada**

"Corporate plans are highly confidential in nature. They contain highly sensitive and often commercially confidential information. As submissions to cabinet and as confidences of the Privy Council, corporate plans are treated in a manner comparable to memoranda to cabinet and are subject to the same strict protective measures. Corporations are advised to assist in maintaining this security by adopting their own security measures such as restricting and numbering the copies of their plan.

The corporate plan should be distinguished from the corporate plan summary which is tabled in Parliament. Sensitive material contained in plans (*e.g.* commercially detrimental information referred to in Section 153(1) of the FAA) should of course not be incorporated in the corporate plan summaries since these become public documents."

Source: Guidelines for the Preparation of Corporate Plans, Treasury Board of Canada, 1994.

1.7. Developing relevant performance indicators

A central difficulty in setting objectives is to develop relevant performance indicators. This is true for any kind of organisation, from government agencies to private sector companies. An extensive literature provides "tips and traps" in developing these indicators. SOEs in many countries have tended to compile an increasingly comprehensive set of non-financial indicators. As they often have both commercial and policy objectives, including public services and other special obligations, they face both the challenges encountered in building performance indicators by government agencies and by private sector companies. But the most difficult aspects to be covered by performance indicators are the public policy objectives.

Performance indicators are a numerical measure of the degree to which an objective is being achieved. Performance indicators, by definition, are not exact measures of performance but "indicate" the level of performance regarding the overall objectives agreed upon. They are practical attempts to improve the quality and consistency of performance measurement by focusing on key synthesis indicators.

A commonly used "tip" to build up effective performance indicators is to make sure that they are "SMART", *i.e.* Specific, Measurable, Achievable, Result-oriented and Time-based. It might be useful also to ensure that performance indicators are not "DUMB", *i.e.* Dangerous, Unethical, Malleable and Biased. Whatever the acronyms used to test the quality of performance indicators, their quality depends on three major characteristics: their relevance, accuracy and reliability (see the examples in Box 1.20):

- To be relevant, performance indicators should be tightly linked to the SOE strategy, *i.e.* reflect the objectives outlined in this strategy.
- To be accurate, performance indicators should be well defined, quantitative, non-subjective as much as possible, practical (direct, with no complex calculations), and measure outcomes rather than inputs.
- To be reliable, performance indicators should not be taken at face value. Information provided by SOEs should be audited appropriately.

Badly chosen performance indicators might bias the incentive structures and consequently have serious perverse effects or unintended consequences. This will be the case when the performance indicators encourage behaviours improving the indicator itself but deteriorating the performance of the SOE in relation to chosen objectives. Dysfunctional behaviours include, among other things, gaming, misinterpretation, myopia, narrow focus, etc.

Beyond developing a relevant mix of performance indicators, one way to assess SOE performance is to use a "balanced scorecard" that may help monitoring the balance between financial and non-financial objectives (see Box 1.21).

Finally, performance indicators must be taken and used for what they are, *i.e.* a "snapshot of performance in time. They do not provide a guide to future performance nor do they explain why a target has been achieved".[9] In reviewing SOE performance, shareholder entities should thus also consider other sources of formal or informal information. They should seek feedback from the entities concerned in order to obtain a broader picture and a better understanding of the current situation and of actions to be taken to improve future performance.

Box 1.20. **Developing relevant performance indicators**

A. The SMART/DUMB Test for performance indicators

SMART Test	DUMB Test
Specific: Clear and focused to avoid misinterpretation. PIs (Performance Indicators) should be *sensitive* and *specific*. The former refers to the probability that targeted events are captured by the measure, while the latter refers to the probability that other events are correctly excluded. **Measurable: Can be observed, quantified and compared to other data, and used to chart trends.** There must be an available and appropriate measurement instrument or technique. **Achievable: Reasonable, and credible under conditions expected.** PIs should allow analysts to observe the absolute and proportional changes from those which prevailed before. **Relevant, Result-oriented, Reliable: Fits into the organisation's constraints and is cost effective**. PIs should relate to either the overall strategy objective or lend themselves to a policy response. PIs should be statistically reliable. **Timely and Time-based: Doable within the time frame given.** That is, the measurement/analysis and reporting should occur as close to the intervention as possible, and PIs should refer to a particular time period.	**Dangerous:** *Danger* refers to physical/psychological and legal threats. Measurement should not involve subjecting either the observer or the target to increased risk. **Unethical:** *Ethical* standards should be applied at all times. Measurement should not involve illegal activities, and this includes invitations to commit offences, or the gathering of information by illegal means. **Malleable:** PIs should not be *malleable*; that is, they should be "game-proof" – not subject to being reported differently to "suit the occasion". **Biased**: PIs should be *bias-proof* and not directed to measuring factors, persons or events which favor a positive result or which involve limited studies that deliberately distort outcomes.

Sources: "SMART, QUEST and Fabric: Are they more than just acronyms?", Paul Williams, School of Social Sciences, Australian National University.

B. New South Wales (Australia)

Useful performance Indicators exhibit the following characteristics:

Appropriateness: Ability to relate to the SOE objectives.

Relevance: Relating to the primary purpose of the SOE, focusing on high-level results, effectiveness or efficiency.

Timeliness: Reporting the most recent data available.

Accuracy: Reflecting the situation as truthfully and as free from error as possible, indicating the use of estimates.

Completeness and comprehensiveness: Showing a true picture of achievements, mixing qualitative and quantitative measures.

Source: Key Performance Indicators, Performance Audit Report by the New South Wales Audit Office, 1998.

Box 1.20. **Developing relevant performance indicators** *(cont.)*

C. France

Relevant so as to assess the results obtained	Consistent with the objectives. Relating to a material aspect of the expected result. Providing the basis for making a judgment. Not producing effects contrary to those sought.
Useful	Being provided at regular intervals. Lending itself to comparisons in time, space and between players. Being immediately exploited by the agencies concerned. Being immediately comprehensible or clearly explained.
Reliable	Being durable and independent of organisational imponderables. Being reliable beyond question. Able to be drawn up at reasonable cost.
Verifiable	

Source: The Performance-Based Approach: Strategy, Objectives, Indicators, June 2004, Ministry of Economy, Finance and Industry, pp. 24-30.

D. New Zealand

Performance indicators (financial and non-financial) must:

- Be meaningful to the SOE's business and the SOE Act.
- Be specific and measurable without ambiguity.
- Be timely and capable of being audited, where appropriate.
- Be within the SOE's responsibility or power of control.
- Be consistent with and influence, as appropriate, the SOE's purpose and principles of operation or business.
- Respect commercial sensitivity, where appropriate.
- Encourage and reflect best practice.
- Where appropriate, ensure employee participation in, and ownership of, these indicators.

Source: CCMAU, *Owner's Expectations Manual for State-Owned Enterprises*, 29 October 2007.

Box 1.21. **Balanced scorecards**

The balanced scorecard is a strategic planning and management system that is used extensively in business and industry, government and nonprofit organisations worldwide to align business activities to the vision and strategy of the organisation, improve internal and external communications, and monitor organisation performance against strategic goals. It was originated by Drs. Robert Kaplan (Harvard Business School) and David Norton as a performance measurement framework that added strategic non-financial performance measures to traditional financial metrics to give managers and executives a more "balanced" view of organisational performance. While the phrase "balanced scorecard" was coined in the early 1990s, the roots of the this type of approach are deep, and include the pioneering work of General Electric on performance measurement reporting in the 1950s and the work of French process engineers (who created the *Tableau de Bord* – literally, a "dashboard" of performance measures) in the early part of the 20th century.

The balanced scorecard has evolved from its early use as a simple performance measurement framework to a full strategic planning and management system. The "new" balanced scorecard transforms an organisation's strategic plan from an attractive but passive document into the "marching orders" for the organisation on a daily basis. It provides a framework that not only provides performance measurements, but helps planners identify what should be done and measured. It enables executives to truly execute their strategies. The balanced scorecard is a management system (not only a measurement system) that enables organisations to clarify their vision and strategy and translate them into action. It provides feedback around both the internal business processes and external outcomes.

Source: Balanced Scorecard Institute website.

The following table describes main steps in developing performance indicators.

Table 1.6. **The main steps in developing relevant performance indicators and setting appropriate targets**

Main steps	**Brief description**[10]
Identify relevant indicators	Performance indicators should be clearly linked to the SOE strategy and reflect truly the achievements of the objectives agreed upon, thus: ● have a strong logical link with these objectives; ● relate to a material aspect of the expected result; ● address all their relevant aspects. To ensure this, it is necessary firstly to identify (a limited number of) broad dimensions of performance that are important, and then identify for each of these dimensions which specific measures or indicators might reflect performance. The quality of the overall performance assessment will depend on the completeness and comprehensiveness of the set of indicators. The combination of all indicators should reflect the overall priorities in objectives. In other words, they should be "balanced and holistic".[11]

Table 1.6. **The main steps in developing relevant performance indicators and setting appropriate targets** *(cont.)*

Main steps	Brief description[10]
	Performance indicators should also provide a reasonable basis for elaborating a judgment on performance and assessing its improvement. Practically, they should thus be "computable" at regular intervals, be easily comprehensible and be produced with appropriate disaggregation or adjustment for context, and timeliness to support performance assessment.
	Performance indicators should be prone to comparisons over time, space and between comparable companies.
	They should not induce bias, or do so only to a limited extent.
	Composite and complex indicators, based for example on a series of weighted variables with assumptions not easily understandable by non-specialists should also be avoided when possible.
Set up appropriate target levels	It is critical to set smart targets that are challenging but achievable. A series of "traps" in setting targets are provided in Box 1.22.
	Main sources to decide on appropriate targets are historical performances, benchmarking against peers and assessment of effective capabilities. This allows putting performance indictors in perspective, providing past values and target values:
	Absolute value indicators must be dealt with cautiously, as they might depend on external factors or be given with a range of values.
	Scattered indicators should be preferred above average values.
	There are always assumptions behind the set-up targets, regarding the economic environment, market evolution, etc. These assumptions must be made explicit. This will allow appropriate revision of targets when these assumptions are significantly changed due to factors outside the control of management.
Put appropriate information systems and structures in place	Performance indicators should not be dictated by the available information provided by the enterprise information systems. It should rather be the other way around.
	Once relevant performance indicators have been developed, it is necessary that appropriate systems be put in place to collect accurate and reliable data necessary for calculating the indicators. The data measured should be rigorously quantified. The measurement system should be reliable.
	As far as possible, indicator measurements should be extracted directly from the information system without any additional manual manipulations. Automatic extraction of the data needed to measure indicators will help limit the cost of drawing them up, while increasing their reliability.

Table 1.6. **The main steps in developing relevant performance indicators and setting appropriate targets** *(cont.)*

Main steps	Brief description[10]
	It is also important that indicators be durable and not affected excessively by organisational changes. The existence of a specific unit relying on information systems to process performance information can be instrumental in ensuring this consistency.
	This data could come mainly from internal information sources, from the SOE's own staff and information systems. But external or indirect sources of information, such as client surveys, might also be used in many cases. In case indicators are based on surveys, these should be carried out by specialists and comply with appropriate rules, regarding, for example, the type of questions asked, the sample characteristics, etc.
Document actual results	When presenting the selected performance indicators, these should be accompanied by a table showing results for previous years and targets, as well as data sources and methodological information, when relevant.
	Performance indicators should also be accompanied by measures of uncertainty.
	Performance indicators should be sufficiently documented to allow their users to verify their relevance and quality of information (ministries and other government agencies, MPs, State Audit Institutions, etc.).
	However, performance indicators should not be disclosed in most cases, either *ex ante* or *ex post*, as it is commercially sensitive information that a private sector enterprise would typically not disclose.
Audit	Performance indicators should be audited, either by external or state auditors.
	This auditing assures the state owner, stakeholders and the public of the quality and accuracy of the information provided by SOEs concerning the achievement of targets.[12]
	Without proper independent audit of performance information, poor quality data, weak analysis or political pressure to look good might lead to a distorted picture of performance.
Review	In addition to auditing performance information, it is necessary to review regularly the relevance of performance indicators, and to do so independently of the SOEs concerned.
	Regular review of performance indicators ensures sufficient responsiveness, particularly with regards to changing economic circumstances and commercial conditions.
	Reviews must also consider side-effects that have manifested themselves.
	Including the views of stakeholders in reviewing performance indicators might bring relevant perspective and additional information on the quality of existing indicators as well as on their potential unintended effects.[13]

Box 1.22. **Traps in setting targets**

It is unsmart to ignore uncertainty.

It is, and for similar reasons, statistically unsmart to sharpen targets progressively by requiring the next year's performance to be better than "the better of current target and current performance".

It is unsmart to cascade targets by imposing the same target at different levels of operations.

It is usually inept to set an extreme value target.

It is unsound to ignore well-understood essential variation that is familiar to practitioners.

Source: *Performance Indicators: Good, Bad, and Ugly*, Journal of Royal Statistical Society, 2005, n° 168, Part 1, pp. 1-27.

Notes

1. These "special obligations" often include "services of general economic interest" as defined in the EU Commission in its "White Paper on Services of General Interests".
2. Doing so would also allow EU member countries to be in line with the jurisprudence set up by the European Court of Justice concerning compensation of public service. The Judgment of 24 July 2003, in the case C-280/00 Altmark Trans, states that compensation for public services obligations should not be considered as state aid, thus not notified to the Commission, as long as the enterprise has been required to fulfil these obligations, parameters to evaluate the compensation are stated transparently, objectively and *a priori*, compensation is not excessive *as regards* related costs, taking into consideration related receipts and "reasonable benefit", and based on cost analysis of "an average well-managed and adequately equipped enterprise".
3. This section draws heavily from the Australian former Industry Commission's work in this issue, including particularly "*Community Service Obligations: Some definitional, costing and funding issues*", 1994, and "*Community Service Obligations: Policies and Practices of Australian Governments*", Information Paper, February 1997.
4. The resultant increase in taxes makes this option sometimes less attractive politically. The effective capacity to raise taxes, particularly at different state levels in federal countries, might thus have an impact on the choice of a funding mechanism.
5. *i.e.* explicitly identifying the cost, but not providing cash funding, and instead acknowledging the lower rate of return through the performance monitoring process. Another major problem with this approach, besides reducing accountability, is that it is often not sustainable, particularly in infrastructure industries. In these sectors there is often an excess of cash on a yearly basis because the costs are largely book costs related to the depreciation of fixed assets for which investment is lumpy. In this case, excess cash flow is used to fund the "special obligations" instead of funding fixed asset renewals.
6. See "*Community Service Obligations: Some definitional, costing and funding issues*", 1994, Australian Industry Commission, Chapter 6.
7. A focus on dividends must have the caveat that dividend levels are sustainable, to avoid free cash flows being used to sustain state finance at the expense of appropriate capital investment or balance sheet management.
8. CCMAU, *Owner's Expectations Manual for State-Owned Enterprises*, 29 October 2007.
9. *Modernizing Government: The Way Forward*, OECD, 2005, p. 75.
10. This table draws on *The Performance-Based Approach: Strategy, Objectives, Indicators*, June 2004, Ministry of Economy, Finance and Industry, France, pp. 24-30.
11. *Intensifying Performance Management*, Blue Book Version 2, Guiding Principle, July 2005, Putrajaya Committee.
12. *Modernizing Government: The Way Forward*, OECD, 2005, p. 69.
13. *Key Performance Indicators*, Performance Audit Report by the New South Wales Audit Office, Recommendation p. 6.

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Chapter 2

Reviewing Performance

This chapter will discuss how to review SOE performance, both on an on-going and annual basis. It will describe the different systems and processes that can be put in place to track and review SOEs' performance on a regular basis, in order to identify problems early and react to them promptly. It will also review in-depth how to evaluate SOE's performance on a yearly basis, i.e. what are the processes involved and the typical information included in performance documents. Finally, it will give some indications on how to develop relevant benchmarking, as the basis for discussing the SOE strategy and assessing the evolution of its value and potential risks.

2.1. Overview

The State's obligation to review the performance of portfolio companies is central to the OECD Guidelines: "*Its prime responsibilities include setting up reporting systems allowing regular monitoring and assessment of SOE performance*" (Guideline II.F.3). To review performance effectively, the ownership entity must first ensure that it has access to accurate and relevant information on a timely basis. The information should allow the ownership entity to continuously evaluate performance and, when necessary, communicate its concerns to the company. Regular and timely reporting reduces the risk of bad surprises and typically gives more time for the ownership entity to take necessary measures. The ownership entity should therefore monitor the performance of portfolio companies both on an ongoing and annual basis.

When putting in place any system for monitoring and reviewing SOE performance, it is necessary to underline the central role of the board. "*The boards of SOEs should be assigned a clear mandate and ultimate responsibility for the company's performance*" (Guideline VI.A). The implementation of the SOE's strategic objectives will depend primarily on the quality of the board. As a first step, the ownership entity should therefore ensure that SOEs have competent boards. It is a prime responsibility of the state as an owner to "*establish well-structured and transparent board nomination processes in fully or majority owned SOEs, and actively participate in the nomination of all SOEs' boards*" (Guideline II.F.2).

Once competent boards are in place, it is necessary that they have continuous training and that they regularly evaluate their own performance. "*SOE boards should carry out an annual evaluation to appraise their performance*" (Guideline VI.F). Based on this evaluation, the ownership entity should be able to sanction bad performance by renewing the board. Although this Guide does not focus on the role of SOE boards, their key role in monitoring performance is important to keep in mind.

The system for **ongoing performance review** typically combines formal and informal mechanisms. The evaluation system needs to balance the information needs of the ownership entity against the autonomy of SOE management. It should therefore avoid putting excessive reporting requirements on SOEs and not bypass the board in monitoring management's performance. Ownership entities will also have to develop their own capacity to treat this information in a productive manner.

The **annual performance review** requires analysis by the ownership entity beyond the company annual reports. This will include an assessment of financial and non-financial results against key performance indicators that have been established in the process of defining corporate objectives and targets. Based on this analysis, actions to be taken by the SOE and the ownership entity will be identified. Evaluation of annual performance should also be used, together with appropriate benchmarking, as the basis for discussing objectives for the coming year. It will also be the basis for discussing the SOE strategy and for assessing the evolution of its value and potential risks.

In order to make the best possible use of the performance review process, it is recommended that corporate performance be compared against a relevant benchmark. This is also recommended in the annotations to Guideline II.F.3 stating that, to monitor performance, the ownership entity

"*could be helped in this regard by developing systematic benchmarking of SOE performance, with private or public sector entities, both domestically and abroad. This benchmarking should cover productivity and the efficient use of labour, assets and capital. This benchmarking is particularly important for SOEs in non-competitive sectors*". **Benchmarking performance** adds useful information to the performance review. It brings perspective and allows taking into account any external effects, such as changes in input prices, etc.

In sum, the process of reviewing performance has three important elements. Each of these elements is covered in more detail below, in order to provide guidance on the main steps involved:

- Ongoing monitoring of performance.
- Developing robust systems to review yearly performance of each SOE.
- Benchmarking SOE performance.

When establishing the process for monitoring and reviewing performance, it is important to keep a balance – both legally and functionally – between the ownership entity's information requirements and the necessary autonomy of boards and management to carry out their responsibilities. Consideration should also be given to the internal capacity of the ownership entity to process and make relevant use of the information requested from SOEs. The monitoring and evaluation system should thus remain as balanced and simple as possible.

2.2. Ongoing monitoring of performance

Ongoing monitoring of performance is the system that the ownership entity puts in place to track and review performance on a regular basis. The ownership entity needs to be informed regularly on the performance of each SOE with respect to the agreed targets. In case of partially owned SOEs, the information provided to the ownership entity should, as a matter of principle, also be provided to all other shareholders.

Ongoing monitoring ensures early identification of problems and opportunities. It allows the ownership entity to react promptly on underperformance or on significant changes in the enterprise's environment that may impact its performance. It also allows focusing on priorities, which often is a key factor for medium-term performance.

Some countries will rely mostly on state representatives within SOE boards to be kept informed adequately of SOE performance (see Box 2.1 for the Italian example). Some other countries will put in place a number of more formal processes, such as management information systems with regular detailed reporting requirements. These could entail significant workload both for the SOE concerned and for the ownership entities. Careful consideration should thus be given to the adequate degree of formality of monitoring processes. Relevant cost-benefit analysis should be performed in this regard (see Box 2.1).

The system put in place for ongoing monitoring must on the one hand ensure the collection of sufficient information for the ownership entity to be able to react adequately and promptly in case of underperformance. Part of this system might include a requirement for continuous disclosure by management and/or a "no-surprise" policy, similar to exchange listing rules but also covering events with potential political impacts (see the New Zealand example in Box 2.2). On the other hand, the system must avoid excessive and burdensome additional information requirements for SOEs in comparison with private sector companies. To find this balance can be a delicate task for the ownership entity, and a dialogue with the individual companies about the costs and benefits of different information requirements can therefore be useful.

Box 2.1. **Monitoring of SOE performance monitoring**

A. In Italy

The Ministry of Economy and Finance, which is the ownership entity, carries on a constant monitoring on SOEs' performance and management. Each company is thus required to provide the ministry with the following detailed information and documents:

- the annual budget for the incoming year;
- half-yearly reports on performance and financial results, with details on the differences with the budget and the previous year's figures;
- the estimated year's end figures.

SOEs are also required to point out the potential critical areas and give all relevant information, including the business plans approved by the board.

In addition, the shareholder can receive information on each SOE by its representatives appointed in both the Board of Directors and the Board of Auditors. (The Italian Civil Code [Art. 2449] allows the state as an owner to appoint one or more members of the Board of Directors and of the Board of Statutory Auditors with the same rights and duties of board members chosen by GSM.)

B. Integrated MIS in Greece

A specific and interesting process is being developed in **Greece** in the framework of the current broad reforms of SOE governance. A specific Management Information System has been put in place to collect directly from the SOEs' own information systems the relevant data to monitor their performance. This will constitute a unique system to monitor closely and frequently SOEs' performance. Monthly data will be automatically compared to budget data. The whole system of business plans, budget and performance monitoring will be based on the same data, allowing a closer monitoring and thus greater transparency and accountability.

C. Traffic Lights in the UK

In the UK, a quarterly "Traffic Light" review is done for each SOE. This review evaluates the quality of the shareholder relationship, the implementation of the shareholder model, the quality of the board and management team, the strategy and financial performance.

For each of these categories, a series of questions are to be answered by "yes" or "no" by the portfolio manager with a possibility also to comment. All, or nearly all, "yes" answers give an overall green light, some specific "no" answers may trigger a red light, otherwise the light is amber. (This type of "traffic light" review is sometimes criticised for lacking nuance).

For each category, in addition to the general appreciation, the portfolio manager must indicate the action taken to improve the situation.

An aggregate monitoring table is then built up, indicating for each SOE the colour of the light for each of the categories mentioned above. This is a type of control board for the shareholder executive's work.

It is also important that active ongoing monitoring by the ownership entity does not bypass the board and result in interference in management. The board must be allowed to exercise its responsibilities and the ownership entity's discussions on performance should typically be with the board, even if the ownership also has a dialogue with senior management. This allows the board to retain responsibility to monitor management performance *per se,* as recommended by the Guidelines. There is a balance to be found between ensuring effective ongoing monitoring of SOE performance and avoiding excessive interference in SOE management.

Box 2.2. **No-surprise policy in New Zealand**

In **New Zealand**, the "no surprise" policy is clearly articulated as follows: "*Shareholding ministers expect Crown company boards to adhere to the 'no surprise' policy and be informed well in advance of everything considered potentially contentious in the public arena, whether the issue is inside or outside the relevant legislation and/or ownership policy.*"

Examples of matter that could fall within the "no surprise" policy include:

- Changes in CEOs.
- Potential/actual conflicts of interest by directors.
- Potential/actual litigation by or against the company, its directors or employees.
- Fraudulent acts by the company's directors or employees.
- Breaches of an SOE's corporate social responsibility obligations.
- Significant company restructuring.
- Large-scale redundancies.
- Industrial disputes.
- Significant acquisitions and disinvestments.
- Significant health and safety issues.
- The release of significant information under the Official Information Act of 1982.
- Imminent media coverage of any activity that could attract critical comment or on which shareholding ministers could be asked to express a view.

Source: Owner's Expectations Manual for State-Owned Enterprises, 29 October 2007, CCMAU, New Zealand.

A number of other mechanisms and information channels, such as dedicated contact points within the SOEs or rating agencies, can also be useful to the ownership entity as additional means of getting a better and more complete picture of the company (see the French example in Box 2.3). It is important, however, that such complementary information not confuse the main information channels and depend excessively upon personal relationships. Informal links between the ownership entity and the management should be subject to formal rules, in accordance with company and capital market laws, that ensure that any contacts are transparent to the chair and the rest of the board.

Once the information is collected, the ownership entity must have the capacity to analyze the information and take adequate action. This requires quite specific capacities and competencies that the ownership entity needs to have at its disposal, either in-house or from external experts. There should thus be a balance between the amount of information collected and the internal capacity to treat it.

Box 2.3. **Relationship between SOEs and the ownership entity (APE) and contact points in France**

Acting as an interface between companies and the government as a shareholder, the APE looks after the following aspects:

1. **Monthly reporting implementation:** Companies transmit monthly to the APE sourced directors reports containing the main financial indicators and if necessary qualitative indicators of the activity based on the Executive Committee's internal reporting. The choice of indicators is adapted to each company and is revised regularly.
2. **Regular financial book meetings and preparation of important milestones:** On a regular basis and at least once a year company management teams meet the APE to present main transactions and strategic prospects. These meetings are also the preferred time to highlight the relationship between the APE and the companies and to measure compliance with governance rules ... During work on annual budgets for government companies milestone meetings are organised between the concerned public services and the company for a detailed discussion if arbitration is needed. Exceptional investments and external growth operations are subject to detailed upfront presentations before any validation process. Meetings are organised to define accounting methods before the Board of Directors' review of the books.
3. **Searching for better company operational knowledge:** Management teams *define regular correspondents as contact points* within the APE. Management teams propose to their APE contacts fixed meeting programs relative to their specific areas of activity as well as site visits.

Source: Rules Governing the Relations Between the APE and Companies with a Government Holding, APE website, *www.ape.minefi.gouv.fr/sections/qu_est_ce_que_l_ape/working_charter*.

Table 2.1. **The main steps and processes to ensure effective ongoing monitoring of SOE performance by the ownership entity**

Main steps	Brief description
Regular information on performance by SOE boards	SOE boards should advise the ownership entity on a regular (monthly or quarterly) basis about where they stand in regards to the achievement of their objectives. They should provide precise data on the realisation of specific targets. To this end, it is advisable that the board meet regularly to conduct a detailed review of the SOE's performance. If there are state representatives on boards, information of the ownership entity might be done "naturally". Ongoing monitoring is part of their function on SOE boards. If there are no state representatives on boards, a specific and formal system might be developed to provide the ownership entity on a regular basis with performance updates. Such progress reports or performance updates could typically include a comparison of actual performance with targets, as well as a qualitative explanation for the current performance. They should also provide main elements of an action plan to address the discrepancies between targets and effective performance. In case of serious underperformance, specific action might be required (see below).

Table 2.1. **The main steps and processes to ensure effective ongoing monitoring of SOE performance by the ownership entity** *(cont.)*

Main steps	Brief description
	Progress reports could also provide information on the human resources including key competencies and the turnover of senior staff members. These progress reports will be provided to the ownership entity on a confidential basis. However, in case SOEs' capital structure is open to other shareholders, the information provided to the state shareholder should not differ from the information provided to all other shareholders.
Put in place systematic information processes	Systematic processes might be developed to monitor more closely and frequently SOEs' performance. Such systems could allow collecting directly from the SOEs' own information systems the relevant data to monitor their performance and automatically comparing it to budget data (see the example of the Management Information System in Greece, Box 2.1).
Develop specific "continuous information"' and/or "no surprise" policy	The ownership entity might develop specific "continuous information" or "no surprise" policies. These will be similar to the requirement for continuous disclosure of market-sensitive information under the usual listing rules, but will have a broader coverage. These policies require SOE boards to keep the ownership entity timely informed about any material or significant events, developments or otherwise that can not only have a significant impact on the SOE's performance and value, but also impact on the sector ministries, the ownership entity or the government either by being contentious and politically sensitive or by attracting public attention in any way. Appropriate implementation of such "no surprise" policy requires SOE boards to understand and be sensitive to the wider policy concerns of the government and be aware of the potential impacts of specific SOE issues on the wider political agenda. The implementation of a "no surprise" policy should not, however, detract SOE boards form their usual obligations nor be an avenue for undue political interference.
Complementary information channels	The ownership entities could develop additional mechanisms to facilitate the flow of performance information to the ownership entity: ● These could include nomination within the senior management team of "correspondents" as contact points for the ownership entity officials. ● They could also include establishing an active dialogue with the external auditors, and even establishing systematic and extensive reporting from the auditors on a regular basis ● Specific "state controllers" might also be positioned within the SOEs in order to have access to information which is not easily accessible by the state as a shareholder.

Table 2.1. **The main steps and processes to ensure effective ongoing monitoring of SOE performance by the ownership entity** *(cont.)*

Main steps	Brief description
Use external information available	External information might also be useful for the ownership entity to complement its own sources. Banks, rating agencies, industry analysts and lawyers could provide the ownership entity with specific ideas on the SOE's strategy, different perceptions of risks and another analysis of performance.
Performance check-up by the ownership entity	The ownership entity might also develop its own evaluation system for a regular performance check-up. This evaluation could be based on performance information provided by the SOE itself. In addition to the evaluation of financial performance, it might also include the ownership entity's own evaluation of key and more qualitative dimensions, such as the quality of the shareholder relationship, the quality of the board and management, and the quality of strategy (see the UK example of Traffic Light Reviews in Box 2.1). These internal reviews might be kept for the ownership entity information only and not shared with the SOE concerned. Such evaluation requires adequate capacity within the ownership entity to collect and analyze the information.
Regular (quarterly) meetings between boards and ownership entities	Besides information collection, the key mechanism for ongoing monitoring of performance might be, if permitted by company law and capital market laws, regular (usually quarterly) meetings between the ownership entities and SOE chairmen (possibly with senior executives). These meetings allow discussion about target achievements with a forward-looking perspective. They are an opportunity to exchange and interact more informally on current issues and emerging trends. However, these meetings should be subject to strict rules and transparent for all board members. Besides identifying issues in target achievement, these meetings could also allow discussing and recommending remedial action.
Feedback by the ownership entity on current performance	The ownership entity or its minister in charge might provide the SOE with written comments and recommendations when appropriate on current performance and target achievement. These comments and recommendations are based on the information collected on current performance and on discussion which has taken place in informal meetings. The SOE might in turn respond in writing to comments received on its performance.

Table 2.1. **The main steps and processes to ensure effective ongoing monitoring of SOE performance by the ownership entity** *(cont.)*

Main steps	Brief description
Revision of targets	Targets could be revised when the external environment has significantly changed, affecting the relevance of hypotheses made to back up the initial targets. This target revision should however remain selective, and requires appropriate discussion between the ownership entity and the board.
Ad hoc meetings	Some specific meetings might be called whenever specific issues arise or significant events occur, having potential impact on the achievement of performance targets. A typical case when there should be a smooth and typically intense exchange between the ownership entities and SOE boards is the case of exceptional transactions such as acquisitions or sales and transfers of material assets.
Take actions in case of serious underperformance	In case of significant shortfalls in performance, boards are expected to provide clear notification to the ownership entity, propose remedial action and keep it informed of the progress on a timely basis. The ownership entity is advised to seek additional information and to work actively with the board to decide on remedial actions. It can eventually review the board composition and appoint special advisors.

2.3. Annual review of performance

Annual reviews of performance are in-depth analyses of a specific SOE's performance done by the ownership entity. These annual reviews allow an assessment of developments during the year and an evaluation of how well the company and the board have performed against the corporate specific objectives set by the state.

The central piece of the annual performance review is the assessment of financial and non-financial performance against annual targets. But it is also useful to include an assessment of operating results, corporate value and risks, board performance and corporate governance practices.

The annual review is a central piece of the accountability process. It provides the basis on which the management, the board and ultimately the ownership entity, will be judged.

The annual review is an important tool for identifying actions that need to be taken in relation to underperforming companies. It is also essential for making adjustments to new performance targets and a natural basis for discussing the development of objectives for the following year.

Performance reviews might vary significantly in depth and scope. In some countries they consist only of brief comments on main performance targets attached to the SOE annual reports. In some other countries extensive analysis is performed on the basis of specific reports which have to be submitted by SOEs. Each ownership entity will have to find the right balance in terms of costs and benefits of requiring specific performance reports from SOEs, in addition to the reports they already publish like private sector companies. Whatever the level of detail and depth of the performance reviews, they should be carried out with rigor and provide a fair picture of the annual performance.

At the center of the annual performance review is the discussion between the board and the ownership entity. This discussion is mostly informal and can allow for a better understanding and interpretation of the formal performance indicators. For this purpose the ownership entity has an important responsibility for developing and articulating a clear judgment on the SOE's performance.

The two other crucial elements to improve accountability are the auditing of performance indicators and their public disclosure. These are not yet widespread practices. However, without auditing of performance indicators their reliability might be questioned. Furthermore, without effective disclosure of these indicators, the accountability to the general public concerning SOE performance remains limited (see Section 1.7).

In addition to annual reviews of performance, some more medium- to long-term reviews could be undertaken. These longer-term reviews would help establish the link between SOE mandates and annual objectives. They would look at what should be in the generic objectives targets, what is the investment and risk profile of the SOE and thus what should be its targeted capital structure. They could in addition discuss in some depth possible benchmarks (see Box 2.4).

Box 2.4. **Longer term owner reviews in New Zealand**

The objective of long-term hold owner's review is, in general terms, to:

- provide advice to shareholding ministers, for discussion between ministers and the board, on any shareholder preferences regarding: *a)* the content of the Statement of Corporate Intent (SCI) for the company's strategic purpose, scope of business, core business, consultation thresholds or investment strategy, in light of the company's strategic direction and investment profile; and *b)* the company's capital structure, in light of its scope of business and core business, its investment profile, its risk profile and the credit-rating benchmark agreed by shareholding Ministers of BBB(flat) and the criteria for exceptions;
- provide a better understanding of the company's performance through benchmarks for measuring performance against comparable companies and/or against the company's past performance, including a set of generic benchmarks for all SOEs;
- provide information on the company's likely equity demands over time, given its planned investment profile and capital structure, and;
- establish processes (such as, potentially, an in-depth strategic review) to look at particular aspects of the company's business where the initial review does not allow for sufficient depth or time to examine such issues.

The terms of reference for the long-term hold review will be agreed between shareholding ministers and the SOE board. Shareholding ministers' expectations or preferences arising out of the review will be included in a "Statement of Shareholder Preferences", which will be available to the board for its consideration. The Statement of Shareholder Preferences should be referred to by the board when developing its SCI in future business planning rounds.

The reviews are not a full examination of the strategic direction of the company. However, they may identify aspects of the company's direction, and make recommendations on issues to be examined outside of the review.

Source: Owner's Expectations Manual for State-Owned Enterprises, 29 October 2007, CCMAU, New Zealand.

The following table describes and provides comments on the mains steps in carrying out the annual review of SOE performance. There might be a great variety in the way each country chooses to realise each step. What will make a difference in terms of accountability is the quality and reliability of the assessments made, whatever the process used to achieve these. These steps are thus mostly indicative and provide only the main actions that will have to be undertaken to ensure an effective performance review.

Table 2.2. **The mains steps in carrying out the annual review of SOE performance**

Main steps	Brief description
Information provided by the board	The board should provide all elements necessary to evaluate the SOE performance as regards the agreed upon targets. This includes firstly the audited performance indicators along with an explanation of why the targets have been achieved or not. These comments qualifying the effective performance regarding the targets is the most value-adding part of the information and will be at the core of discussion between the board and the ownership entity. The ownership entity will also receive all the elements publicly available such as annual (and quarterly) reports. Some formal systems might be developed requiring SOEs to submit specific reviews or reports to the ownership entity as a basis for the annual review (see the example of the Korean specific review report, Box 2.5). These could be extensive and specific reports commenting on a number of performance indicators and providing significantly more information to the state as an owner than what a usual private sector company would be required to do. Careful consideration should be given to costs and benefits of these additional information requirements.
Gathering additional elements	In addition to the elements provided by the SOE itself, the ownership entity might gather additional elements, discuss and evaluate specific issues and make judgments on important topics which might complement the assessment and put it in perspective. This could be done, among other things, through the complementary information channels mentioned above in Section 2.2, particularly the auditors, both external and state ones, as well as industry analysts, rating agencies, etc.
Discussion with the board	Annual reviews might be discussed with the boards of the SOEs concerned. Discussion will allow qualifying the performance and will provide more background to the ownership entity to understand the factors explaining such performance. This formal or informal discussion with the SOE board is the central stage of reviewing performance by the ownership entity. It allows the ownership entity to develop and confront its own judgment about the SOE's performance.

Table 2.2. **The mains steps in carrying out the annual review of SOE performance** *(cont.)*

Main steps	Brief description
In-depth internal discussion	Some specific mechanisms might be developed within the ownership entity to discuss in-depth annual reviews. As an example, internal panels including senior management of the ownership entity, in addition to the officer usually in charge of following a specific entity, would allow developing a broader perspective and fresh views on the evolution of performance of the SOE concerned.
Summary of the performance review	A summary document should be developed by the ownership entity underlying the most important elements of annual performance. This document should provide an overall qualitative evaluation of the performance, together with main performance indicators as regards original targets. This summary performance document could be shared with the SOE concerned. This would be useful as the summary document will also constitute a good basis for the development of the following year's performance targets.
Publication of synthesis document	It might be useful for the general public and the media to have access to a synthesis document providing the list of main performance indicators or outcomes against targets for each SOE. This synthesis table would at least provide outcomes against main financial targets, including profitability, capital structure and dividend. It could also mention the existence or not of special or policy-oriented targets.

Box 2.5. **Korean review report**

Each year the Minister of Planning and Budget sets a series of up to 30 performance indicators for each SOE. Each year SOEs have to submit "completion reports" on their performance both to the Minister of Planning and Budget and other line ministries. These performance reports can range from 200 to 1 000 pages.

2.4. Benchmarking performance

Benchmarking SOE performance means that SOEs are compared with companies in the same industry that are of similar size and subject to similar complexity and risk. These "peers" could be from the private or the public sector, domestic or foreign. The chief purpose of benchmarking is to identify performance gaps and areas of potential improvement. It allows taking into account the impact of market evolution or other "external" factors on performance.

The following table presents the main steps in benchmarking SOE performance are:

- Identify relevant peers.
- Develop relevant industry research.
- Collect performance information for peers and compare it with actual performance.
- Interpret comparisons.

It is often challenging to benchmark the performance of public sector enterprises as they might be in sectors where there are no similar public or private sector enterprises. In this case, benchmarking could be done with foreign companies active in the same sector.

The rate of return is often very useful for benchmarking performance, since it focuses on the cost of capital, which is often underestimated or neglected by SOE management. However, estimating the cost of capital for SOEs is not always straightforward and includes a series of judgments and assumptions, including on the riskless rate of return, the asset beta and systematic risk (see Box 2.6).

Box 2.6. **Estimating the cost of capital**

The estimated cost of capital (k) is based on the assumption that the SOE is subject to income tax and that it is independent from the proportion of debt and equity in the SOE capital.

The basic formula is as follows: $\mathbf{k = R_f (1 - T) + \Theta\beta}$, where:

- $\mathbf{R_f}$ = the riskless rate, proxied by the current five-year government stock rate. For value-based reporting, it is desirable to have a rate that reflects the value weighted average duration of the entity's future cash flows. Unless there is a clear reason to use a different term, the five-year rate at the beginning of the reporting period is recommended.
- **T** = the marginal personal tax rate on interest income.
- Θ = the (estimated) tax adjusted market risk premium: the tax adjusted excess over the riskless rate (**Rf**) of the expected rate of return to investors in a fully diversified portfolio of equities.
- *Rf* – the riskless rate.
- β = the relevant asset beta: denotes systematic risk that is the degree of association of returns from a particular investment with the returns from the whole market. For value-based reporting, where the reporting entity has different lines of business, the systematic risk to be assessed is the risk of the separate lines of business. The beta for the entity as a whole needs to reflect a weighted average of the betas of the individual businesses that make up the entity.

Beta is likely to be the most difficult variable to determine when estimating the cost of capital rate. The process involves the following two steps:

- As the equity of SOEs is not traded, the returns to the equity holder are not observable. This problem can be addressed by identifying comparator firms (with similar characteristics, in terms of output supplied, nature of customers and suppliers, types of trading contracts, and so on) that do have traded equity, and using their returns to estimate an equity beta. Any such comparison involves a degree of judgment.
- The recommended formula for estimating the cost of capital rate requires an asset beta. An asset beta is a measure of systematic risk in the absence of debt. Most comparator firms have debt, and their equity betas must be converted to asset betas. An average of the asset betas of the comparator firms is then calculated to arrive at the asset beta for the particular investment or line of business being assessed.

Source: Estimating the Cost of Capital for Crown Entities and State-Owned Enterprises, October 1997, A Handbook prepared for the Treasury, New Zealand.

The use of synthetic financial ratios might also facilitate benchmarking when enterprises are not in the same industry. Different measures of value creation could be used (see Box 2.7 for the methodology of measuring value creation in the UK).

Box 2.7. **Methodology for measuring value increase in the UK**

The UK Shareholder Executive selected an economic profit methodology to measure the increase in shareholder value. The ***Economic Profit*** is the after-tax operating profit (EBITA) less the cost of capital charge for the operating assets. It thus excludes the gains and losses arising from non-operating assets, the financing flows and tax impacts of the debt/equity capital structure.

This measure of value creation has the following advantages:

a) It is grounded in the fundamental drivers of economic value creation, such as growth and return on invested capital, and explicitly charges for the economic cost of the invested capital.

b) It reflects generally accepted and understood practices in the financial community for how to analyse value and value changes.

c) It applies to all business in different sectors across the portfolio.

d) It demonstrates historic performance, rather than changes in future expectations, as well as changes in ongoing performance.

e) It is flexible enough to measure both in-year performance, through economic profit, and cross-year performance through value change.

Source: Shareholder Executive Annual Report, 2005-2006.

EVA is an example of a well-established, widely used measure which is applicable to a wide range of industries consistently. It might thus be very useful in benchmarking the performance of SOEs across sectors and time (see Box 2.8).

Box 2.8. **Value-based reporting and use of EVA in New Zealand**

A core expectation for SOE boards is that there is a continual focus on managing for value… Boards should understand the company's value drivers and monitor enterprise value constantly. To support this … ministers also encourage the use of VBR. VBR represents a useful tool to assist both ministers and boards to advance the objectives of SOEs. The most widely used form of VBR is Economic Value Added (EVA) performance measurement.

EVA is a useful additional measure of performance for any long-term owner of businesses, and it can be calculated from publicly available information. EVA focuses on the changes in a company's economic value from a shareholder perspective. In light of the government's current long-term hold policy for SOEs, EVA can help measure their economic performance over time. It is internationally recognised as a measure of performance.

Put most simply, EVA is net operating profit minus an appropriate charge for the opportunity cost of all capital invested in an enterprise. The resulting EVA is therefore the profit (or loss) in excess of (or below) an investor's required return. A key benefit of EVA is that the system encourages a mindset in which managers recognise that all capital has a cost and therefore they should allocate capital to its most effective use.

While each SOE is required to be as profitable and efficient as comparable private sector companies, a number of SOEs have no companies with which to compare their performance. EVA is a useful benchmarking tool in such cases. Some SOEs already use EVA for internal purposes and/or publish their EVA results… Shareholding ministers support and encourage this approach. By providing decision-makers with additional information focusing on shareholder value, EVA should be able to contribute to improving overall performance over time.

Source: Owner's Expectations Manual for State-Owned Enterprises, 29 October 2007, CCMAU, New Zealand.

Whatever peer is chosen for benchmarking, there will still be differences in a number of dimensions. It will always be challenging to make robust like-with-like comparisons. Consequently, care is always required in interpreting comparisons of performance. The review of generic benchmarks used to evaluate an SOE's performance could be done regularly within the framework of medium-term reviews as described in Section 2.3.

Table 2.3. **The main steps in benchmarking SOE performance**

Main steps	Brief description
Identify relevant peers	It is critical and challenging to identify relevant peers with which performance of a specific SOE could be compared meaningfully. In many cases it will be difficult to find perfect peers as SOEs are often active in newly liberalised industries, with few or still smaller private sector competitors, etc. To do so, the ownership entity could look into the same industry, both in the private and the public sector, as well as abroad. Foreign peers might be useful in many cases to compensate for real domestic peers. When choosing peers for benchmarking, it is also necessary to identify and keep in mind the most significant differences with the SOE concerned. This could be in terms of size, specific business lines, status, regulatory environment, market presence, etc., to the extent that these dimensions might have an impact on objectives and performance. It might be useful to discuss the choice of relevant peers between the ownership entity and the SOE board and management. They might have more in-depth market knowledge and thus provide useful elements to identify main commonalities and differences, as discussed above.
Develop relevant industry research	It is useful for the ownership entity to develop relevant industry knowledge, or to have an easy access to such knowledge, at least for its largest SOEs. The ownership entity should thus collect series of relevant industry-specific indicators, both financial and non-financial.
Collect performance information for peers and compare it with actual performance	The ownership entity and the SOE itself should strive to collect performance information for the identified peers. Synthesis tables of performance indicators could be built up showing the performance of the SOE in a comparative perspective as regards its peers.
Interpret comparisons	Careful interpretation of performance comparison should be developed in order to identify performance gaps and derive areas of potential improvement. Appropriate consideration should be given to the differences among targeted peers, including those concerning the regulatory environment.

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Chapter 3

Auditing Performance

This chapter will discuss how to ensure appropriate audit of SOE performance. It will cover three different types of audits, namely internal, external and state audits, discussing their respective role, what kind of information and reports they provide to whom, how and to which point these are disclosed to the public, and what is the relationship of these different auditors with the audit committee.

3.1. Overview

Auditing performance provides credibility to the performance indicators and the performance review process. It also ensures a robust basis for the accountability system, *i.e.* setting objectives, reviewing performance and disclosing information.

The Guidelines cover in their recommendations three different types of audits: internal, external and state audit. Not all SOEs will necessarily be covered by state audits.[1] To ensure an overall robust auditing system and avoid duplication, it is important to clearly define the respective roles of these audits and explain how they complement one another. It is also necessary to define the state's relationship, if any, with these different types of auditors.

Internal auditors have a unique position and can play an important role by scrutinizing governance practices, reporting routines, the implementation of risk-management policies, and internal control processes, etc. The Guidelines recommend that SOEs "*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 company organ*" (Guideline V.B). The annotations also provide clear guidance on the role and functions of the internal auditors: "*Internal auditors are important to ensure an efficient and robust disclosure process and proper internal controls in the broad sense*". Internal auditors constitute the first level of review of the quality of information concerning the extent to which the organisation has achieved its established objectives. Internal auditors contribute to the improvement of risk-management and control systems, which tend to be in some cases underdeveloped in comparison with the private sector. They are an important instrument to assist SOEs to better identify and evaluate risks. This risk evaluation is becoming more critical with the growing deregulation and internationalization of industries in which SOEs often operate.

The Guidelines also recommend that "SOEs, especially large ones, should be subject to an annual independent external audit based on international standards. The existence of specific state control procedures does not substitute for an independent external audit" (Guideline V.C). This recommendation is based on the analogy that SOEs are the ultimate public companies, as they are owned in fine by the general public, the state being the agent of this general public. They should thus be subject to at least the same level of transparency and disclosure requirements as listed companies. One central consequence is that SOEs should be audited by an **external independent auditor**. In terms of auditing standards, the Guidelines recommend that SOEs be "subject to the same high quality … auditing standards as listed companies".

Finally, the Guidelines recognise the presence of **state or "supreme" auditors**: "The co-ordinating or ownership entity should … have clearly defined relationships with relevant public bodies, including the state supreme audit institutions" (Guideline II.E). The annotations to this Guideline provide further recommendations for the ownership entity: "In particular, the ownership entity should maintain co-operation and continuous dialogue with the state supreme audit institutions responsible for auditing the SOEs. It should support the work of the state audit institution and take appropriate measures in response to audit findings, following in this regard the INTOSAI Lima Declaration of Guidelines on Auditing Precepts." However, the Guidelines are neither specific nor detailed on what should be the role of state auditors in auditing the

performance of both the SOEs themselves and the co-ordinating or ownership entity. The annotations mention that "specific state audit and control systems (…) are sometimes considered sufficient to guarantee the quality and comprehensiveness of accounting information". They also mention the possible limits of such state audits: "these specific controls are designed to monitor the use of public funds and budget resources, rather than the operations of the SOE as a whole".

Finally, implementation of the Guidelines also requires that the state "maintain(s) a continuous dialogue with external auditors and specific state control organs… when permitted by the legal system and the state's level of ownership" (Guideline II.F.4).

The audit committee plays a central role in overseeing the relationship with the three types of auditors. Internal auditors should have a direct reporting line to the audit committee, which should ensure their independence, support their work and discuss their findings. The audit committee is also responsible for nominating or appointing external independent auditors and for overseeing the relationship with them. Finally, audit committees should also discuss the results of state audits, and in general ensure that appropriate action is taken upon audit findings.

In sum, the process of auditing performance contains three main elements (see the Italian example in Box 3.1):

- effective internal audit systems are put in place in SOEs;
- SOE financial statements are audited by external and independent auditors according to international standards;
- the role of state audit *vis-à-vis* SOEs and the co-ordinating or ownership entities is clearly defined; their mission is supported and appropriate use of the audits is done.

These topics will be covered in the following pages, providing guidance on processes and main steps which could be undertaken by the state as an owner to ensure appropriate implementation of the Guidelines regarding auditing performance.

Box 3.1. **Audit of SOE performance in Italy**

Internal Audit: In all SOEs, the internal audit office reports directly to the Board, usually every 6 months, on the following matters: evaluation of the efficiency of the internal audit procedures, checks effectively made and possible risk areas. Moreover, the Ministry of Economy and Finance, as the ownership entity, has actively promoted that all SOEs appoint a senior officer (usually the CFO) responsible for the company's accounting procedures and financial statements. This officer is appointed by and reports to the Board of Directors and is accountable to all stakeholders for the Company's Annual Reports and financial data.

External and independent Audit: All SOEs, both listed and unlisted, are subject to an annual audit by independent external auditors, who are appointed by the GSM. The external auditors of SOEs are required to be duly registered by the Italian Securities and Exchange Commission (Consob), to ensure that they meet the same high quality auditing standards of listed companies.

State Audit: The activity of SOEs is supervised and audited by the National Audit Office (Corte dei Conti). An appointed official of NAO attends SOEs' Board meetings and an annual report by NAO on the performance of each SOE is sent to the Parliament.

3.2. Internal audit

"Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organisation's operations. It helps an organisation accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes."[2] The Guidelines provide in their annotations some useful indication of the main functions of internal auditors: "They should define procedures to collect, compile and present sufficiently detailed information. They should also ensure that company procedures are adequately implemented and be able to guarantee the quality of the information disclosed by the company".

The Guidelines also provide important indications on the authority of internal auditors and necessary means to fulfil this authority: "*To increase their independence and authority, the internal auditors should work on behalf of, and report directly to the board and its audit committee in one-tier systems, to the supervisory board in two-tier systems or the audit boards when these exist. Internal auditors should have unrestricted access to the Chair and members of the entire board and its audit committee. Their reporting is important for the board's ability to evaluate actual company operations and performance*."

The ownership entity should demand that their portfolio companies have appropriate procedures for internal auditing that meet the *International Standards for the Professional Practice of Internal Auditing*. It should also encourage internal auditors to focus not only on compliance but on risk, *i.e.* on ensuring that the risk management policy is properly implemented. In addition, they could recommend first that internal audits are acted upon and secondly that the internal audit departments of the main SOEs be audited regularly, by the external independent auditors of by the state auditors.

Below is an overview of the key elements that the ownership entity should demand in order to ensure an effective internal audit process in SOEs. The recommendations build on the *International Standards for the professional Practice of Internal Audit* mentioned above.

Table 3.1. **Overview of the key elements that the ownership entity should demand**

Main steps/points	Brief description
Develop appropriate policies regarding the role of audit committees in supporting internal audit	Governance policies or guidelines developed by the ownership entities for SOEs should underline the role of audit committees in supporting the independence and authority of internal auditors. They should also encourage close working relationships between the board, the audit committee and the internal auditors. SOE boards and their audit committees should understand the invaluable role of internal auditors to strengthen their own oversight role. They should ensure that internal auditors get sufficient resources and are well positioned within the SOE (*i.e.* at sufficiently high level and separated from functional areas) to guarantee their independence. Internal auditors should also have a direct reporting line to the audit committee. Ownership entities should particularly encourage SOE boards and their audit committees to discuss significant risk, control and governance issues with internal auditors.

Table 3.1. **Overview of the key elements that the ownership entity should demand** *(cont.)*

Main steps/points	Brief description
Ensure that appropriate risk assessments are carried out in SOEs	Priorities for the internal audit work are determined based on an analysis of risks faced by the organisation. The evaluation of risk exposure should cover operations, governance and information systems. This risk assessment should be carried out by the chief audit officer, and be discussed with senior management and within the audit committee. The risk assessment plan should be discussed and approved by the entire board or the supervisory board. The ownership entity should pay attention to the implementation of a risk-management system in the company and should be provided with at least a summary of the risk assessment. This is an important element to complete its knowledge of the industry and of the company, and provides a useful perspective for discussing strategy objectives and performance.
Recommend boards to follow up internal audit plans and their implementation	The ownership entities should require internal audits to be acted upon. SOE boards should discuss and follow implementation of internal audit plans. These audit plans should include the evaluation of the relevance and effectiveness of internal control systems. The audit committees should also monitor and assess the effectiveness of internal audits. To this end, the board should ensure that senior management has undertaken appropriate follow-up based on internal audit's recommendations.
Make performance indicators audited by internal auditors	In evaluating the internal control systems, internal auditors could also review to what extent the performance of the SOE is consistent with its established objectives. This includes reviewing criteria or indicators chosen to evaluate performance. This also includes an audit of performance indicators as provided by the information systems.
Encourage appropriate communication among boards, internal and external auditors	SOE governance processes should ensure appropriate co-ordination and communication among the board, external auditors and internal auditors. Ownership entities could develop policies encouraging such communication and remind internal auditors, when reviewing the governance of SOEs, to assess this communication and make recommendations towards its improvements.
Require SOEs to include internal control reports in their annual reports	It is a good practice to include in the financial statements an internal control report describing the internal control structure and procedures for financial reporting. Ownership entities should require SOEs to include such internal control reports in their annual reports and follow up on how effectively they comply with this requirement.

Table 3.1. **Overview of the key elements that the ownership entity should demand** *(cont.)*

Main steps/points	Brief description
Require periodic audit of internal audit departments	SOE boards could require the periodic external audit or quality assessment of internal audit departments, in order to assess the quality of their findings and their status within the SOE. This would emphasise the importance of internal audit for the quality of the information disclosed by the SOE.

3.3. External and independent audit

The annual external audit shall provide the board and shareholders with an independent, critical and objective report on how financial statements have been prepared and presented. They are carried out to ensure that accounts fairly represent the financial position and performance of the company in all material aspects.

The Guidelines recommend that the external audit be based on international standards (Guideline V.C) and "*the same high quality … auditing standards as listed companies*". The use of these standards is expected to significantly improve credibility of the audit performed, and thus of the information provided to the state owner, to other investors as well as to the general public. It will also improve its comparability.

In addition to competence and qualification, one essential consideration is the effective independence of the external auditors. The state as an owner should thus clearly require adherence to relevant principles or standards aiming at reinforcing, among other things, auditors' independence.

An important factor favouring external auditors' independence is the way they are appointed and to whom they are accountable. External auditors should be accountable to the shareholders via the boards, and not to the managers they work with while performing their assignment. Consequently, it is considered as good practice that external auditors are appointed by the AGM following recommendation of the board audit committee.

Table 3.2. **Recommendations on steps that could be taken by the state to ensure that SOE financial statements are appropriately audited by external and independent auditors**

Main steps	Brief description
Require external audit by an independent auditor	Ownership entities should develop a specific recommendation, or refer to a more general code or listing requirements, requiring all SOEs above a certain size to be audited by an external independent auditor. This requirement could be reminded in the ownership policy, the SOE code of corporate governance or any other document related to the transparency and disclosure of SOEs.

Table 3.2. **Recommendations on steps that could be taken by the state to ensure that SOE financial statements are appropriately audited by external and independent auditors** *(cont.)*

Main steps	Brief description
Develop procedures for the selection of external auditors	The ownership entities could develop specific recommendations regarding the selection and appointment of external auditors. Good practice in the private sector calls for external auditors to be recommended by the audit committee of the board or an equivalent body. In the case of fully owned SOEs, external auditors might be appointed directly by the ownership entity, based on the audit committee's recommendation. For partially owned SOEs, the usual good practice applies, *i.e.* nomination by the AGM following recommendation of the board audit committee. In the case of fully owned SOEs, appointment by the ownership entity allows tightening the auditors' accountability as regards the state owner. In any case, the ownership entity should have the capacity to follow the overall process of procurement, from the definition of criteria to the assessment of candidates and final selection.
Define criteria for independence of external auditors	It is crucial that external auditors be independent from the management as well as from large shareholders, *i.e.* the state in the case of SOEs. Criteria for independence should be similar to those used in the private sector. They could include limits on providing consulting or other non-audit services to the audited SOE, as well as periodic rotation of audit partners or audit firms, as mentioned in the annotations of the Guidelines. Ownership entities could develop policies specifying criteria for independence of external auditors. They could take inspiration from the IOSCO standard "*Principles of Auditor Independence and the Role of Corporate Governance in Monitoring an Auditor's Independence*" which states that – "*Standards of auditor independence should establish a framework of principles, supported by a combination of prohibitions, restrictions, other policies and procedures and disclosures, that addresses at least the following threats to independence: self-interest, self-review, advocacy, familiarity and intimidation.*"
Adopt international audit standards	The state as an owner should require that its large SOEs adopt high-quality internationally recognised auditing standards. This will also depend on the circumstances under which listed companies in the private sector use these standards, for example whether these are used only as an option or for consolidation. It will also depend on the point to which domestic standards can be considered as effectively consistent with international standards.

Table 3.2. **Recommendations on steps that could be taken by the state to ensure that SOE financial statements are appropriately audited by external and independent auditors** *(cont.)*

Main steps	Brief description
Require oversight of the relationship with external auditors by the audit committees	The ownership entities should develop recommendations towards ensuring oversight of external auditors by audit committees. This board oversight underlines the fact that the external auditors are accountable not only to the state shareholder but also to the board. Their duty is to the company and not to the managers they interact with in the course of their audit. Effective oversight of the relationship with external auditors by audit committees is necessary to ensure that the SOE gets appropriate value from this audit. It also requires adequate financial expertise within these committees. The audit committees should also follow the implementation of the audit findings and ensure that external audits, as well as internal audits, are acted upon.
Assess external auditors' work	The ownership entity should be able to assess and effectively review regularly the quality of the external auditors' work. This assessment aims at correcting potential weaknesses and provides input for the selection process. It also provides an opportunity for the owner to clarify its expectations or specific wishes it would have.
Inform on SOEs' external auditors and related fees	The ownership entity could provide information in their aggregate reports and websites on which auditors are auditing SOEs. It could also provide systematic information on the fees received by SOES' external auditors, both for statutory audits and audit-related services.

3.4. State audit

The traditional task of state audit institutions (SAIs) is to audit how government entities use public resources, and particularly the legality and regularity of their financial management and accounting. The objectives of SAIs can usefully be summarised as auditing the "legality, regularity, economy, efficiency and effectiveness of financial management"[3]. SAIs are deemed to be independent institutions and have considerable autonomy. They usually decide on their priorities while still acting as agents of Parliaments, performing audits on their instructions. They are often a powerful tool and information source for the Parliaments.

It is considered good practice that non-listed SOEs be subject to audit by SAIs "if the government has a substantial participation in them – particularly where this is majority participation – or exercises a dominating influence". Such audits should address issues of economy, efficiency and effectiveness.[4] When SOEs are also subject to high-quality external independent audit, SAIs can usefully focus on areas where they complement the external independent audit, *i.e.* performance audits and audits of the ownership entity.

SAIs are also increasingly in charge of performance audits, *i.e.* in-depth reviews of the performance, economy, efficiency and effectiveness of an entity. Performance audits cover the full range of activities, not only the financial operations but also the organisation and all operational systems in place. Since it is recommended that SOEs be audited by external independent auditors,

state audits could put more emphasis on auditing performance. As for financial audits, these could be outsourced in some cases to external auditors.

It is important, as recommended in the annotations to the Guidelines, that the ownership entity maintain co-operation and continuous dialogue with the SAI responsible for auditing the SOEs. The Guidelines also recommend ownership entities to support the work of the state audit institution by making appropriate use of their audits and taking action based on their findings.

The following table provides recommendations on what should be the scope and focus of state audits as regards SOEs and ownership entities. It also provides guidance on how to ensure that audits by state audit institutions are useful and lead to appropriate actions.

Table 3.3. **Recommendations on what should be the scope and focus of state audits**

Main steps	Brief description/comments
Define clearly the scope of state audits	The ownership entity could disclose clearly which SOEs are concerned by state audits and what will be the scope and timetable of such audits. The ownership entity could discuss with the SAI and other relevant institutions, such as the Parliament, what could be the most appropriate criteria for submitting specific SOEs to state audit, such as percentage of control, financial results, etc. It could be useful if it could also request the audit of a specific SOE. The scope of state audits could also be discussed on a case-by-case basis to target more specifically the audits according to relevant strategic issues or challenges. A generic discussion could be undertaken on the appropriate scope of such audits, taking into consideration the complementarities with internal and external audits. This could lead to an increased focus on performance audits. State audits institutions should consequently be given the capacity to carry out performance audits on both SOEs and ownership entities.
Ensuring regular in-depth performance reviews of SOEs	Ownership entities could develop a policy through which the SAI will be asked to undertake a performance audit of most SOEs in a regular manner. These performance audits are instrumental in building up the knowledge base of the ownership entity. They will also feed substantially the accountability towards the Parliament. Finally, they might be essential tools for the review of SOE mandates.
Request performance audit of ownership entities	The performance of the ownership entities with regard to the overall objectives of state ownership could also be reviewed regularly by state auditors. The ownership entity should co-operate appropriately and support this audit. This includes providing adequate information and access to staff. The results of the ownership entity review could also be discussed with the Parliament and disclosed to the general public. This could make the general public better informed about the effective behaviour of the state as a shareholder and allow broader participation in related debates.

Table 3.3. **Recommendations on what should be the scope and focus of state audits** *(cont.)*

Main steps	Brief description/comments
Support the work of state audit institutions	The ownership entity could develop guidelines or recommendations supporting and facilitating the audit work of SAIs in SOEs. This will include specific requirements ensuring that SOEs give appropriate access to information, both in terms of access to documents and records, capacity to request complementary information and access to staff.
Discuss results of state audits with SOE boards	Ownership entities could put in place specific processes to discuss in a systematic manner the results of state audits with the concerned boards. These discussions could cover the comments on state audit results as well as action plans prepared by SOE management to address issues identified by the audit. To ensure appropriate co-operation and follow-up action, it is important that the audited entity agrees on the audit findings. Open discussion of these audit findings and agreement on the final report is a critical step in this regard.
Disclose appropriately results of state audits and performance reviews	The ownership entity could adopt a policy by which state audits, including performance reviews of SOEs, are in principle disclosed to the public, or at least meaningful summaries highlighting most strategic issues. An effective means for dissemination of state audits is to post them or their summaries on the SAI's website. However, any disclosure policy in this area should give appropriate consideration to the need for protecting government, commercial, industrial or trade secrets, and not put the SOEs in a difficult situation as regards their competitors.
Take action based on SAIs' audits	Ownership entities and the audited SOEs themselves are required to take appropriate measures in response to audit findings. This includes providing comments on the audit findings in a timely manner and explaining which actions will be taken to remedy weaknesses identified by the audit. The ownership entity could develop a systematic follow-up of actions taken as an answer to audit findings, including asking SOEs concerned to regularly report on these actions and ensure dialogue with the SAI to validate their appropriateness.

Notes

1. In some countries all SOEs, whatever the level of state ownership, will be subject to state audits. In some others, only SOEs with majority state control or full control by the state will be subject to state audit. Whatever the case, the state auditor can in some countries, and often does, outsource financial audits to external auditors.
2. Definition of the Institute of Internal Auditors (*www.theiia.org*).
3. Lima Declaration I. 4.3.
4. Lima Declaration, Section 23. 1. And 23.2.

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Chapter 4

Reporting on Performance

This last chapter covers how to report on SOE performance, both at the aggregate level for the state as an owner and at individual SOE level. It will thus describe how to develop Aggregate Reports, i.e. which processes need to be put in place to collect and synthesise relevant information into a short and easy to read report providing the general public with an overview of the overall performance of the state sector. It will also briefly discuss web-based communication, as a mean to ensure greater transparency towards the general public. It will review how SOEs and ownership entities should report to Parliaments, thus which are the appropriate processes to compile, check, review and question information provided by SOEs on their performance, still maintaining an appropriate balance between lack of accountability and excessive oversight, thus avoiding political interference into SOE management.

4.1. Overview

The OECD Guidelines on Corporate Governance of State-Owned Enterprises provide a number of recommendations regarding reporting on performance, covering the publication of aggregate reports by the ownership entity, web-based communication and reporting to Parliament.

The Guidelines first recommend that "co-ordinating or ownership entities should develop consistent and aggregate reporting on state-owned enterprises and publish annually an aggregate report on SOEs" (Guideline V.A). The Guidelines consider **aggregate reporting** as a key disclosure tool directed to the general public, Parliament and the media.

Aggregate reports serve a range of complementary objectives and are useful for both external and internal purposes. The actual process of developing the reports can sometimes be just as important as the final product. The reports have many different users, ranging from the general public, media and parliamentarians to banks and other market participants. Aggregate reports are key communication tools and trust-building instruments. Developing them helps the ownership entities to clarify their policies and improve internal reporting systems. They are also useful for building consensus on specific issues and sensitive policy choices.

In addition to publishing aggregate reports, the SOE Guidelines observe that "*it has proven useful for the co-ordinating or ownership entity to develop a website*" (Annotation of Guideline V.A). Having a website and continuously improving its content is a means of ensuring public transparency. To the extent that the SOE Guidelines recommend transparency towards the general public, **web-based communication** should form a part of the communications strategy.

The Guidelines also recommend that "*the co-ordinating or ownership entity should be held accountable torepresentative bodies such as the Parliament*" (Guideline II.E). This accountability should be "*directly or indirectly, to bodies representing the interests of the general public, such as the Parliament*". **Reporting to Parliament** is an important element of the overall accountability framework, as Parliaments represent the ultimate owners of SOEs, *i.e.* the general public.

The accountability of both the ownership entity itself and of the SOEs to the legislature should be clearly defined. The annotations to the Guidelines provide an ambitious scope for it, broadly defined as covering the ownership entity performance in exercising state ownership and in achieving the state objectives. It "*should go beyond ensuring that the exercise of ownership does not interfere with the legislature's prerogative as regards budget policy*".

The checking, reviewing and questioning engendered by reporting to Parliament allows reviewing SOEs' actual performance against public expectations and therefore is instrumental in improving the transparency and accountability of the state as an owner and of the SOEs themselves. To report adequately, the Guidelines ask ownership entities to "*provide quantitative and reliable information to the public and its representatives on how the SOEs are managed in the interests of their owners*". They also call for "useful" specific mechanisms such as *ad hoc* or permanent commissions to be set up to maintain the dialogue with the legislature. The annotations also remind that constitutional laws and parliamentary traditions and roles might vary greatly among countries, having a direct impact on the form, frequency and content that this dialogue can take.

Finally, the annotations call attention to the sensitive issue of confidentiality, particularly whenever SOEs operate in a competitive sector. Specific procedures might be put in place, such as confidential or closed meetings. The annotations also warn against excessive accountability requirement which would "*restrict unduly the autonomy of the co-ordinating or ownership entity in fulfilling their responsibilities*". They call for limiting the cases for which the ownership entities would have to get *ex-ante* approval from the Parliament. They also warn against diluting the accountability of SOEs by virtue of the intermediary reporting relationship through the ownership entity.

The Guidelines and their annotations do provide a number of indications on aggregate reporting, both to the general public and to Parliament. To implement the OECD Guidelines in terms of transparency and accountability, and more specifically the Guidelines II. E and V.A., the ownership entity should thus:

- publish aggregate reports, and make active use of them;
- develop and update websites;
- report adequately to, and maintain dialogue with, the Parliament.

These topics will be covered in the following pages, providing guidance on processes and main steps to ensure appropriate implementation of the Guidelines in this area.

The different channels for reporting on performance could also be used to provide the media with relevant information, with proper consideration for commercial sensitive information. Having informed and active media covering SOEs' performance is an instrumental and effective way of ensuring public pressure for performance. The ownership entities should thus be pro-active in communicating with the media.

4.2. Publication by ownership entities of aggregate reports

Aggregate reports are yearly reports developed by the ownership entity(ies) and covering the whole state sector. They provide the general public with value adding, concise and accessible information about the overall performance of the state sector, the state ownership policy and the performance of the state as an owner.

Aggregate reports are instrumental in showing that the state is an accountable and predictable owner. They are also an effective tool for the ownership entity(ies) to clarify its(their) policy, systematise and improve internal reporting and develop consensus on good practices.

- Aggregate reporting is an important communication tool. They provide the general public and key stakeholders with a synthesis of main developments of state ownership and the performance of the state as an owner. They are thus an instrument to enhance the transparency and accountability of the state in exercising its ownership function.
- Aggregate reports are also trust-building instruments. By facilitating improved public insight and democratic control of state ownership, they demonstrate openness on the part of the authorities, which is often seen as an end in itself. They also demonstrate consistency in the ownership policy and in the way the state exercises its ownership function, helping to build trust and market confidence in the competence of the state as an owner. In addition, it sends a strong message to the SOEs themselves to meet high transparency standards.
- Developing aggregate reports helps to make information consistent and improve internal reporting systems. This function is of particular importance when the ownership function is not centralised. Under such circumstances aggregate reports allow the co-ordinating entity to emerge as a competence center and standard-setter for state ownership. This, in turn, helps to make ownership more professional across government.

- Developing aggregate reports helps the ownership entities themselves to clarify their policies and identify areas for improvements. The information collection process provides a means to compare performance across SOEs. The information obtained can also be used to provide examples of leading SOEs' performance and good practice as a lever or benchmark for other companies.
- Finally, the process of developing aggregate reports is also useful to build consensus on specific issues and sensitive policy choices, both within the ownership entities and within the administration. It is thus part of the process of setting standards and stabilising practices. Once consensus has been reached and formalised in the aggregate reports, these are used as references and might be useful for ownership entities' officials in their discussion with other departments, the SOEs themselves and the politicians.

Aggregate reports should be easy-to-read, easily accessible and easy to communicate with the general public, the Parliament and the media. They tend to be similar in terms of format to companies' annual reports. They add value in terms of aggregate data and analysis but remain concise and focused. They are usually more concise and accessible summary documents than reports to Parliaments. In a number of countries, aggregate reports are attached to reports to Parliament as useful synthesis documents. However, if reports to Parliaments are concise and synthetic enough, and disclosed publicly, aggregate reports might in this case be the same as reports to Parliament.

Aggregate reports usually provide rich information on state ownership, including the following main elements:

- A central component is the review of financial performance, including a synthesis presentation of aggregate balance sheets, income statements and cash flows. Key financial ratios for individual SOEs and the overall state portfolio may also be provided, with their recent evolution.
- A highlight of main events of the year, including specific outstanding achievements by SOEs and major transactions to inform the general public on the development of the state portfolio.
- Essential background elements as a framework to evaluate the performance of the state as an owner. This includes the state ownership policy and information about the organisation of the ownership function, its main activities and major related reforms. Information on systems for setting objectives and reviewing performance might also be provided. Finally, matters of special interest for the state or that are topical in view of current economic or political developments might also be covered, regarding, for example, employment, competition, innovation and remuneration.
- Synthesis presentations on all or the largest SOEs with comments and data about their current performance, including essential elements on their mandate, objectives and comment on their achievements. Description of main events, financial performance of the current year and summarised financial information with key ratios are usually provided. Information is also given on dividends received by the state, as well as on board composition, senior manager and auditors. Finally, specific ownership policy objectives and their implementation by SOEs, such as ethical, environmental or gender policies might also be covered.
- Reference and systematic information on a series of practical matters, such as changes in ownership, shareholding ministries with specific persons in charge, board members and legal and regulatory documents.
- Additional background information on the history of state ownership and prospective or opinion pieces may enrich further the overview of state ownership.

Aggregate reports could also provide some form of "combined" accounts for the whole state sector, giving a clear and reliable picture of its size and financial situation. These "combined" accounts

allow the compilation of reliable main aggregates on asset size, indebtedness, etc. and provide a solid basis for a more rigorous analysis of the financial performance of the state sector as a whole. However, such "combined" accounts are not "consolidated" accounts in the usual accounting sense. These "combined" accounts do not mean whatsoever that the state and SOEs could be compared to a group of companies, nor that the state is a parent company in the legal sense. The development of "combined" accounts should therefore come with appropriate clarification on their nature and methodological information on the way accounts have been "combined" (see Box 4.1).

Developing aggregate reports entails developing specific processes within the ownership entity to collect and synthesise information on SOEs. These processes involve active consultation and co-ordination among different parts of the ownership entity to build consensus on the structure and the content of the synthesis. It also involves adequate data collection from the SOEs themselves and appropriate co-ordination with them. SOEs have to be part of the process of developing the aggregate reports, and possibly effectively integrated in this process up-front. They should be interested in doing so as the aggregate report might also have a significant impact on their own image.

Box 4.1. **Combined accounts in France**

The French aggregate report has provided since 2004 combined accounts for the state sector. The criteria for combination are neither the economic interests nor the organisational ties existing between combined entities, but the fact that they are controlled by the state. "*The aim of combined accounts is to present the capital, financial situation and results of a group of entities where the cohesion arises from state ownership or, at another level, from organisational links leading to common social, commercial, technical or financial behaviour*" (*L'État Actionnaire*, 2003, p. 43). Combined accounts do not however cover all minority participations, and exhaustive information in this regard can be found in the state *comptabilité patrimoniale*.

A specific manual has been developed to explain and describe the way to proceed to develop these combined accounts. The combined accounts are provided with accompanying accounting principles and notes. They are reviewed by a group of independent experts who certify the conformity of the combining principles with the accounting principles for listed companies referred to in France and that their implementation provides the best image possible of the state patrimony, its financial status and performances.

Developing an aggregate report is a significant task which involves different persons within the ownership entity: the officers in charge of, and in direct contact with, SOEs and the accounting and financial specialists. It is necessary to clearly designate the respective responsibilities of those involved in putting all the elements together. The ownership entities could designate one or two persons in charge of co-ordinating information-gathering and developing the synthesis. However, the development of the aggregate report will intensively involve the whole entity at the time of finalisation and publication. External assistance can be used for design and publication.

It is also advisable for the responsible team to begin developing aggregate reports as early as possible. A large part of the content can be ready in advance, while the whole process usually takes around 5 to 6 months. The responsible team will still have to wait for data availability from SOEs to be able to finalise the report. Ideally, aggregate reports should be published soon after individual companies' annual reports, *i.e.* at the end of the first semester. Sufficient time needs to be set aside for internal and external co-ordination, as the most time-consuming aspect is to discuss and agree with all the persons involved.

The following table describes the main steps that might be followed in developing an aggregate report. It also provides guidance and draws attention on critical aspects or key success factors, particularly for ownership entities which have not yet developed such aggregate reports.

Table 4.1. **Main steps that might be followed in developing an aggregate report**

Main steps	Brief description
Clarify key messages, main content and structure	A preliminary step is for the ownership entity to clarify the key messages it wishes to communicate, to whom and why. This could be subject to internal discussion and an opportunity for the ownership entity to reflect on its role and missions. The main message could, for example, highlight an important new development in the ownership policy of the state. It could also explain significant evolution in SOE performance. Another option is for the ownership entity to emphasise a particular theme or set of priorities. As an input in developing this key message, it might be useful to consider how to respond to the questions most frequently asked by visitors, the media or other interested parties. It could also keep in mind the typical misunderstandings about how the state carries out its ownership function. Aggregate reports should allow clarifying most of these misunderstandings. An important and useful step is to agree within the ownership entity on the main content and structure of the report. This includes agreeing on the main analysis on financial performance and specific focus which will be covered, if any. This step usually triggers a lot of internal discussion within the ownership entity. This should not be reduced, as it is *per se* one important benefit from developing such reports.
Collect relevant information	A central stage in developing aggregate reports is collecting information both within the ownership entity and from the SOEs themselves. In order to do so, ownership entities could put in place systematic information collection processes with accompanying guidance, covering the ownership entity different officers and/or board members as well as the SOEs themselves. ● Specific data sheets could be sent to companies for them to fill out with their updated figures. ● Specific working groups with representatives of all the SOEs covered in the report could also be formed. ● Another option is to identify or use "contact points" in each SOE. These contact points might work in close relation with the officer in charge of the SOE within the ownership entity, not only to provide the necessary information to develop the aggregate report, but also as a means more generally to strengthen their relationship; ● Finally, ownership entities could also use external consultants to ensure data consolidation on the whole state portfolio.

Table 4.1. **Main steps that might be followed in developing an aggregate report** *(cont.)*

Main steps	Brief description
	This information collection stage is not only central, but allows involving SOEs early in the process. This active involvement is necessary and important. The information asked from SOEs to develop aggregate reports would in most cases be also necessary to actively and strategically oversee SOEs. Developing aggregate reports might thus in some cases be instrumental in systematizing reporting.
Review of company data by the SOEs	Information on specific SOEs should always be approved or reviewed by the companies themselves. This could be done formally or informally, through the officer in charge of the SOE within the ownership entity. In some cases, company information could even be directly written by the companies. The aggregate report will have an impact on their image and value. Listed companies, for example, might indeed be particularly careful with market-sensitive information. However, the report should still reflect the views of the ownership entity as the owner.
Co-ordinate with other government departments	Developing aggregate reports also entails discussing and agreeing on a number of points with other government departments. This will be the case especially whenever the ownership function is not fully centralised. This co-ordination might be politically difficult and give rise to rivalries, conflicts of interest or turf battles. It might indeed become the most difficult and time-consuming step of developing aggregate reports. This step should thus not be underestimated, particularly in planning for the development of such reports.
Draft main elements and agree on a final draft	Based on collected information, internal discussions and external co-ordination, the team in charge could draft the synthesis and comment on the overall performance. It will also complete the different sections in light of most recent data and events. The final draft of the aggregate report should be agreed on both by senior officers of the ownership entity and by the ones in charge of the relationship with the companies covered.
Endorsement by the relevant authority	In developing and publishing aggregate reports, ownership entities may have them endorsed by a relevant authority, highlighting the main elements or priorities of the state ownership policy. The presence of a foreword or other statement signed by the main ministry in charge of state ownership might give more visibility, political weight and thus appropriate status to this key communication tool.

Table 4.1. **Main steps that might be followed in developing an aggregate report** *(cont.)*

Main steps	Brief description
	These forewords set the tone and provide a good indication of the current policy on state ownership. They can highlight, for example, the importance of state ownership for the concerned economies and clarify the objectives of such ownership for the current government.
Active use of aggregate reports as a main communication tool	Ownership entities could make active use of aggregate reports in many different ways. Internally, aggregate reports might serve the role of updated reference documents. Once consensus on practices has been reached and formalised in the aggregate reports, these can be used as a helpful reference for discussion with other departments, the SOEs themselves and relevant political authorities. Externally, aggregate reports might be actively used as a main communication device by the ownership entity and its officials in communicating with the media and external visitors. Aggregate reports can also be useful documents to explain the state's practices regarding ownership in international fora.
Use of the media to improve transparency	The ownership entities should encourage active media coverage of state sector performance. The press, by raising difficult questions, can play a critical role and contribute to accountability. The ownership entities should thus be pro-active in providing relevant information to the media. They could use the aggregate report as a main device in informing and communicating with the media.

4.3. Development and timely update of websites by the ownership entity

Web-based reporting has great potential value for the state as an owner in terms of transparency to the general public. It provides the general public with easy access and timely information about the performance of the state sector and on how the state exercises its ownership function. It is also an important channel for communicating with the media.

Web communications of ownership entities reflect, of course, the organisation of the ownership function:

- Developing a website for the ownership function will be easier in case of centralisation. Some centralised ownership entities have dedicated websites. Others often have less-developed sites integrated into larger governmental sites, typically that of the Ministry of Finance.
- However, web-based communication is also doable, even if more difficult, where the ownership entity is not centralised. In this case, the co-ordinating entity would gather necessary information from different ministries or agencies concerned and make them available on a single website.

Web-based communication usually provides some general and framework information as well as links to reference documents on the following aspects of state ownership:

- *Founding documents/charters of ownership entities,* generally items of legislation. This information may be presented in different ways, by providing links to the legislation, by integrating it directly into the site, or doing both by providing a web summary with a link to the original.

- *Clear statement of the objectives of state ownership:* Discussion of the objectives of state ownership might be displayed prominently on the site, with links to legislation or aggregate reports.
- *Governance statements* describing the principles of governance that apply to SOEs. Summarised principles might also be found with a link to separate documents, other guidance or more specific governance policies that the state might employ in its oversight of SOEs. This could include a governance code, guidelines for setting remuneration or appointing directors, etc.
- *Organisation chart for the ownership entity* and information on the accountability framework of the ownership entity within the state.
- Information on management or executives of the ownership entity, with links to CVs, etc.

The major advantage of web-based communication is that it can be timely updated and used to provide the general public with the latest news regarding the state portfolio. It can also be used as a way to provide interim reports in between the publication of annual aggregate reports.

websites also allow reaching an international audience, by providing most or part of their information in English. Legislation, however, is not always translated.

Table 4.2. **Web-based communication**

Main steps	Brief description
Decide on the main structure	Discuss internally which should be the main elements of the website and its architecture (main paths, etc.). To do so, it is important to think about the main messages that the ownership entity wishes to communicate to the general public regarding its activity, its organisation, its performance, etc. It could also be useful to get inspiration from other existing websites and figure out the typical questions that will be asked by external visitors.
Collect relevant information	All relevant information regarding the ownership entity objectives, organisation, constituting documents, the size and composition of the state sector, governance principles, etc., should be collected. Short summaries of most important documents should also be provided with links to the full document.
Draft main pages	Main pages are strategic in terms of image. Their drafting is important. Management should agree on them and review them on a regular basis. The web manager has an overall responsibility of ensuring coherence and consistency in terms of style, length, etc., but the responsibilities for drafting different pages should be allocated to relevant officers.
Design a simple website and enrich the page architecture progressively	It is preferable for the website to be built step by step, keeping it simple at the beginning and enriching it progressively. Keeping it simple, using ready-made script and easy-to-customise templates will minimise the resources required. It should be simple in terms of animation, as visitors want to get what they want fast, while sophisticated animation usually takes time to be loaded.

Table 4.2. **Web-based communication** *(cont.)*

Main steps	Brief description
Test the website	It is important to test the website by browsing though it as a typical visitor. The objective it that the most valuable or targeted visitors will find access easily to the information they are looking for. Give a clear guide and site's path to what visitors want. Getting regular feedback on the quality and usefulness of the website might be useful to improve it.
Put in place updating processes	Websites are valuable as long as they are updated regularly. It is thus important to designate internal responsibilities for updating the different pages in terms of content and develop internal routines to alert the relevant persons on the need to update their pages. A clear process for feeding the "what's new" or "news" section has also to be developed.

4.4. Reporting to Parliament

Reporting to Parliament is important for the overall process of transparency and accountability and is recommended in the Guidelines. It requires a process of compilation and checking that includes a large number of parties, such as SOEs, ministries, parliamentarians, parliamentary support staff, the public and the media. Accountability is achieved through the interaction between various parties in what can be viewed as a "disclosure dynamic".

In practice, the responsibility for reporting to Parliament is usually shared among different ministries and an ownership entity. Reporting to Parliament may be done directly by a branch ministry even where there is a centralised ownership entity not under this branch ministry authority. In this case, branch ministries might report on individual SOEs while the ownership entity would report on the aggregate state portfolio. Often, branch ministries focus on policy issues while the ownership entities focus on ownership issues.

There are three types of reporting to Parliament: *Periodic* reporting, *ad hoc* reporting and reporting *for approval*.

Periodic reporting typically occurs on an annual basis and is usually associated with the approval of state budgets. Periodic reporting may be on individual enterprises or may combine or consolidate information on a number of SOEs, and may be used as a supplement to budget acts or to provide information on the performance of SOEs. Ownership entities may also provide periodic reports on their performance in managing the companies under their tutelage.

Ad hoc reporting derives from the capacity of parliaments to demand and receive information outside the periodic reporting process. *Ad hoc* reporting can cover a broad range of issues, responding to matters of immediate concern or to important current events. *Ad hoc* reports may cover issues that may be politically charged, such as sales of SOEs or participations, pension liabilities, employment levels and layoffs, remuneration, etc.

Reporting for approval provides the information necessary to secure specific authorisations, regarding, for example, sales of shares or certain fundamental governance decisions such as board nominations, business plan approval, etc. Reporting for approval is more structured since it covers a number of areas that are often clearly specified in law.

Periodic reporting has advantages and drawbacks:

- The principle advantage of periodic reporting is that it creates a framework for holding SOEs accountable on a regular basis. It can contain a wide range of information including: financial indicators; budgetary impact indicators; privatisation transaction data; extraordinary events; corporate governance-related matters; the performance of the ownership entity and its portfolio; policy and performance objectives as well as performance against these objectives; human resources data; compliance reporting; discussion on sustainability, etc.
- The principal drawback of periodic reporting is that it is based on the annual reporting cycle of SOEs. By the time information is received, reviewed, consolidated and made available to Parliament, it describes a state of affairs at the company that is generally well over a year old. Periodic reporting might thus have limited use for decision making. Furthermore, the content of periodic reports tends to focus on financial issues, which do not always raise great interest among parliamentarians. Therefore, periodic reporting may not receive the in-depth attention it deserves outside of specialised parliamentary committees such as a budget and finance committee.

Ad hoc reporting presents a different set of advantages and challenges:

- *Ad hoc* reporting is often considered as more action-oriented and more responsive to parliamentary interests and needs than periodic reporting. It can cover any issue that is of interest to parliamentarians, ranging from financial issues to ones of social and environmental concern. Parliaments usually have significant powers to demand information at will and, if need be, can call on a chief executive to provide direct testimony (see Box 4.2).
- However, as *ad hoc* reporting is largely determined by the interests of parliamentarians, some important issues may not receive the attention they deserve, at least in the view of the civil servants in charge of SOEs. Technocrats and politicians may have very different visions of what needs to be reported on, the former often wanting to present hard information on SOE performance and the latter on issues of current interest or social impact. Civil servants might feel discomfort with the potential for politicisation of parliamentary reporting. *Ad hoc* reporting sessions are thus sometimes perceived as insufficiently structured and subject to political grandstanding.

Box 4.2. **Reasons for appearing before a select committee in New Zealand**

There are several reasons for which an SOE may appear before a select committee.

- An SOE could be asked to advise a select committee on legislation under formation.
- An SOE may wish to make a submission on a bill as a witness.
- A select committee may receive a petition form private citizens regarding an SOE, which may then be called in for a review.
- Every select committee has the power to launch an inquiry, and could call an SOE in to provide evidence.
- In addition, SOEs are regularly required to appear before the Finance and Expenditure Committee for a financial review.

Source: CCMAU, *Owner's Expectations Manual for State-Owned Enterprises*, 29 October 2007, pp. 23-24.

The level of government's involvement in transmitting SOE information to the Parliament might vary:

- It might be comparatively small, where aggregation by an ownership entity is not required and when individual SOE reports are tabled in Parliament after basic due diligence by government. Clearly, the tabling of individual SOE reports is not possible in countries where the number of SOEs is large. Parliamentarians would be inundated by reports. The main advantages of light government processes are speed and low cost.
- Government's involvement in the preparation of parliamentary reports might on the other hand be very intensive, and include evaluation, dialogue with the SOE and analysis. It could also imply or require intermediate reviews by specific ministries and specialised committees outside the Parliament. Extensive involvement can provide more information and value-adding analysis on SOE performance and might allow more in-depth discussion. It is also likely to be more costly and burdensome to both SOEs and government, and could possibly result in information overload.

Parliaments seem to be increasingly concerned with the problem of receiving excessive information that is difficult to digest or use effectively. More reporting does not always equate with more transparency or accountability. In many cases, parliaments would probably benefit from more concise and to the point information, as well as from better structured debates. Providing the correct level of information will depend on the specific policy or business context as well as parliamentary and administrative traditions.

In some cases, there is a concern with the potential for political interference in the work of the ownership entity or even the management of specific SOEs. In other cases, more active oversight and parliamentary involvement in strengthening the accountability of SOEs and the ownership entity might be needed. How to find the correct balance often presents a challenge.

While many aspects of reporting to Parliament derive from legal requirements that are difficult to change or are embedded in parliamentary traditions that are beyond the scope of this work, a number of them also derive from procedures that have evolved over time and that might be subject to improvement.

Table 4.3. **Reporting to Parliament**

Main steps	Brief description
Developing broad guidelines for dealing with MPs	The ownership entities should clarify the process for reporting to parliaments and provide guidance to all relevant entities for doing so. This guidelines could encourage SOE officials to be open and direct in dealings with parliamentarians, to familiarise themselves with parliamentary functioning and even to take specific training in this regard if necessary. Nevertheless, these guidelines should include safeguards to deal with confidentiality issues (see below).
Collection of reports from SOEs	Audited annual financial statements of individual SOEs should be sent to or collected by the ministries and/or ownership entities.

Table 4.3. **Reporting to Parliament** *(cont.)*

Main steps	Brief description
Transmission to Parliament	SOEs' annual financial statements might have to be reviewed by the ownership entity or branch ministry and transmitted to the Parliament, according to relevant laws. Annual financial statements are often used to generate budget supplements as background to budget acts, and may be aggregated into a combined or summary report on the SOE sector by an ownership entity. The ownership entity and other ministries' involvement in transmitting SOE information to the Parliament might be relatively light, or very intensive, implying extensive evaluation, analysis and dialogue with SOEs. A right balance has to be found to adjust to parliamentary needs and ensure adequate accountability. As both line ministries and ownership entities might be involved in reviewing and transmitting documents to Parliament, active co-operation and co-ordination is necessary to ensure a free flow of information.
Developing specific, more in-depth but concise performance documents	When reports to the Parliaments are in the form of annexes to the budget, they tend to be strongly summarised and focus on the fiscal impact of SOE operations, not providing enough information on SOE performance. Ownership entities (be they centralised or sector branch ministries) should develop specific yet concise documents describing SOE performance to allow a focused discussion by parliamentarians on how the state is performing its ownership rights. If performance reports are detailed with extensive evaluation and analysis, summaries should be provided to ensure effective reading and coverage by parliamentarians.
Providing some form of aggregated data	In the same vein, some form of consolidation or aggregation of financial and performance data should be provided to the Parliament to allow relevant discussion on the overall state portfolio performance.
Report on timing of reporting	When individual SOEs' financial statements are tabled in Parliament, this usually has to be done within a specific time frame. In this case, the ownership entities should report on how effectively the time limits have been respected, both by the SOEs themselves and by the ministries/ownership entities in charge of transmitting the information. This could avoid transmission to be drawn out simply because of co-ordination difficulties and the multiple steps involved.
Encouraging discussion in committees	Use should be made of specialised committees of Parliament (often finance or budget committee). Specialised committees allow for more in-depth and technical discussion on SOE performance because of their expertise and smaller size. They fulfil the important function of preparing and flagging key issues for plenary debates.

Table 4.3. **Reporting to Parliament** *(cont.)*

Main steps	Brief description
Focusing full assembly discussion	Depending on parliamentary tradition as well as the importance of a particular SOE, reports may be discussed in the full assembly. This could be (and is often) done in the context of approval of the budget act. A specific and separate discussion on the performance of SOEs could be organised to focus the discussion on important aspects of state ownership other than only its impact on the state budget.
Allowing timely performance discussion	A special discussion on SOE performance could also be organised based on incomplete (and unaudited) data late in the current fiscal year. This would allow more timely discussion on recent performance. This communication on current year's performance should, however, be handled very carefully, especially regarding listed SOEs. It should not interfere with the SOEs' own communication.
Developing long-term performance reporting	Ownership entities could also develop some form of long-term performance reporting, covering between four and five years. Long-term performance reporting allows for a periodic analysis of the effectiveness of state ownership and a discussion and review of specific SOEs' mandates. It is also well suited for consideration of whether or not SOEs are better kept within the state portfolio or whether other means of achieving the policy goals are more appropriate. Specific rules could be adopted to ensure that each SOE will be discussed or reviewed this way by the Parliament at least every 5 years.
Get ready for efficient *ad hoc* reporting	The ownership entities and/or branch ministries should be prepared to answer questions covering a large range of issues, including answering orally to committee hearings. Some typical events or public issues will tend to provoke specific questions. The ownership entity can anticipate them to some extent, even if, by definition, *ad hoc* reporting is difficult to structure in a systematic way. The ownership entity should pay attention to parliamentary schedules and even gather elements to answer typical and/or anticipated questions in a systematic fashion. The time requested from SOE senior officials to testify or answer questions from parliamentarians should be limited. It is also important to avoid that *ad hoc* reporting leads to excessive interference either in the ownership entity mandate or in the SOE management. Mechanisms have to be developed to limit excessive politicisation and instrumentalisation of these debates for other political purposes.

Table 4.3. **Reporting to Parliament** *(cont.)*

Main steps	Brief description
Developing safeguards to deal with confidentiality issues	Specific procedures should also be developed to deal with confidentiality issues, particularly when the SOEs concerned are in competitive sectors. Reporting to Parliament, especially *ad hoc* reporting and specific hearings, should not put these SOEs in a difficult situation, forcing them to disclose commercially sensitive information. These procedures could include requirement that the committee receives the information as private or secret evidence and that the meeting be kept confidential or closed. These procedures could be put in place whenever this is requested by the SOE on legitimate grounds.
Limit the cases where *ex ante* approval is requested	The cases where the ownership entities would have to get *ex ante* approval from the Parliament should be limited to significant decisions both politically and in terms of financial consequences. This will avoid undue political interference in the exercise of ownership rights as well as in the SOE operations.
Make parliamentary reports publicly available	Reports to the Parliament as well as minutes of discussion within the Parliament should be made available to the general public, such as through the Parliament and the ownership entities' websites. This public disclosure allows a series of other actors inside or outside the government and the Parliament to have access to information and scrutinise the exercise of state ownership.

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Chapter 5

Ensuring Adequate Disclosure and Transparency at Company Level

This chapter will describe how the ownership entities should develop a disclosure policy for SOEs and how they could encourage and monitor effective implementation of transparency requirements by SOEs. One specific session will cover the critical issue of how to ensure an equitable treatment and communicate actively with of all shareholders. Another specific session will provide guidance on how to avoid abusive related party transactions. Finally, this chapter will also address the issue of how to report on stakeholders' relations and encourage SOEs to do so.

5.1. Overview

To be transparent as a shareholder, the state must ensure that appropriate information is disclosed at the SOE level. It should therefore establish an adequate framework to ensure that SOEs provide all the necessary information for: *a)* the state itself to be able to carry out its ownership function; *b)* the Parliament to play its role in reviewing the performance of the state as an owner; *c)* the media to raise awareness on relevant issues; *d)* the general public to get a clear picture of SOE performance.

The Guidelines provide a number of recommendations regarding transparency and disclosure at the SOE level. Underlying all these recommendations is the objective that "*in the interest of the general public, SOEs should be as transparent as publicly traded corporations*" (Annotation to Guideline V.D, p. 43). The Guidelines refer to the OECD Principles of Corporate Governance, which are mentioned in the introduction to the Transparency and Disclosure chapter: "*State-owned enterprises should observe high standards of transparency in accordance with the OECD Principles of Corporate Governance.*"

In the Guidelines, transparency and disclosure requirements for SOEs are numerous and not all in the Transparency and Disclosure chapter. Some of the requirements are therefore covered already in other sections of this Guide. These include: the requirement to disclose "special obligations", their costs and funding mechanism (Guideline I.C), covered in Section 1.5 of the Guide; the requirement to disclose clearly company objectives and their fulfilment (Guideline V.E.1), covered in Section 1.6 and 2.3; the requirement to put in place effective internal audit systems (Guideline V.B), covered in Section 3.2; the requirement to be audited by external and independent auditors (Guideline V.C), covered in Section 3.3.

This section will provide guidance on how to achieve the remaining requirements, including:

- Using high-quality accounting and auditing standards: "SOEs should be subject to the same high-quality accounting and auditing standards as listed companies. Large or listed SOEs should disclose financial and non-financial information according to high-quality internationally recognised standards" (Guideline V.D).
- Disclosing information according to the OECD Principles of Corporate Governance: "SOEs should disclose material information on all matters described in the OECD Principles of Corporate Governance and in addition focus on areas of significant concern for the state as an owner and the general public" (Guideline V.E).
- Disclosing adequate information on ownership and voting structure, risk and related party transactions: "*The ownership and voting structure of the company*" (Guideline V.E.2): "*Any material risk factors and measures taken to manage risks*" (Guideline V.E.3); "*Any financial assistance, including guarantees, received from the state and commitments made on behalf of the SOE*" (Guideline V.E.4); "*Any material transactions with related entities*" (Guideline VI.E.5).

a) Ensuring transparency towards other shareholders: "*SOEs should observe a high degree of transparency towards all shareholders*" (Guideline III.B), and "*SOEs should develop an active policy of communication and consultation with all shareholders*" (Guideline III.C).

b) Reporting on stakeholder relations: "*Listed or large SOEs, as well as SOEs pursuing important public policy objectives, should report on stakeholder relations*" (Guideline IV.B).

This chapter will provide guidance on what the state can do to ensure adequate transparency and disclosure at the SOE level. This will require that the state:

- develop adequate policies in terms of SOE disclosure and transparency;
- follow up the implementation of this policy in individual SOEs and encourage good practice.

Some specific areas of disclosure and transparency might be of special concern. These include:

- ensuring equitable treatment of minority shareholders by SOEs;
- managing related-party transactions;
- ensuring appropriate disclosure of stakeholder relations.

5.2. Developing an SOE disclosure and transparency policy

To ensure appropriate disclosure and transparency at the SOE level, the state as an owner should first develop a coherent disclosure policy for its portfolio companies. This policy should identify what information should be disclosed; how and to whom the information should be disclosed; and the procedures for ensuring the quality of the information.

Developing a disclosure policy should start with an inventory of the requirements of existing legal and regulatory framework as well as actual practice at the SOE level. This will allow an assessment of actual implementation and weaknesses in the overall framework. On the basis of this analysis, the existing framework might then be modified, adapted or complemented to cover all necessary requirements as recommended in the OECD Principles and Guidelines.

In reviewing the legal and regulatory framework, the state should focus on material information, *i.e.* whose omission or misstatement could have an influence on the economic decisions taken by users of this information. This will help avoid unnecessary disclosure requirements and ensure a level playing field between state-owned enterprises and private sector companies.

Finally, in reviewing the existing legal and regulatory framework for SOE transparency, the state should also make proper use of regulatory impact assessments. "*Regulatory Impact Assessments can, alongside the use of expert groups and evidence-focused consultations, provide a way of bringing method, rigor and caution into the process of regulation in the area of corporate governance.*" This entails clearly formulating the regulatory objectives and always considering different alternatives to achieve these objectives. The evaluation of costs and benefits is sometimes challenging, particularly in the transparency area, but can be overcome by use of proxies and qualitative techniques. The OECD has issued a useful manual on practices and experiences with regulatory impact assessment in the area of corporate governance.[1]

Table 5.1. **Guidance on how to develop a disclosure and transparency policy for SOEs**

Main steps	Brief description
Review existing requirements	The ownership entity should first review the existing legal and regulatory requirements in terms of SOE transparency and disclosure. These might differ according to the legal structures of SOEs and be based on different pieces of legislation and regulation, including statutory laws, specific SOE laws as well as general company laws, specific regulations, principles or codes, etc. Reviewing disclosure requirements implies not only reviewing the different elements of information supposed to be disclosed, but also whether effective mechanisms are in place to enforce these requirements, as well as the existence of effective remedial mechanisms for those harmed by inadequate or misleading disclosure.
Review effective disclosure practices by SOEs	In addition to reviewing the existing legal and regulatory framework, the ownership entity should review effective practice of SOEs. This review could allow identifying areas where SOEs do not implement existing requirements as well as areas where SOEs have developed voluntary good practices going further than existing requirements.
Identify weaknesses and discrepancies	Existing disclosure and transparency requirements should be compared with the recommendations of the OECD Guidelines and the Principles of Corporate Governance, as well as with the listing requirements. Based on this comparison and the review of effective practice, the ownership entities might identify discrepancies or weaknesses in the existing legal and regulatory framework.
Adapt and complete the transparency and disclosure framework	Based on these reviews of the legal and regulatory framework and effective practices, the ownership entity might consider the following actions to complete the set of transparency and disclosure requirements: ● propose amendments to the current legal and regulatory framework; ● develop specific new regulation(s) encompassing existing as well as additional and necessary requirements; ● develop specific principles, guidelines or codes that would complement the existing framework and mandate or encourage better practice at SOE level (see Box 5.1). In considering these different types of instruments, the ownership entity should take into full consideration their respective strengths and weaknesses, including their "enforceability", adaptability, etc.

Table 5.1. **Guidance on how to develop a disclosure and transparency policy for SOEs** *(cont.)*

Main steps	Brief description
Consult adequately	Focused and structured consultation should be carried out while reviewing the legal and regulatory framework, whatever the type of instrument chosen. These consultations should include SOE management and board members, regulators, relevant professional organisations, members of Parliament, stakeholders, etc. In case of principles and codes, key players might even be the driving forces in their development.
Make appropriate use of RIAs	When possible, the state should carry out regulatory impact assessments to base proposed legal or regulatory changes on evidence. To do so, it will be necessary to clarify the regulatory objectives, consider alternative approaches and compare respective costs and benefits. In doing so, appropriate use of existing guidance could be made.[2]
Communicate effectively on the new framework	The ownership entity should communicate actively on the new transparency framework for SOEs. Such communication could target SOEs concerned, relevant institutions, the general public and the media. Its objective would be: ● to ensure that SOEs fully understand their obligations and the underlying rationale for such disclosure; ● to give an opportunity to members of Parliament to clarify their own expectations and better understand how they could actively play a role in the SOE accountability framework; ● to raise awareness of the general public and the media on what is expected from SOEs in terms of disclosure.
Develop appropriate guidance in sensitive areas	The ownership should also develop, when necessary, appropriate guidance to help SOEs effectively implement the new framework. This guidance should focus on areas where: ● new requirements have been added; ● previous implementation of existing requirements was weak; ● there is significant concern or complexity.
Develop specific and relevant mechanisms to encourage and follow up implementation	In addition to a new framework, the ownership entity might put in place specific mechanisms that would ensure, encourage, reinforce and follow effective implementation of transparency requirements by SOEs. These mechanisms are discussed in more length in Section 5.3 of this Guide.

Box 5.1. **Guidelines for external reporting by SOEs in Sweden**

The Swedish Government adopted the following guidelines for external reporting by state-owned companies on 29 November 2007, complementing and extending previous guidelines adopted in 2002. The companies shall present their reports in accordance with these guidelines at the latest from and including the financial year starting on 1 January 2008.

"In those cases where the state is one of a number of joint owners, the government intends, in consultation with the company and the other owners, to endeavour for these guidelines to be applied in the jointly owned companies. These guidelines are based on the principle of 'comply or explain', which means that a company can deviate from the guidelines if a clear explanation and justification of this departure is provided. This design enables the guidelines to be applicable and relevant to all companies, regardless of size or industry, without having to abandon the main purpose of the accounting and reporting. The board shall describe in the annual report how the guidelines have been applied during the past financial year and comment on any deviations."

"The boards of the state-owned companies are responsible for the companies' accounting and reporting complying with these adopted guidelines… The regulatory framework to which the companies are subject is changed and updated continuously. The state-owned companies are expected to follow developments and changes in legislation, standards and recommendations. The board shall follow developments and decide without delay on relevant measures ensuing from these changes."

	Financial information	**Non-financial information**	
Reasons	Follow up and assess the financial development of the companies	Follow up and assess the companies' corporate governance, sustainability work and performance of societal tasks.	
Source	Laws and standards	Guidelines	Decision by the owner
Basic principles	IFRS	The Corporate Code GRI	Decision by Annual General Meeting (Government guidelines) (Riksdag decisions)
Annual	Annual report Year-end report	Sustainability report Corporate report Statement on internal control	Report on compliance with societal task
During the year	Quarterly reports	Key ratios	
Current	Special press releases/information measures. Openness towards the public and the media		

Source: Guidelines for External Reporting by State-Owned Companies, Regeringskansliet, 2007.

5.3. Implementation by SOEs and encouraging good practice

Once the disclosure and transparency policy is in place, the state should make sure that it is implemented at company level.

Ownership entities should be pro-active in informing SOEs on disclosure and transparency requirements. This would first entail active communication on the specific requirements and their rationale. Guidance can also be provided in the form of focused manuals or specific seminars and training.

Ownership entities may also encourage SOEs to follow good practice that are not mandatory. This may include reporting on environmental, social and broader economic issues.

Special initiatives and arrangements can also be developed to encourage and support better disclosure. One example is to hold meetings open to the general public mimicking AGMs. Other examples include special awards, focused seminars, etc. (see Box 5.2).

The ownership entity should also develop mechanisms to measure or assess implementation of disclosure requirements by SOEs and report on it.

The following table provides guidance on how to ensure effective implementation of the transparency and disclosure policy for SOEs.

Box 5.2. **Criteria for performance information for the award for excellence in reporting by crown corporations in Canada**

Criteria for the award include information on objectives, strategies, targets and performance as follows:

- Objectives are clear and stated in an appropriate level of detail. They include commercial, public policy and financial objectives. Wherever possible, these are measurable. Significant changes in the corporation's objectives, if these arise, are highlighted and trade-offs for conflicting objectives are explained.
- The relationship between the corporate plan summary (or the previous annual report for the Crown corporations that do not have a legislative requirement to prepare a separate corporate plan summary) and the annual report are clear. Budget amounts used in the financial analysis are consistent with those in the corporate plan or the difference between the two sets of numbers is explained.
- The corporation's performance is compared with each stated objective in terms of outputs, outcomes or secondary impacts.
- Performance reporting, including financial and non-financial information (preferably subject to some form of external validation), clearly presents results as compared with targets. Actual results numbers used in the financial analysis are consistent with those in the audited financial statements or the difference between the two sets of numbers is explained.
- The corporation evaluates its performance with respect to its public policy objectives.

Source: Auditor-General of Canada, *Award for Excellence in Reporting by Crown Corporations*, *www.oag-bvg.gc.ca/domino/other.nsf/html/98award_e.html*.

Table 5.2. **Implementation and encouragement of good practices**

Main steps	Brief description
Update SOEs on transparency and disclosure requirements	Ownership entities should support SOEs' efforts in being up-to-date on transparency and disclosure requirements. To do so, they could first provide up-to-date and complete information on their websites on legal and regulatory requirements. They could also circulate clear synthesis documents providing useful references and explaining the rationale for disclosure. Specific "contact points" might be nominated in SOEs and gathered by the ownership entity on a regular basis for an update on the evolution of disclosure requirements. These meetings could also allow discussing specific difficulties in implementation, identifying areas where further guidance is needed, etc.
Support SOEs in implementation	Ownership entities could provide SOEs, when necessary, with focused guidance on implementation. This could be done through the development of focused methodological documents, the organisation of specific seminars and trainings, etc.
Encourage best practices	The ownership entity may encourage SOEs to follow best practice that are not mandatory.
Underline board responsibility	The SOE boards' responsibility in ensuring appropriate disclosure should be underlined. This responsibility entails overseeing disclosure of material information as well as the SOE's communication with all shareholders. The particular role of the audit committees, whenever they exist, should also be clarified. It is to reinforce boards' competencies and underpinning their critical responsibility in this matter, but the ultimate responsibility remains with the full board.
Organise public meetings to mimic AGMs	For fully owned SOEs, the ownership entity could organise public meetings that would play the role of AGMs in allowing the public to challenge SOE management and boards. Such public meetings could be opened to all citizens upon prior registration.
Organise transparency awards for SOEs	A classical mechanism for encouraging appropriate disclosure is to organise competition and provide awards for excellence in reporting (see Box 5.9). The ownership entity or other relevant institution might organise specific awards covering SOE transparency. Alternatively, the ownership entity should encourage SOEs to compete in existing and relevant awards for listed companies, such as best annual reports, etc.

Table 5.2. **Implementation and encouragement of good practices** *(cont.)*

Main steps	Brief description
Measure implementation	To measure effective implementation, the ownership entity could proceed in different ways: ● Evaluate directly whether the information made publicly available by SOEs does fulfil legal and regulatory requirements. ● Measure through specific questionnaires the extent of effective implementation by SOEs. ● Include specific questions or measures in regular reviews of performances. ● Ask external advisors, consultants or rating agencies to review SOE disclosure and transparency on a regular basis. These measures could be completed by "subjective" evaluation of SOE transparency by market participants. In any case, the evaluation will have to differentiate between mandatory and voluntary requirements.
Report on effective implementation	To report on effective implementation by SOEs of disclosure requirements, ownership entities could do the following: ● Report in their annual aggregate report on how SOEs implement the most important disclosure and transparency requirements. This could include reporting on the quality and timeliness of annual reports publication. ● Provide relevant information on their websites, with appropriate link to the SOE information. ● Provide the Parliament with a synthesis on how SOEs implement disclosure and transparency requirements.

5.4. Ensure equitable treatment of shareholders by SOEs

The Guidelines highlight the importance for the state as an owner to ensure equitable treatment of all shareholders by SOEs. Given its capacity to dominate the AGM, to control board nomination and to pursue specific policy objectives at the expense of minority shareholders, it is at the same time challenging and crucial for the state to "*establish itself as exemplary and follow best practice regarding the treatment of minority shareholders*". Building up a reputation of a transparent, predictable and fair owner will have a significant impact on the state's future capacity to attract outside funding as well as on the valuation of SOEs.

To ensure equitable treatment of minority shareholders, the Guidelines recommend that "*the state and state-owned enterprises should recognise the rights of all shareholders and in accordance with the OECD Principles of Corporate Governance ensure their equitable treatment and equal access to corporate information*" (Guideline III). The Principles state that "*Minority shareholders should be protected from abusive action by, or in the interest of, controlling shareholders acting either directly or indirectly, and should have effective means of redress*." The Principles also prohibit insider trading and abusive related party transactions and suggest pre-emptive rights and qualified majorities for certain shareholder decisions as means of minority shareholders' protection.

At company level, the Guidelines recommend that the SOE "observe a high degree of transparency towards all shareholders" (Guideline III.B) and "develop an active policy of communication and consultation with all shareholders" (Guideline III.C). Participation of minority shareholders in shareholder meeting should also be facilitated (Guideline III.D).

To ensure that the Principles and Guidelines' recommendations regarding minority shareholders protection are effectively implemented, the state as a shareholder should develop a clear policy regarding treatment of minority shareholders in SOEs, ensuring that SOEs implement effectively this policy and encouraging them to adopt good practice in terms of board nomination, participation in general shareholder meetings and disclosure of information to all shareholders.

The state should also clarify its own policy with respect to its treatment of, and communication with, fellow shareholders as a dominant one (see Norwegian Policy in Box 5.3). This will include, *inter alia*, adequate consultation of other significant or minority shareholders before important decisions to be made in the board and/or AGMs, even when the state can ensure dominance through the formal voting process. It also requires that the state is clear on its objectives as owner and on a specific SOE's objectives (see Chapter 1, Sections 1.3 and 1.6 of this Guide), allows the board to carry out its responsibilities once the company objectives are defined, and does not interfere in company management (Guideline II.B and II.C). Finally, the state should not abuse at the expense of other shareholders any information it gets as a dominant shareholder or through its other roles as regards any given SOE. Clear separation between the different state functions is necessary (Guideline I.A). The equitable treatment of all shareholders thus requires the effective implementation of Guidelines not related directly or mainly to disclosure and transparency.

Box 5.3. **Equal treatment with respect to information and rules for inside information in Norway**

The state's administration of its ownership is exercised within the limits set out in legislation relating to the stock exchange and securities, not least in connection with the consideration of equal treatment of shareholders. Pursuant to the Stock Exchange Regulation Section 23-8 first paragraph, a company must not unreasonably discriminate between its shareholders. The ministry will therefore not normally receive more information than other market players.

However, a company may have a legitimate need to provide some shareholders, and major shareholders in particular, with more information than is otherwise available to the other shareholders and the market. This could be the case, for example, in connection with preliminary discussions about a forthcoming capital increase, negotiations about a merger, a decision on demerger and similar decisions which, pursuant to the Public Limited Liability Companies Act, require the same majority as for an amendment of the articles of association. The shareholders who receive such information will be subject to the general prohibition on trading in Section 2-1 until the information has been made public or generally known to the market.

Pursuant to the Stock Exchange Regulations, a company is obliged to obtain non-disclosure declarations and stand-still declarations when such inside information is shared with third parties, cf. the Stock Exchange Regulations Section 5-1. Notification about such matters must be sent to the Stock Exchange by the issuing company. The declaration is only sent to the Stock Exchange on request.

Source: Government's Ownership Policy, Naerings Og Handelsdepartmentet, 2007, p. 55.

Table 5.3. **Main steps or actions that can be taken to ensure equitable treatment of all shareholders in SOEs**

Main steps	Brief description
Develop a clear policy of equitable treatment of all shareholders	The state as a significant shareholder should "tie its own hands" and develop a clear policy of equitable treatment of all shareholders (see Box 5.10). This policy should provide all shareholders with a consistent menu of mechanisms usually adopted to prevent abuse of minority shareholders by boards, management and controlling shareholders. These mechanisms include pre-emptive rights, qualified majority for certain decisions, capacity for minority shareholders to call for a shareholder meeting and to be represented in boards, access to redress, etc. This policy should include a reasonable balance of *ex ante* and *ex post* mechanisms taking due consideration of the legal characteristics of the country concerned. It should be at a minimum as protective as legal and regulatory provisions meant for protecting minority shareholders in listed companies. All relevant elements of this policy should be integrated in any code of governance for SOEs as well as in the state ownership policy. They could also be integrated into the charters of individual SOEs. A simple and effective option is to submit all SOEs to the general company law, listing requirements and corporate governance codes valid for private sector companies, especially when these are deemed to ensure effective fair treatment for minority shareholders. When this is not the case, the state could negotiate with other shareholders enhanced governance provisions in terms of minority shareholders' protection, beyond those required for publicly traded companies.
Communicate actively on this policy	This policy should be actively communicated to all SOEs, the market and stakeholders. This is necessary to build trust in the state shareholder and ensure it is perceived as a fair and predictable owner. Communication will be facilitated if significant elements of this policy are integrated in the state ownership policy and in SOE corporate governance codes.
Encourage minority shareholders' representation in boards	The state should develop nomination processes that are favourable to minority shareholders representation in boards, such as cumulative voting. When possible, individual SOE charters could provide for such nomination processes. Alternatively, the state could enter into shareholders' contracts granting minority shareholders representation on boards. Minority shareholders could also be represented in the nomination committees for board nomination.

Table 5.3. **Main steps or actions that can be taken to ensure equitable treatment of all shareholders in SOEs** *(cont.)*

Main steps	Brief description
Clarify the duty of loyalty of SOE board members	The legal and regulatory framework for SOEs should strongly establish and clearly articulate the duty of loyalty of SOE board members towards the SOE itself and to all its shareholders, and not to the state in case they are nominated by the state. This is an essential prerequisite for controlling abuse of minority shareholders and for allowing any *ex post* redress.
Encourage active participation of minority shareholders in general shareholder meetings	Active participation of minority shareholders in general shareholder meetings could be encouraged at the SOE level through mechanisms allowing voting *in absentia* and developing the use of electronic means to reduce the costs incurred. This could also include mechanisms facilitating employee-shareholder participation through, for example, collection of proxy-voting.
Encourage SOEs to communicate actively with all shareholders	The ownership entity should require that partially owned SOEs identify their minority shareholders and keep them duly informed in a timely and systematic fashion of any material information, following the practice mandated for listed companies. One good practice in this regard is for SOEs to organise active consultation with minority shareholders for specific issues.
Avoid abuse of information by ownership entities	Specific mechanisms and procedures need to be developed regarding non-listed but partially owned SOEs to ensure that ownership entities not abuse the information they receive as a controlling or significant shareholders.

5.5. Develop appropriate framework to deal with related-party transactions

Abusive related-party transactions are frequently reported as one of the most serious breaches of good corporate governance around the world. Such transactions are used by controlling shareholders or company insiders as a mechanism for extracting private benefits at the cost of other shareholders. To this end, the OECD Principles recommend "*to fully disclose material related-party transactions to the market, either individually, or on a grouped basis, including whether they have been executed at arms' length and on normal market terms*".

In many jurisdictions, disclosure and approval of related transactions are legal requirements. International Accounting Standards (IAS 24) also provide guidance to ensure that financial information includes all necessary information to draw attention to the fact that financial statements might have been impacted by the existence of related parties and transactions with these related parties. However, even if the regulatory framework is satisfactory, implementation and enforcement remain a challenge. In many cases, detecting a related transaction is difficult and proving abuse even more so.

In the case of SOEs, the usual definition of related parties might be considered as too extensive, as it includes "*entities that control or are under common control with the company, significant*

shareholders including members of their families and key management personnel". It might be difficult to identify when transaction counterparties are effectively related as also controlled by the state. This is particularly the case in countries where state ownership is pervasive. Furthermore, the costs of disclosing all relevant information on related transactions might then be excessive with regards to its benefits. Finally, even in the case of large related transactions, it may be also tough to identify whether the transactions are abusive, especially if there is no market price. A critical question is whether the relationship leads in fact to changed conditions for the parties (see Box 5.4).

Box 5.4. **Reasons for modifying IAS 24 on related party transactions for state-controlled entities**

The main reasons for concern regarding the disclosure requirements for state-controlled entities are:

a) It is extremely onerous, if not impossible, for a state-controlled entity to identify all of its related parties. Identification will involve extensive work, the accuracy of which will be limited because of practical difficulties. This can lead to incomplete disclosures and thus non-compliance with IAS 24.

b) The number of transactions that need to be disclosed could be excessive and in some cases, it may mean the disclosure of a large percentage of an entity's total transactions. For example, purchases, sales, deposits of cash, etc., may need to be identified and disclosed as related-party transactions. The relevance of these disclosures is of limited value to users of financial statements.

Not only is the problem pervasive around the world but it is causing divergence in practice. Some entities disclose extensive information regarding all "known" transactions with all "identifiable" related parties. However, others disclose the fact that they are a state-controlled entity, but go on to indicate that directors/management do not think transactions with other state-controlled entities are related-party transactions. This divergence creates a lack of comparability between entities.

Source: Amendments to IAS 24 Related Party Disclosures, IASB, September 2007.

This is why the IAS 24 is being modified in the case of state control. Two entities are not deemed to be related to each other simply because they are both significantly influenced by the same state. An indicator approach is proposed to identifying when an exemption should be provided for entities controlled or significantly influenced by the state. However, the actual exercise of influence would preclude the use of this exemption (see Box 5.5).

As a significant shareholder and often board member, the state should ensure that SOEs do not undertake abusive related-party transactions. To do so, it could develop a clear policy in this regard and provide adequate guidance to SOEs to ensure that they duly identify, decide on and disclose related transactions. Finally, the ownership entity could also encourage gatekeepers and the media to be vigilant in identifying and disclosing abusive transactions (see Box 5.6).

Box 5.5. **IAS 24/State control and the definition of a related party**

Summary: In September 2006 the *(IASB)* board tentatively agreed that relief should be given to entities that are related parties simply because of the existence of common control from the state. However, the *(IASB)* board noted that if there was any indication that transactions or circumstances exist that would give the impression that the relationship should be disclosed, then the entity will not receive relief from the disclosure requirements regarding that relationship.

The board tentatively decided that a list of indicators could include: *a)* The existence of direction or compulsion from the state for entities to act in a certain way; *b)* the existence of transactions at non-market rates between the two entities (other than by way of regulation); *c)* the use of shared resources; *d)* common board members between the two entities controlled by the state; or *e)* economically significant transactions between the common controlled entities.

This list is not exhaustive and other indicators might exist that would require an entity to disclose the relationship and transactions as a related-party relationship. The term "state" would refer to national, regional or local governments.

IAS 24 proposed amended text:

17A: A reporting entity is exempt from the disclosure requirements of paragraph 17 in relation to an entity if: *a)* the entity is a related party only because the reporting entity is controlled or significantly influenced by a state and the other entity is controlled or significantly influenced by that state; and *b)* there are no indicators that the reporting entity influenced, or was influenced by, that entity.

17B: Indicators that the influence referred to in paragraph 17A(b) exists are when the related parties: *a)* transact business at non-market rates (other than by way of regulation); *b)* share resources; or *c)* engage in economically significant transactions with each other.

17C: The existence of direction or compulsion by a state for related parties to act in a particular way could indicate that the influence referred to in paragraph 17A(b) exists. Furthermore, the presence of common members on the boards of the reporting entity and the other entity could lead to the relationship having an effect on the profit or loss and financial position. Entities shall consider whether the existence of direction or compulsion by a state or the existence of common board members indicates that the influence referred to in paragraph 17A(b) exists.

17D: The indicators of influence described in paragraphs 17B and 17C are not exhaustive. A reporting entity might identify other factors or circumstances that suggest the reporting entity could influence, or be influenced by, the related party that would require the reporting entity to comply with the requirements in paragraph 17.

17E: When there are no indicators that the reporting entity influenced, or was influenced by, any other entity controlled or significantly influenced by the state, as provided by paragraph 17A, the reporting entity shall disclose a statement to that effect. When a reporting entity does not qualify for the exemption in paragraph 17A, it shall comply with all the disclosure requirements of this standard for that related party.

Source: Amendments to IAS 24 Related Party Disclosures, IASB, September 2007.

Box 5.6. **Rules pertaining to related-party transactions in SOEs in Italy**

With regard to related-party transactions, Italian SOEs comply with the same regulations as privately owned companies, set by the Civil Code and, in case of listed companies, by TUF (*Testo Unico della Finanza*).

This matter is dealt with in the annual reports, in the reports of the statutory auditors and, for listed companies, in the six-monthly report set by Article 2828 of the Civil Code and Article 154-ter of TUF.

Moreover, according to the Civil Code (Article 2391-bis), the rules set for listed companies by the Italian Securities and Exchange Commission (CONSOB – *Commissione Nazionale per le Società e la Borsa*) are compulsory for all companies issuing stocks or bonds. Specific information has to be provided about the characteristics of transactions and the consequent economic advantage for the company.

Source: Italian Civil Code and TUF.

The following table provides some of the main actions that could be taken:

Table 5.4. **Framework to deal with related-party transactions**

Main steps	Brief description
Define related-party transactions	The state should define clearly what should be considered as a related-party transaction by SOEs. It should be based on IAS 24, taking into consideration specific exemptions provided for in case of state control. The ownership entity should be aware in particular that in case it gives a direction to act in a certain way or if transactions between two state-controlled entities are carried out at non-market price, the concerned transactions will be deemed to be related. This will also be the case if two SOEs entering into a specific transaction have common board members.
Develop a clear policy for dealing with related-party transactions	This policy should mandate adequate decision processes for approval of these transactions. This includes the requirement that board members and key executives disclose whether they, directly or indirectly, or on behalf of a third party, have a material interest in a transaction. In the case of a related-party transaction between two SOEs, state representatives in boards will be considered as having a material interest. These persons should then not be involved in making any decision related to this transaction. An option is to require a majority of the minority shareholders to approve related-party transactions. The policy should also require SOEs to follow appropriate standards regarding disclosure of related-party transactions, referring to and compatible with amended IAS 24. Such standards should mandate that the SOE reports in its financial statements all material related-party transactions (see the Italian example in Box 5.6). The policy could prohibit outright certain types of related transactions, such as personal loans and guarantees to company directors, senior officers and other insiders, based on an adequate estimation of costs and benefits.

Table 5.4. **Framework to deal with related-party transactions** *(cont.)*

Main steps	Brief description
Provide specific guidance to SOEs to ensure appropriate implementation	Specific guidance could be provided to SOEs regarding the identification of relevant related parties and related transactions. This could include some threshold based on materiality of a transaction, keeping flexibility so that there is not an easy way to circumvent the requirement by breaking up major transactions into smaller ones. Guidance could also be provided on how to deal with the approval of these transactions and their disclosure, underlining the central role of the audit committees in reviewing related-party transactions and in ensuring adequate disclosure. SOEs could be encouraged to develop a specific policy at company level on controlling related-party transactions so that all players understand their respective roles and obligations.
Encourage gatekeepers and the media to be vigilant	The ownership entity could encourage external auditors to be vigilant regarding the disclosure of related parties by SOEs. Non-compliance with the policy regarding related-party transactions, and particularly the lack of adequate disclosure, should lead to a "qualified" opinion on the financial statements. The role of the media in exposing abusive related transactions might also be important. Appropriate training and information could be provided to encourage professional coverage.

5.6. Ensure appropriate disclosure on stakeholder relations

The Guidelines recommend SOEs to acknowledge the importance of stakeholder relations for building sustainable and financially sound enterprises and fully recognise their rights as established by law or mutual agreement. Stakeholder relations are particularly important for SOEs "*as they may be critical for the fulfilment of general services obligations whenever these exist and as SOEs may have, in some infrastructure sectors, a vital impact on the economic development potential and on the communities in which they are active*" (Annotations, p. 37).

The Guidelines also emphasise that governments should not use SOEs to further goals which differ from those which apply to the private sector. Whatever rights are granted to stakeholders, the general shareholders meeting and the board should maintain their decision-making powers. In terms of transparency and accountability, the Guidelines clearly state that any specific rights granted to stakeholders or influence on the decision-making process should be explicit. Disclosure of stakeholder relations may also encompass, or be complemented by, reporting on aspects that are covered by various voluntary standards on sustainability, such as the Global Reporting Initiative. One example of such requirement for SOEs to refer to the GRI for sustainability reporting is provided in Box 5.7.

The Guidelines put the emphasis on reporting on stakeholders' relations (Guideline, IV.B), primarily for listed or large SOEs, as well as SOEs pursuing important policy objectives. This reporting allows SOEs to demonstrate their commitment to co-operation with stakeholders. Through adequate reporting and communication, SOEs will get public recognition, build up trust and improve their reputation. It will also be an important tool for managing risks that relate to stakeholder expectations (see Box 5.8).

Box 5.7. **Requirements on sustainability reporting in Sweden**

In **Sweden**, the recently adopted "Guidelines for External Reporting by State-Owned Companies" (see Box 5.1) require SOEs to publish "sustainability reports": "A sustainability report in accordance with the Global Reporting Initiative Guidelines shall be published on the respective company's website in conjunction with publication of the company's annual report. The sustainability report can either be a separate report or an integrated part of the annual report document. The sustainability report shall be quality-assured by independent scrutiny and assurance. The date for publication of the report shall be in compliance with the reporting cycle for the annual report."

"According to the **GRI Guidelines**, a sustainability report shall include, for example:

- A report and brief analysis of the sustainability issues considered as important … and the reasons for this.
- A clear report of risks and opportunities, taking into consideration sustainability issues, in particular those non-financial risks and opportunities that are needed to understand the company's development, performance and position.
- A clear report of the stakeholder analysis and stakeholder dialogue with a view to identifying and taking a position on significant risks and opportunities, taking into consideration sustainability issues for the company's most important stakeholders.
- An account of the company's strategies and adaptation to the requirements for sustainable development and how the strategy and adaptation affect the company's results and position now and in the future.
- A report on the positions adopted by the company in its own policy documents and in the form of international conventions, such as the UN Global Compact.
- An account of how active sustainability work is pursued, with objectives, action plans, allocation of responsibility, education and training and control and incentive systems for follow-up.
- A clear report on results and objectives based on selected performance indicators. These shall be complemented by explanations in the body of the text that explain the outcome in relation to the objectives together with a report on new objectives.
- Accounting principles that clarify the company's points of departure for the report and (its) delimitation."

Source: Guidelines for External Reporting by State-Owned Companies, Regeringskansliet, 2007, pp. 3-4.

Box 5.8. **Requirements on stakeholder reporting by SOEs in Norway**

In **Norway**, the "Government's Ownership Policy" mentions specific requirements for SOEs in terms of stakeholder relations: "The state expects companies in which the state has an ownership interest to maintain an open dialogue with their surroundings about their finances, social responsibility and environmental matters, and that the companies take steps to provide information about how they deal with these matters in practice and the results they achieve. Both the companies' annual reports and their websites are appropriate channels in this context. Large companies with international operations should consider using the reporting norm 'Global Reporting Initiative'. This norm has broad support and is supported by the UN's environmental programme, UNEP."]

Source: Government's Ownership Policy, Naerings Og Handelsdepartmentet, 2007, p. 42.

The Guidelines recommend reporting on stakeholder issues particularly for listed and large SOEs, as well as for SOEs pursuing important policy objectives or having general services obligations, with due consideration for the costs involved. They refer to existing best practices and recently developed guidelines on social and environmental responsibility disclosure. They also call for an independent scrutiny of this reporting to reinforce its credibility. Finally, the state as an owner could report itself at the aggregate level on stakeholder relations, setting good example and indicating clearly its policy in this regard.

The Guidelines also recommend SOEs "*develop, implement and communicate compliance programmes for internal codes of ethics*" (Guideline IV.C). Ensuring credibility in ethical commitments and effective behaviour is considered particularly critical in SOEs, given the interaction of commercial and policy objectives and the influence SOEs might have on general business practices. Stakeholders are important constituencies to consider when developing and implementing the codes; they are also the first one impacted by related corporate decisions. Reporting on stakeholder relations would thus typically cover compliance with internal ethical codes (se Box 5.9).

Box 5.9. **Corporate social responsibility and codes of ethics in SOEs in Italy**

The Ministry of Economy and Finance, as a shareholder, has developed corporate governance principles and best practice for both listed and non-listed state-owned companies.

Promotion of corporate social responsibility is an important element of the SOE corporate governance model. The largest state-owned companies publicly state in their annual report and in their mission statement the commitments towards the promotion of corporate social responsibility, as well as satisfaction and professional growth for its staff members. Some companies like Enel, Eni and Trenitalia (the passenger railway service company), annually issue "social and environmental sustainability reports" with indicators, targets and results on safety, environment and service quality.

Moreover, most SOEs have issued a "Corporate Code of Ethics" clearly defining specific duties towards their stakeholders. The ethics code states the general principles governing the company's relations with its stakeholders, as well as the commitments and responsibilities fulfilled in the performance of business activities and corporate operations.

Table 5.5. **How to develop effective reporting mechanisms on SOE relations with stakeholders**

Main steps	Brief description
Require SOEs to report on stakeholder relations	The ownership entity should clearly require SOEs to report on their stakeholder relations, either in their annual report or in a specific stakeholder report. This policy could be stated, for example, in the state ownership policy, any specific governance code or more focused guidelines on transparency (see Box 5.8). The ownership entity should set a clear threshold and the criteria to determine which SOEs are concerned. These should include listed and large ones, as well as those pursuing important policy objectives.

Table 5.5. **How to develop effective reporting mechanisms on SOE relations with stakeholders** *(cont.)*

Main steps	Brief description
	The ownership entity should also indicate clearly what should be the main content of stakeholder reporting and choose a specific reference for doing so. This could be either an appropriate national standard or, preferably, international standards for SOEs having international operations (see Box 5.7). This should be done with due consideration of the costs incurred, the relevance of items covered, and the availability of specific guidance to facilitate implementation.
Ensure stakeholder reporting covers compliance with ethics code	Stakeholder reporting should include information on how effectively SOEs comply with their internal codes of ethics. It should also indicate whether SOEs have put in place mechanisms protecting stakeholders reporting on illegal or unethical conduct by corporate officers, such as confidential access to the board or an ombudsman.
Clarify boards' responsibilities in stakeholder reporting	The ownership entity should ensure that SOE boards are well aware of their responsibilities regarding stakeholder issues and effectively oversee stakeholder reporting, more particularly board members nominated by the state. SOE boards should be held responsible for the accuracy of the content of stakeholder reports. This responsibility includes at least an annual discussion on stakeholder issue, an effective discussion on the stakeholder report and its formal approval. This could be done through a specialised committee if deemed necessary, *i.e.* when stakeholder relations are considered as strategic, when they incur significant costs or risks.
Have stakeholder reports audited	The state as an owner could also require stakeholder reports to be audited by independent and possibly specialised auditors. This could be done at the initiative of each SOE. Alternatively, the state shareholder could hire specialised auditors to audit all SOEs' stakeholder reports. This could allow assessing the current practice and the development of specific guidance to improve the quality of stakeholder reporting.
Set good example by reporting at the aggregate level on stakeholder relations	The state as an owner should itself report at the aggregate level on its relations with stakeholders. This could be done within the annual aggregate report published by the ownership entity. This aggregate report could expose what state policy is regarding stakeholder relations and provide information on current practice among SOEs in this regard.

Table 5.5. **How to develop effective reporting mechanisms on SOE relations with stakeholders** *(cont.)*

Main steps	Brief description
Encourage SOEs to report adequately	The ownership entity could encourage SOEs to report on stakeholder relations adequately by a series of specific actions. It could first provide specific guidance on stakeholder reporting. It could also organise awards on stakeholder reporting or encourage SOEs to compete in specific relevant awards (see Box 5.3).
Adopt an active communication policy	The ownership entity could develop an active communication policy regarding stakeholder issues, informing the media on related policies and SOE practices and inviting them to follow up on SOE effective behaviour in this regard.

Box 5.10. **Specific bawards related to stakeholder issues in France**

In **France**, a number of SOEs have been identified as having good practices in terms of "diversity" in their human resources by a specialised authority in charge of fighting against discrimination. Its 2006 report, for example, congratulated Thales for integrating diversity in its global strategy, Areva for integration of handicapped persons, gender equality, integration of young employees and diversity training, EDF for gender policy and reduction in wage inequality, La Poste for its diversity diagnosis, Air France for an internal poll on diversity, and ADP for diversity training. A growing number of large SOEs have adopted the GRI Sustainability Guidelines, including GDF and EDF.

Source: L'État Actionnaire, 2007, p. 18.

Notes

1. For further guidance on the use of RIAs for corporate governance related issues, please refer to: *Towards Better Regulation in Corporate Governance, Experience in Implementing Regulatory Impact Assessment*, OECD (2008), forthcoming.
2. See footnote 28, *Towards Better Regulation in Corporate Governance, Experience in Implementing Regulatory Impact Assessment*, OECD (2008), forthcoming.

Summary

This Guide is intended to facilitate the practical implementation of the *OECD Guidelines on Corporate Governance of State-Owned Enterprises* (the "SOE Guidelines"). It is focused on ensuring a high quality of transparency and accountability, which is the very basis of any sound corporate governance regime. It aims to help evaluate existing practices, identify their strengths and weaknesses and provide examples of successful practices. The Guide provides viable policy options and a "road map" of the practical steps that might be taken to implement the *SOE Guidelines*, pointing at typical difficulties, risks and hurdles that may be encountered during the implementation process. It also provides examples that illustrate the implementation of provisions and can serve as references and inspiration to governments that are confronted with similar challenges.

This Guide has been developed by the OECD Working Group on Privatisation and Corporate Governance of State-Owned Assets. It also strongly benefited from a broad consultation with non-OECD countries, within the framework of the Global Network on Privatisation and Corporate Governance of State-Owned Enterprises.

The Guide covers all relevant accountability and transparency recommendations in the *SOE Guidelines*. These recommendations have been grouped into five broad areas, namely setting objectives, reviewing performance, auditing performance, reporting on performance and disclosure by individual SOEs.

Enhancing transparency and accountability is a central recommendation of the OECD Guidelines: "*The state should act as an informed and active owner … ensuring that the governance of state-owned enterprises is carried out in a transparent and accountable manner, with the necessary degree of professionalism and effectiveness*" (Main Guideline, Chapter 2). It gives substance to shareholders' rights by providing the information essential to their exercise. It is also a remedy of choice for fraud and market manipulation. Finally, it is a prerequisite to, and underpins, public trust. Enhancing transparency and accountability entails complex challenges but is also an efficient entry point for further SOE governance reforms. It is politically feasible, suitable for gradual implementation and effective in mobilizing support for further reform.

This Guide is primarily directed at ministries and other government branches charged with assisting national reform efforts. Other users may include Parliaments as well as independent evaluators that seek a tool to make an assessment of the accountability and transparency framework and practices.

Like the *Guidelines* themselves, the Guide is "outcome-oriented". Rather than being prescriptive in terms of specific provisions, it acknowledges that there may be different ways to achieve the same outcome. The existence of competitors, of minority shareholders, the specific legal status of the SOE concerned, as well as the way the

ownership function is organised within the state administration might all have a non-trivial impact on the way the Guidelines are implemented. There is not a "one size fits all" approach. This Guide, for example, refers to the "ownership entity" to cover different ownership models as identified by the Survey of Corporate Governance of SOEs in OECD countries (OECD, 2005). Most of the recommendations made or policy options described in this Guide concern mainly non-listed SOEs. As soon as SOEs are listed, the state will have to exercise its shareholder rights but will not be more than a significant or controlling shareholder. Market mechanisms then apply, as well as listing regulations. International standards in terms of transparency and accountability do apply in this case; any additional transparency measures that governments apply should complement, and be consistent with, such standards.

Setting objectives

Accountability can be greatly facilitated by a process of performance benchmarking against clearly defined objectives. This requires defining objectives at different levels: firstly, for the state as an owner, with the "ownership policy" for high-level and long-term objectives and then specific yearly targets; secondly, for the SOEs themselves, with their high-level mandates, then their yearly objectives with specific performance indicators.

Since state ownership is often characterised by vague, complex or contradictory objectives, improvement in setting objectives is typically the very first step towards better accountability. At the aggregate level, the government should define its own overall objectives and ownership practices. An effective way of doing so is by developing an **ownership policy for the state shareholder**, as recommended in Guideline II.A (Section 1.2). An ownership policy serves as an effective tool for public communication and provides companies, the market and the general public with a clear understanding of the state's objectives as an owner and of its long-term commitments.

The ownership policy is a short but high-level policy document providing a clear statement of the state's overall objectives as an owner. Such overall objectives could also be defined at a sector level. In addition, it is useful if the ownership policy defines the mandate given to the ownership entity, its main functions and organisation, as well as the main principles followed in exercising the state ownership rights. Finally, it could also provide a summary of the main reference documents that define or frame the exercise of ownership rights by the state.

Developing an ownership policy is often an iterative and inclusive process that may involve several parties and wide consultation. It is based on directions received from the government on its ownership objectives, as well as on an appropriate survey of existing documents and their effective implementation. To improve its relevance, broad understanding and support, the ownership entity might consult with all concerned entities (the relevant parliamentary committees, other concerned ministries, the state audit institution, relevant regulators, etc.). It could also be fruitful to consult broadly with board members and management of SOEs and make appropriate use of public consultation to test the market and political reaction. Once the ownership policy is finalised, it is important to obtain and demonstrate high-level political support to reinforce its credibility. The ownership policy could also be endorsed by relevant public servants, publicly disclosed and widely circulated.

Based on the general objectives that are formulated in the ownership policy, it is useful to identify more specific **targets for the ownership entity** (Section 1.3). Doing this allows communication and evaluation of the ownership entity's performance, as called for in Guideline II.E. Targets could be both quantitative and qualitative, including financial targets covering the whole state portfolio, as well as the combined value of this portfolio. An aggregate **unique target** to increase this value, or a significant portion of the portfolio by a certain per cent over a specified time, is appealing in terms of simplicity. However, it has some inherent limitations and needs to be supplemented by sub-targets for the most important SOEs. Whatever the targets chosen, they will always represent imperfectly the real performance of the ownership entity. An appropriate mix of targets should be selected, with appropriate consideration given to aggregation difficulties. They also need to be discussed widely internally to analyse their practical impact on individual civil servants' motivation and behaviour. When discussing targets, focus should be on their relevance, ensuring that they have a close link with the overall objective of state ownership. They need to effectively reflect the performance of the ownership entity, with due consideration for market and business environment.

The process for formulating targets may vary depending on the institutional setting and the organisation of the ownership function. However, it is essential that all institutions that have a say *ex post* in evaluating the ownership entity's performance be somehow included in discussing its objectives *ex ante*. This may include the Parliament, relevant ministries, state audit agencies, etc. Finally, the overall targets of the ownership entities, as agreed with the government, should be clearly disclosed.

In fully owned companies, it is necessary for the state to **define and review SOEs' mandates** (Guideline V.E.1 and Section 1.4), *i.e.* simple and brief descriptions of the high-level objectives and missions of the individual SOEs in the long run. Clear mandates are necessary to build up appropriate accountability and as a basis for discussing more specific yearly targets. SOE mandates usually define the main lines of business and provide some generic indication regarding the ambition in terms of market leadership, quality of service or innovation and financial sustainability. They quite often show a clear mix of commercial and policy objectives and need to give some clear indication of how to articulate the trade-offs between the two. Mandates are intended to be valid over a long period of time and updated only in the event of fundamental changes. They should be publicly disclosed, posted on the individual SOEs' websites and clearly stated in annual reports.

The process of defining and reviewing SOEs' mandates is carried out by the state, mostly the ownership entity. But the ownership entity, in doing so, should also discuss with SOEs' boards and their chairs, as well as check appropriately existing documents which either define the missions of SOEs or provide the general framework to do so. SOE mandates should be reviewed periodically and systematically to maintain their relevance and consistency with the overall ownership framework and economic environment. Mandate reviews could be done internally, *i.e.* by the SOE and the ownership entity, conducted by independent panels with full public input and contracted experts, or by relevant parliamentary committees. Whatever the process, it needs to be done in a transparent manner and with appropriate consultation of stakeholders concerned.

Based on their overall mandate, and as a preliminary step to setting **specific objectivesand targets at the company's level** (Guideline VI.A), it is necessary to clearly **identify any public services and other special obligations,** decide on their relevance**,**

evaluate their cost and fund them transparently (Section 5). This is essential to ensure a level playing field with the private sector, as their costs might be high and are often hidden or at least not easily identifiable. These "special obligations" usually have a significant impact on SOEs' performance and the risks they face. Clear identification and costing allows an informed public debate about their relevance, their budgetary implications as well as their distributional consequences. It is an important but complex undertaking that requires time, method and a good deal of discussions and negotiations between the ownership entity, the SOEs themselves and in many cases the relevant stakeholders.

After agreeing on a clear definition of what constitutes a "special obligation", which is not trivial, the ownership entity might require SOEs to identify and **map existing** "**special obligations**". SOEs are also required to provide information on their actual cost, based on a consistent methodology in order to reduce inconsistencies among SOEs and make benchmarking easier. This is not a straightforward exercise and will in many cases require discussion as well as trade-offs between precision, time and resources. Once duly identified and costed, these special obligations will have to be reviewed, to ensure their relevance and effectiveness and make them the result of a well thought-out process and explicit political decision. This review would assess to which point these special obligations could be replaced by other mechanisms and how they could be funded in order to achieve the same objectives at a lesser cost, more effectively and/or without having the same impact in terms of market distortion and/or SOE efficiency. The state should also monitor the effective fulfilment by SOEs of their special obligations.

Once the "special obligations" and their costs have been reviewed, it is crucial that the government's expectations of the (fully owned) SOE be formally, clearly and publicly communicated in the form of "objectives documents". These documents might be relatively short and agreed usually on a yearly basis. They clarify high-level expectations and specific objectives agreed upon between the ownership entity and the SOE boards, and must be duly approved by the general shareholder meeting whenever appropriate, for example for partially state-owned enterprises. Objective documents include financial objectives (including sustainable dividend levels) and related performance indicators allowing measurement, following-up and assessment of SOEs' profitability, efficiency and risk level. It is also useful for the objectives document to include, but not necessarily publish, estimation by the boards of the company value, with relevant information on the methodology used and assumptions made. Objectives documents also increasingly include performance indicators for non-financial and public policy objectives, as well as some more "structural" objectives, related, for example, to governance or human resources policy.

The development of an objectives document (Section 1.6) is generally a collaborative process with ongoing communication between the SOE itself (its board and CEO) and the ownership entity. It is useful to formalise this process in order to clarify the requirements in terms of content, time frame and respective responsibilities and powers. Based on communication by the government of its high-level objectives, under the form of "letters of expectations", for example, SOE boards are expected to submit draft objectives documents describing main objectives for the SOE, key performance indicators and specific yearly targets. The informal negotiation of the draft is key to building consensus and ensuring clarity. Formal feedback has to be received from the ownership entities within a defined time limit. The final document should be officially approved, clearly endorsed, in some cases tabled in Parliament and always publicly disclosed.

Developing objectives documents is also a complex task which requires a combination of industry knowledge, financial capability and operational experience. These competencies need to be present in SOE boards and reflected within the ownership entity to allow an informed and balanced dialogue. The whole process also raises important questions about the respective roles of the board and the ownership entities and can be perceived by the boards as a usurpation of their authority. It thus requires a delicate balance that respects the board in the exercise of strategic control.

A central but technical difficulty in this process is to **develop relevant performance indicators** (Section 1.7). Performance indicators, by definition, are not exact measures of performance but "indicate" the level of performance regarding the overall objectives agreed upon. They are practical attempts to improve the quality and consistency of performance measurement by focusing on key synthesis indicators. An extensive literature provides "tips and traps" in developing these indicators. A commonly used "tip" to build-up effective performance indicators is to make sure that they are "SMART", *i.e.* Specific, Measurable, Achievable, Result-oriented and Time-based. Whatever the acronyms used, the quality of the indicators depends on three major characteristics: their relevance, accuracy and reliability. As for the target levels, they have to be challenging but achievable, based on historical performances, benchmarking against peers and an assessment of effective capabilities. Appropriate information systems and structures could be put in place to collect accurate and reliable data necessary for calculating the indicators, possibly extracted directly from the information systems. Actual results need in turn to be duly documented, showing results for previous years accompanied with measures of uncertainty as well as data sources and methodological information, when relevant. Finally, performance indicators should also be audited and reviewed regularly to ensure their reliability and maintain their relevance. Badly chosen performance indicators might bias the incentive structures and consequently have serious perverse effects or unintended consequences.

Reviewing performance

A state's obligation to review the performance of its portfolio companies is central to the OECD Guidelines: "*Its prime responsibilities include setting up reporting systems allowing regular monitoring and assessment of SOE performance*" (Guideline II.F.3). To review performance effectively, the ownership entity must first ensure that it has access to accurate and relevant information on a timely basis, and monitor the performance of portfolio companies both on an ongoing and annual basis.

The system for **ongoing performance review** (Section 2.2) tracks and reviews performance on a regular basis, ensuring early identification of problems and opportunities and allowing prompt reaction to under performance. It typically combines, in accordance with corporate and capital market law, formal and more informal mechanisms, including state representatives on boards, meetings with boards and senior management or more formal reporting processes. Systematic processes might be developed to allow collecting data directly from the SOEs' information systems. "No surprise" or continuous disclosure policies could also be adopted, requiring SOE boards to keep the ownership entity informed in a timely manner about any material or significant events. Complementary information channels might be used, such as dialogue with external auditors, contact points in SOEs and use of external sources such as industry analysts, etc. Whatever the processes in place, they need to be balanced so as not to place

excessive reporting requirements on SOEs or to bypass the board. Ownership entities will also have to develop their own capacity to treat this information. They should seek to provide SOEs with written comments and recommendations when appropriate on current achievements and take actions whenever necessary.

The **annual performance review** (Section 2.3) requires in-depth analysis by the ownership entity of the SOE performance. It might vary significantly in depth and scope but will always include an assessment of financial and non-financial results against key performance indicators, based on information and comments provided by the board. It could also include an assessment of operating results, corporate value and risks, board performance and corporate governance practices. Careful consideration needs to be given to costs and benefits of these information requirements. At the center of the annual performance review is the mostly informal discussion between the board and the ownership entity. Specific mechanisms might be developed within the ownership entity, such as internal panels to allow a broader perspective and fresh views in discussing the evolution of one SOE's performance. A summary document could be developed by the ownership entity, possibly shared with the SOE concerned, and even publicly disclosed. Annual performance reviews are an important tool for identifying actions that need to be taken in relation to underperforming companies and are a natural basis for discussing future objectives. In addition, some more medium- to long-term reviews could be carried out, together with appropriate benchmarking, as the basis for discussing the SOE strategy and assessing the evolution of its value and potential risks.

Ownership entities should also strive to **benchmark SOE performance** (Section 2.4), *i.e.* compare them with relevant peers in the same industry, of similar size and subject to similar complexity and risk, from the private or the public sector, domestic or foreign. The chief purpose is to identify performance gaps and areas of potential improvement, taking into account the impact of market evolution or other "external" factors. The rate of return is often very useful, since it focuses on the cost of capital, which is often underestimated or neglected by SOE management. The use of synthetic financial ratios might also facilitate benchmarking when enterprises are not in the same industry, including different measures of value creation such as EVA (Economic Value Added). Whatever peer is chosen for benchmarking, care is always required in interpreting comparisons of performance and use of relevant industry research is useful.

Auditing performance

Auditing performance provides credibility to the performance indicators and review process, ensuring a solid basis for the overall accountability system. To ensure an overall robust auditing system, it is important to clearly define the respective roles of the three different types of audits, *i.e.* internal, external and state audit, in order to avoid duplication and promote complementarity. The audit committee plays a central role in supporting and overseeing the three types of audit. Appropriate co-ordination and communication has to be ensured among the board, external and internal auditors.

Internal auditors constitute the first level of control (Section 3.2). They can play an important role by scrutinizing and contributing to the improvement of governance practices, reporting routines, risk management and internal control processes. This is becoming critical with the growing deregulation and internationalization of industries in which SOEs often operate. The ownership entities should demand that SOEs have

appropriate procedures for internal auditing, meeting the *International Standards for the Professional Practice of Internal Auditing*, and encourage internal auditors to focus not only on compliance but on risk management. SOEs' financial statements should comprise an internal control report describing the internal control structure and procedures for financial reporting. Internal auditors should have a direct reporting line to the audit committee, which in turns must ensure their independence, support their work and discuss their findings. Finally, periodic audit of internal audit departments could also be required.

The Guidelines also recommend that "*SOEs, especially large ones, should be subject to an annual independent external audit based on international standards*" (Guideline V.C). The annual **external audit** (Section 3.3) shall provide the board and the shareholders with an independent, critical and objective report to ensure that accounts fairly represent the financial position and performance of the company in all material aspects. To improve credibility and comparability, the Guidelines recommended that SOEs be "*subject to the same high-quality (…) auditing standards as listed companies*". Another essential consideration is the effective independence of the external auditors. Criteria for such independence include limits on providing consulting or other non-audit services as well as periodic rotation of audit partners or audit firms. External auditors are accountable to the shareholders via the boards, thus nominated by the AGM (Annual General Meeting) following recommendation of the board audit committee. The audit committee is also responsible for overseeing their work and needs to follow the implementation of the audit findings. Besides that, the ownership entities themselves should "*maintain(s) a continuous dialogue with external auditors*" (Guideline II.F.4) and be able to assess and effectively review regularly the quality of their work. They could provide information both on external auditors and related fees, on their annual reports and websites.

It is often the case that at least large non-listed SOEs are subject to audit by **state audit institutions** (SAIs) (Section 3.4). Their traditional task is to audit the use of public resources, and particularly the legality and regularity of financial management and accounting. SAIs are often powerful tools and information sources for Parliaments. However, the scope of their audits needs to be clearly defined and duplication avoided, with financial audits carried out either by external auditors or by state auditors, depending on the legislation and their respective quality. SAIs could rather focus increasingly on audits of the ownership entities themselves and on performance audits, *i.e.* in-depth reviews of the performance, economy, efficiency and effectiveness of an entity. Ownership entities could put in place specific processes to discuss in a systematic manner the results of state audits with the concerned boards. It is important that they maintain continuous dialogue with SAIs and support their work, ensuring them appropriate access to information, making appropriate use of their audits and taking action based on their findings. Disclosure of audit findings to the public, with due consideration for the protection of commercial, industrial or trade secrets, can also be instrumental in this regard by creating public pressure for action.

Reporting on performance

The Guidelines provide a number of recommendations regarding reporting on performance, covering the publication of aggregate reports, web-based communication and reporting to Parliament.

Aggregate reports (Section 4.2) are short, easy to read and regular reports developed by the ownership entities and providing the general public with value-adding, concise and accessible information about the overall performance of the state sector. They are key communication tools and trust-building instruments directed to the general public, Parliament and the media, and are instrumental in showing that the state is an accountable and predictable owner. The actual process of developing these reports helps clarify policies, make information consistent and improve internal reporting systems. Aggregate reports are also useful for building consensus on specific issues and sensitive policy choices. Their central component is the review of financial performance, including a synthesis presentation of aggregate financial statements with key financial ratios for individual SOEs and the overall state portfolio. Highlights of main events of the year as well as short presentations on the largest SOEs are usually provided, together with essential background information on the framework for exercising state ownership. Aggregate reports could also provide "combined" accounts, giving a clear picture of the whole state sector's financial situation.

Developing aggregate reports entails specific processes within the ownership entity to collect and synthesise information on SOEs. It also involves active consultation and co-ordination among different parts of the ownership entity and with the SOEs and other government departments concerned, which might be time-consuming and not necessarily easy. Clarification of key messages might trigger a lot of internal discussion within the ownership entity. The collection of information both within the ownership entity and from the SOEs themselves is the central stage. The use of specific data sheets, working groups or contact points within SOEs could be helpful, and SOEs need to review the information provided on them. Endorsement of the final draft by the relevant authority gives it more visibility and political weight. Ownership entities could then make active use of aggregate reports, including with the media.

In addition to publishing aggregate reports, **web-based communication** (Section 4.3) is a powerful means of ensuring transparency towards the general public. It provides easy access and timely information about the performance of the state sector, the objectives of state ownership and the way the state exercises its ownership function. Its major advantage is that it can be timely updated. It can be used to provide the latest news and interim reports. It could also be a main channel and support for communicating with the media.

Reporting to Parliament (Section 4.4) is another important element of the overall accountability framework, as Parliaments represent the ultimate owners of SOEs, *i.e.* the general public. It requires a process of compilation, checking, reviewing and questioning that includes a large number of parties. Accountability is achieved through their interaction in what can be viewed as a "disclosure dynamic". There are three types of reporting to Parliament. *Periodic reporting* creates a framework for holding SOEs accountable on a regular basis, but the information is often dated when it reaches the Parliament. *Ad hoc reporting* derives from the capacity of Parliaments to demand information covering a broad range of issues and responding to matters of immediate concern or to important current events. It is sometimes insufficiently structured and subject to political grandstanding. Finally, reporting *for approval* could be discouraged, or at least strictly limited to significant decisions both politically and financially to avoid undue political interference. In practice, the responsibility for reporting to Parliament is usually shared among different ministries and ownership entities. The government's involvement in

transmitting information to the Parliament might be comparatively small, when individual SOE reports are tabled in Parliament after basic due diligence; or very intensive, including evaluation, dialogue with the SOE, analysis and intermediate reviews. In many cases, Parliaments would probably benefit from more concise and relevant information, as well as from better structured debates. It is not easy to find the correct balance between lack of accountability and excessive oversight, which could lead to political interference.

Ownership entities need to clarify the process for reporting to Parliaments. As both line ministries and ownership entities might be involved in reviewing and transmitting documents, active co-operation and co-ordination is necessary to ensure a free flow of information. Specific yet concise documents describing SOE performance, possibly including some form of aggregate data, could be developed to allow a focused discussion by parliamentarians. Appropriate use should also be made of specialised committees to encourage more in-depth and technical discussion and prepare and flag key issues for plenary debates, where a specific and separate discussion on the performance of SOEs could be organised. Ownership entities could also develop long-term performance reporting, allowing for a periodic analysis of the effectiveness of state ownership and a systematic review of SOEs' mandates. Mechanisms have to be developed to limit inappropriate politicisation of debates. Specific procedures need to be developed to deal with confidentiality issues, including confidential or closed meetings, particularly when the SOEs concerned are in competitive sectors. Finally, to facilitate the "disclosure dynamic" referred to above, reports to the Parliament as well as minutes of discussions within the Parliament should be made available to the general public.

The ownership entities are also advised to be pro-active in **communicating with the media**. Having an educated, professional and active press covering SOEs' performance is an instrumental and effective way of ensuring public pressure for performance. The role of the media in exposing, for example, abusive related transactions might be particularly important.

Ensuring adequate disclosure and transparency at the company level

To be transparent as a shareholder, the state must ensure that appropriate information is disclosed at the SOE level. This will allow the state itself to carry out its ownership function, the Parliament to play its oversight role, the media to raise awareness on relevant issues, and the general public to get a clear picture of SOE performance. The Guidelines provide a number of recommendations in this regard, with the underlying objective of ensuring that SOEs are as transparent as publicly traded corporations.

To ensure appropriate disclosure and transparency at the SOE level, the state as an owner needs first to **develop a coherent disclosure policy** (Section 5.2) for its portfolio companies, identifying what information has to be disclosed, how and to whom, and the procedures for ensuring its quality. Developing such a policy would start with an inventory and review of the existing legal and regulatory requirements as well as actual practice at the SOE level. After identifying weaknesses and discrepancies, the framework might be adapted and completed. In doing so, the ownership entity would consult adequately, focus on material information to avoid unnecessary requirements, and make proper use of regulatory impact assessments.

Specific mechanisms could be put in place to **encourage and monitor effective implementation of transparency requirements by SOEs** (Section 5.3). It is necessary for

the ownership entity to develop guidance in sensitive areas, in the form of focused manuals or specific seminars and training. It could also underline boards' responsibilities and the particular role of the audit committee in ensuring appropriate disclosure. Ownership entities need to communicate effectively on the new framework, to ensure that SOEs fully understand their obligations and to raise awareness of the general public and the media. Special initiatives could encourage and support better disclosure, such as holding meetings open to the general public and mimicking AGMs, special transparency awards, etc. SOEs should be encouraged to go beyond requirements and adopt best practices, for example regarding sustainability reporting. The ownership entities have anyhow to measure and assess effective implementation by SOEs and report on it.

The Guidelines highlight the importance for the state as an owner to ensure **equitable treatment of all shareholders** by SOEs (Section 5.4). Building up a reputation of a transparent, predictable and fair owner will have a significant impact on the state's future capacity to attract outside funding as well as on the valuation of SOEs. The state as a shareholder should "tie its own hands" and ensure a clear protection of minority shareholders. An essential prerequisite is to strongly establish and clearly articulate the duty of loyalty of SOE board members towards the SOE itself and to all its shareholders. This policy could then provide a consistent menu of mechanisms, usually adopted to prevent abuse of minority shareholders, with a reasonable balance of *ex ante* and *ex post* mechanisms and taking due consideration of the legal characteristics of the country concerned. This would include pre-emptive rights, qualified majority for certain decisions, capacity for minority shareholders to call for a shareholder meeting, access to redress, etc. The state could also develop nomination processes that are favourable to minority shareholders' representation in boards, such as cumulative voting or participation in nomination committees. Active participation of minority shareholders in general shareholder meetings might also be encouraged by facilitating voting *in absentia* or collection of proxy voting from employee-shareholders. A simple and effective option is to submit all SOEs to the general company law, listing requirements and corporate governance codes applying to private-sector companies. Specific mechanisms and procedures also need to be developed to ensure that ownership entities do not abuse the information they receive as a controlling or significant shareholder.

This policy needs to be actively communicated to all SOEs, the market and stakeholders. The ownership entity should ensure that it is effectively implemented and encourage SOEs **to communicate actively with all shareholders** and adopt good practice in terms of board nomination, participation in general shareholder meetings and disclosure of information to all shareholders.

Abusive related party transactions (Section 5.5) are frequently reported as one of the most serious breaches of good corporate governance around the world. In many jurisdictions, disclosure and approval of related transactions are legal requirements. But implementation and enforcement remains a challenge as detecting a related transaction is difficult and proving abuse even more so. In the case of SOEs, the usual definition of related parties might be considered as too extensive, particularly the case in countries where state ownership is pervasive, as it includes "*entities that control or are under common control with the company, significant shareholders (…) and key management personnel*". This is the reason why the International Accounting Standard (IAS 24) is being modified in the case of state control. Exemptions would be provided for entities controlled or significantly influenced by the state, but the actual exercise of influence would preclude the use of this exemption.

As a significant shareholder and often board member, the state should ensure that SOEs do not undertake abusive related party transactions. To do so, it has firstly to define clearly what should be considered by SOEs as a related party transaction, based on IAS 24. It will then develop a clear policy in this regard, mandating adequate decision processes for approval of these transactions, tough standards regarding their disclosure, as well as outright prohibition of certain types of related transactions. It needs also to provide adequate guidance to SOEs to ensure that they duly identify, decide on and disclose related transactions. This guidance would cover the identification of relevant related parties and related transactions and underline the role of the audit committee in their review and disclosure. Finally, the ownership entity could also encourage gatekeepers and the media to be vigilant in identifying and disclosing abusive transactions.

The Guidelines recommend SOEs to acknowledge the importance of stakeholder relations for building sustainable and financially sound enterprises and fully recognise their rights as established by law or mutual agreement. However, any specific rights granted to stakeholders or influence on the decision-making process should be explicit. Adequate **reporting on stakeholders' relations** (Section 5.6) allows SOEs, particularly listed and large ones, as well as those pursuing important policy objectives, to demonstrate their commitment to co-operation with stakeholders, build up trust and improve their reputation. It is also an important tool for managing risks related to stakeholder expectations.

The state shareholder should thus clearly require and encourage SOEs to follow existing best practices and recently developed guidelines on sustainability reporting, with due consideration for the costs involved. This reporting needs to be independently scrutinised to reinforce its credibility. It might also include information on compliance with internal codes of ethics and mechanisms protecting stakeholders reporting on illegal or unethical conduct by corporate officers, such as confidential access to the board or an ombudsman. SOE boards should also be encouraged to fulfil their responsibility regarding sustainability reporting, and have at least an annual discussion on it.

ANNEX A

Relevant Guidelines and Corresponding Topics Covered in the Guide

	1. Setting objectives	
II.A.	The government should develop and issue an ownership policy that defines the overall objectives of state ownership, the state's role in the corporate governance of SOEs, and how it will implement its ownership policy.	1.2. Developing an ownership policy. 1.3. Setting specific targets for the ownership entity. 1.4. Defining and reviewing SOE mandates. 1.6. Defining SOE objectives and yearly targets. 1.7. Developing relevant performance indicators.
VI.A.	SOE boards should carry out their functions of monitoring of management and strategic guidance, subject to the objectives set by the government and the ownership entity.	
V.E.1.	SOEs should disclose material information on all matters described in the OECD Principles of Corporate Governance and in addition focus on areas of significant concern for the state *as an owner and the general public. Examples of such information include;* A clear statement to the public of the company objectives and their fulfilment.	
I. C.	Any obligations and responsibilities that an SOE is required to undertake in terms of public services beyond the generally accepted norm should be clearly mandated by laws or regulations. Such obligations and responsibilities should also be disclosed to the general public and related costs should be covered in a transparent manner.	1.5. Identifying, costing and funding special obligations.
	2. Reviewing performance	
II.F	The state as an active owner should exercise its ownership rights according to the legal structure of each company. Its prime responsibilities include setting up reporting systems allowing regular monitoring and assessment of SOE performance.	2.2. Ongoing monitoring of performance. 2.3. Annual review of performance. 2.4. Benchmarking performance.
	3. Auditing performance	
V.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 company organ.	3.2. Internal audit.
V.C.	SOEs, especially large ones, should be subject to an annual independent external audit based on international standards. The existence of specific state control procedures does not substitute for an independent external audit.	3.3. External and independent audit.
II.E.	The co-ordinating or ownership entity should be held accountable to representative bodies such as the Parliament and have clearly defined relationships with relevant public bodies, including the state supreme audit institutions.	3.4. State audit.
II.F	The state as an active owner should exercise its ownership rights according to the legal structure of each company. Its prime responsibilities include: When permitted by the legal system and the state's level of ownership, maintaining continuous dialogue with external auditors and specific state control organs.	

	4. Reporting on performance	
V.A.	The co-ordinating or ownership entity should develop consistent and aggregate reporting on state-owned enterprises and publish annually an aggregate report on SOEs.	4.2. Publication by ownership entities of aggregate reports. 4.3. Development and timely update of websites by ownership entities.
II.E.	The co-ordinating or ownership entity should be held accountable to representative bodies such as the Parliament and have clearly defined relationships with relevant public bodies, including the state supreme audit institutions.	4.4. Reporting to parliaments
	5. Ensuring adequate disclosure by SOEs	
V.D.	SOEs should be subject to the same high-quality accounting and auditing standards as listed companies. Large or listed SOEs should disclose financial and non-financial information according to high-quality internationally recognised standards.	5.2. Developing an SOE disclosure and transparency policy. 5.3. Follow up implementation and encourage good practice.
V.E.	SOEs should disclose material information on all matters described in the OECD Principles of Corporate Governance and in addition focus on areas of significant concern for the state as an owner and the general public.	
VI.E.2.	The ownership and voting structure of the company.	
VI.E.3.	Any material risk factors and measures taken to manage such risks.	
IV. B.	Listed or large SOEs, as well as SOEs pursuing important public policy objectives, should report on stakeholder relations.	
VI.E.4.	Any financial assistance, including guarantees, received from the state and commitments made on behalf of the SOE.	
VI.E.5.	Any material transactions with related entities	5.5. Develop appropriate framework to deal with related-party transactions.
III.B.	SOEs should observe a high degree of transparency towards all shareholders.	5.4. Ensure equitable treatment of shareholders by SOEs.
III.C.	SOEs should develop an active policy of communication and consultation with all shareholders.	
IV.B.	Listed or large SOEs, as well as SOEs pursuing important public policy objectives, should report on stakeholder relations.	5.6. Ensure appropriate disclosure on stakeholder relations.

ANNEX B

Participants of the First Meeting of the Global Network on Privatisation and Corporate Governance of SOEs, Paris, March 2008

Country	Participant	Designation
Austria	Mr. Johannes RANFTL	Director Public Investments and Real Estate, Ministry of Finance
Belgium	Mr. Piet RAEPSAET	Directeur de l'Administration de la Trésorerie, SPF Finances
	Mrs. Hilde VAN DEN HOUTEN	Premier attaché, Service Support de la Dette, Service Public Fédéral Finances
Brazil	Mr. Francklin FURTADO	Gestor Governamental – EPPGG, Department of Co-ordination and Control of State-Owned Enterprises, Ministry of Planning Budget and Management
	Ms Luciana PONTES	Co-ordinator, Department of Co-ordination and Control of State-Owned Enterprises, Ministry of Planning Budget and Management
Bulgaria	Mr. Todor NIKOLOV	Executive Director, Privatisation Agency
Canada	Mr. Sebastian BEAULIEU	First Secretary, Permanent Delegation to the OECD
Chile	Ms Leticia Celador IZQUIERDO	Advisor to the Minister, Ministry of Finance
Peoples Republic of China	Ms Jun HAN	Program Co-ordinator, Foreign Affairs Bureau, SASAC
	Mr. Tingyu HUANG	Secretary, Supervisory Committee, China Netcom (Group) Company Ltd.
	Mr. Yongfa QIN	Deputy Head, Board Pilot Project Office, SASAC
	Mr. Guijun WU	Secretary to the Board, Office of Directors, General Dept., China Netcom (Group) Company Ltd..
Croatia	Mr. Ivo RADKOVIC	Advisor, Investment and Export Facilitating Division, Ministry of Economy, Labour and Entrepreneurship
Czech Republic	Mr. Petr MUSIL	Advisor, Ministry of Finance
Egypt	Dr. Ashraf GAMAL EL DIN	Executive Director, Egyptian Institute of Directors
Estonia	Mr. Tarmo PORGAND	Head of Division, Ministry of Finance
Finland	Mr. Arto HONKANIEMI	Senior Financial Counselor, Ownership Steering Department, Government Office
	Mr. Ilkka PUROQ	Senior Financial Counselor, Ownership Steering Department, Prime Minister's Office
France	Ms Lucie MUNIESA	Secretary General, APE (State Participation Agency)
Germany	Dr. Wilhelm WILTING	Referat VIII B 1, Federal Ministry of Finance (BMF)
Greece	Mr. Aimilios STASINAKIS	Special Secretary for Public Enterprises and Entities, Ministry of Economy and Finance
	Ms Dimitra PANAGOPOULOU	Economic Advisor of Special Secretariat for Public Enterprises and Entities, Ministry of Economy and Finance
	Mr. Dimitri ANDREOU	First Secretary, Permanent Delegation to the OECD
India	Mr. Sumant BATRA	Senior Partner, Kesar Dass B and Associates
	Dr. Sikander DEWAN	Director General, Standing Conference of Public Enterprises (SCOPE)
	Mr. K PADMAKUMAR	Secretary, Government of Kerala, Public Sector Restructuring and Internal Audit Board Industries Dept.
	Mr. K D TRIPATHI	Joint Secretary, Department of Public Enterprises, Ministry of Heavy Industries and Public Enterprises
Indonesia	Mr. Mas Achmad DANIRI	Chairman, Indonesia National Committee on Governance
	Mr. Pandu DJAJANTO	Expert Staff in Corporate Governance, State Ministry of State-Owned Enterprises
Israel	Mrs. Avitak BIRGER	Deputy Legal Counsel, Israel Government Companies Authority
Italy	Mr. Giovanni FINO	Director, Direction VII – Office 5, Ministry of Treasury
Japan	Mr. Takashi KAMIYA	First Secretary Finance, Permanent Delegation to the OECD

Country	Participant	Designation
Korea	Mr. Kyung-Ho CHOO	Counsellor for Economics and Finance, Permanent Delegation to the OECD
	Dr. Jiyoung KIM	Visiting Fellow, Korea Institute of Public Finance
	Mr. Heechul MIN	Research Fellow, Korea Institute of Public Finance
Malaysia	Mr. Abdul Wahab JAAFAR SIDEK	CEO, Minority Shareholder Watchdog Group
Morocco	Mr. Abdesselam ABOUDRAR	Président de la Commission Lutte contre la Corruption, CGEM
Mozambique	Mr. Abilio Justino INGUANE	Director-Advisory Staff, State Shares Management Agency, IGEPE
	Mr. Daniel TEMBE	Chairman, IGEPE
	Dr. Maria Iolanda WANE	Executive Director, IGEPE
Norway	Mr. Morten KALLEVIG	Deputy Director General, Ministry of Trade and Industry, Department of Ownership
Pakistan	Mr. Rana Assad AMIN	Joint Secretary Corporate Finance, Ministry of Finance
Peru	Mr. Mario GONZALEZ	Manager Operations, FONAFE
Philippines	Mr. Jonathan Juan MORENO	Vice President, Head of Corporate Governance Division, The Philippine Stock Exchange
	Mr. Jeremius PAUL	Undersecretary, Ministry of Finance
Poland	Mr. Andrzej ZADRUZYNSKI	Counsellor, Permanent Delegation to the OECD
Portugal	Mr. Carlos Lopes PEREIRA	Head of Cabinet, Entrepreneurship, Partnerships and Concessions, Treasury.
Romania	Mr. Valentin MACEC	Director, SME's Ministry
	Ms Mihaela POPESCU	Counsellor OECD Office, Embassy of Romania in Paris
Russian Federation	Ms Elena KURITSINA	Deputy Head, Federal Service for Financial Market (FSFM)
	Mme Tatiana MEDVEDEVA	Senior Legal Expert, Federal Service for Financial Market (FSFM)
	Mr. Ivan OSKOLKOV	Director, Department of Corporate Governance, Ministry of Economy
Singapore	Mr. John LIM	President, Singapore Institute of Directors (SID)
Slovenia	Ms Anka CADEZ	Secretary, Ministry of Finance
	Mr. Leonardo PEKLAR	Chairman, Socius Consulting Inc.
	Ms Nevenka REBRICA	Head of Public Sector Analysis and Evidence, Ministry of Finance
South Africa	Mr. Mohamed ADAM	Corporate Secretary and Legal Counsel, Eskom Holdings Ltd..
	Mr. Bernard MHANGO	Corporate Secretary, Development Bank of Southern Africa
	Mr. Higgo du TOIT	Director Corporate Governance, Assets and Liabilities Management, Public Finance, National Treasury
Spain	Mr. Juan Munuira GONZÁLEZ	Legal Advisor, International Affairs, Commission Nationale du Marché des valeurs (CNMV)
	Mr. Dioniso Usano CRESPO	General Director, FUNEP/SEPI, Ministry of Economy and Finance
	Mrs. Paloma AVILA DE GRADO	Economic and commercial counselor, Permanent Delegation
Sweden	Mr. Lars Erik FREDRIKSSON	Desk Officer, Ministry of Energy and Communications
Switzerland	Mr. Robert MÜLLER	First Secretary, Permanent Delegation to the OECD
Thailand	Dr. Areepong BHOOCHA-OOM	Director General, State Enterprise Policy Office (SEPO)
	Dr. Sathit LIMPONGPAN	Deputy Permanent Secretary, Ministry of Finance
Turkey	Mr. Volkan TASKIN	Chief Economic Counsellor, Permanent Delegation to the OECD
	Mr. Ali Gokhan ASLAN	Expert, Corporate Finance Department, Capital Markets Board of Turkey
	Ms Arzu ATIK	Head of Group, Privatisation Administration
	Mr. Mustafa KORHAN	Member Board, Corporate Finance Department, Capital Markets Board of Turkey
	Mr. Salih KOSE	Head of Department, State Planning Organisation
	Mr. Mehmet Akif KÖSEOGLU	Expert, State Planning Organisation
	Mr. Sefa PAMUKSUZ	Director General, for SEEs, Turkish Treasury
	Ms Filiz Ipek YIKILMAZ	Head of Department, Privatisation Administration
United States	Ms Rebecca FONG	Investment Policy Advisor, Permanent Delegation to the OECD
Vietnam	Ms Thuy TRAN THI PHUONG	Deputy Director, Operating Office, Secretariat Department, State Capital Investment Company (SCIC)
Zambia	Mr. Derrick SIMUKOKO	Senior Economist, Investment and Debt Management Unit, Ministry of Finance and National Planning
	Mrs. Rachel ZYAMBO	Chief Economist, Industry, Investment and Debt Management Unit, Ministry of Finance and National Planning
	Mr. Eugene CHANDI	Director (Non-Executive), Institute of Directors
	Mr. Mumba KAPUMPA	President, Institute of Directors
World Bank	Mr. Philip ARMSTRONG	Head, Global Corporate Governance Forum, IFC/World Bank Corporate Governance Department
	Mr. Sebastian LOPEZ AZUMENDI	Sustainable Development Network, Latin America and the Carribean Region
	Mr. David ROBINETT	Economist, Corporate Governance Unit

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