

CORPORATE GOVERNANCE IN STATE OWNED ENTERPRISES:

MAJOR CHALLENGES AND WAYS OF IMPROVEMENT

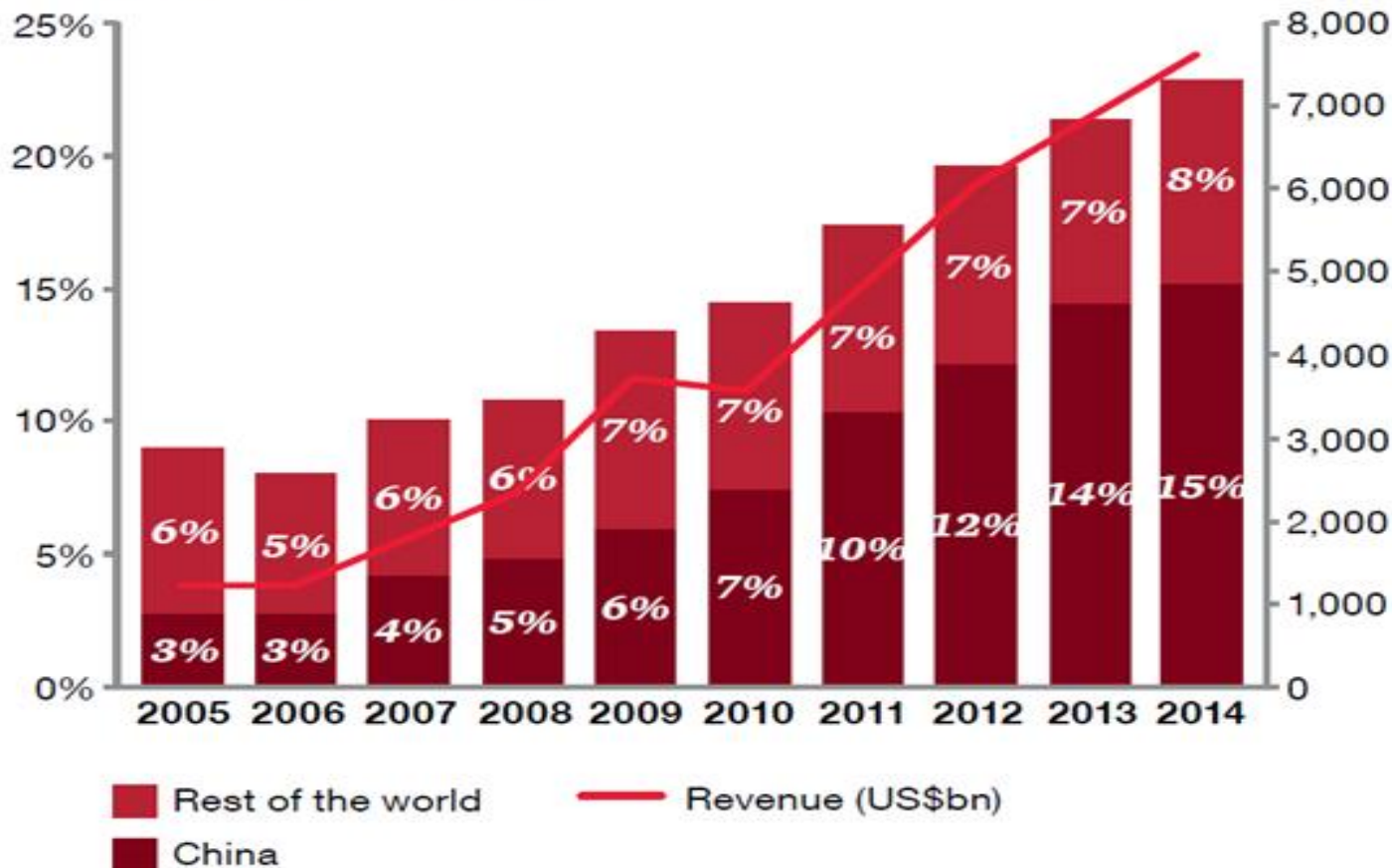


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Tbilisi, November 21, 2016

SOEs as % of Global 500
(based on number of companies)

**Global 500
SOE revenues**
(US\$bn)



Note: SOEs defined as having 50% or more government ownership

Source: PwC analysis, Fortune

What Is Corporate Governance

“If management is about running business, governance is about seeing that it is run properly. All companies need governing as well as managing.”

Prof. Bob Tricker, 1984

Sound corporate governance is an important element of sustainable development -- not only because it strengthens businesses' ability to attract investment and grow but also because it makes companies and those running them more accountable.

“Corporate Governance is the system by which companies are directed and controlled.”



Examples of the SOEs with Good Corporate Governance



Statoil





- In 2014, Brazil's biggest corruption schemes, not yet fully uncovered, came to light: Petrobras, which had employed Brazil's current president as CEO, had been involved in a kickback scheme involving contracts worth upward of 4 billion USD.
- Money from the inflated contracts was eventually fed back to the governing Workers' party and other major parties for political campaigns.
- By 2015, over 100 executives and politicians were indicted for money laundering and corruption.

Corporate Governance Challenges associated with SOEs

“State-owned companies operate as the Hungarian state does: often non-transparently”.

“The process of appointing government representatives to boards in Russia lacks transparency and board members are often passive and non-contributing members”.

“Bribes, preferential tendering and disastrous management have turned these companies into ‘black holes’ in Romania’s state budget”.

“Key governance challenges for SOEs in India: lack of awareness of the corporate governance framework by government and political leaders, lack of board training in corporate governance, lack of transparency in disclosure of information, fragmented board structures, lack of disclosure of performance evaluations of directors’.

“Poor governance practices in Chinese SOEs include inappropriate transfer of assets, theft of corporate assets through insider dealings, embellishment of financial documents, stock price manipulation and nepotism”.

Corina Murafa, State-owned enterprises: A challenge for anti-corruption fight in Central and Eastern Europe (2013)
*Adele Thomas, Governance at South African state-owned enterprises:
What do annual reports and the print media tell us? (2012)*

Corporate Governance Challenges associated with SOEs

- Poor Board of Directors/Supervisory Board and Management
- Inefficient Internal Controls
- Low Level of Transparency and Disclosure
- The State as an Owner-Improper Mechanisms of Control/Nepotism in Appointments

Board of Directors/Supervisory Board

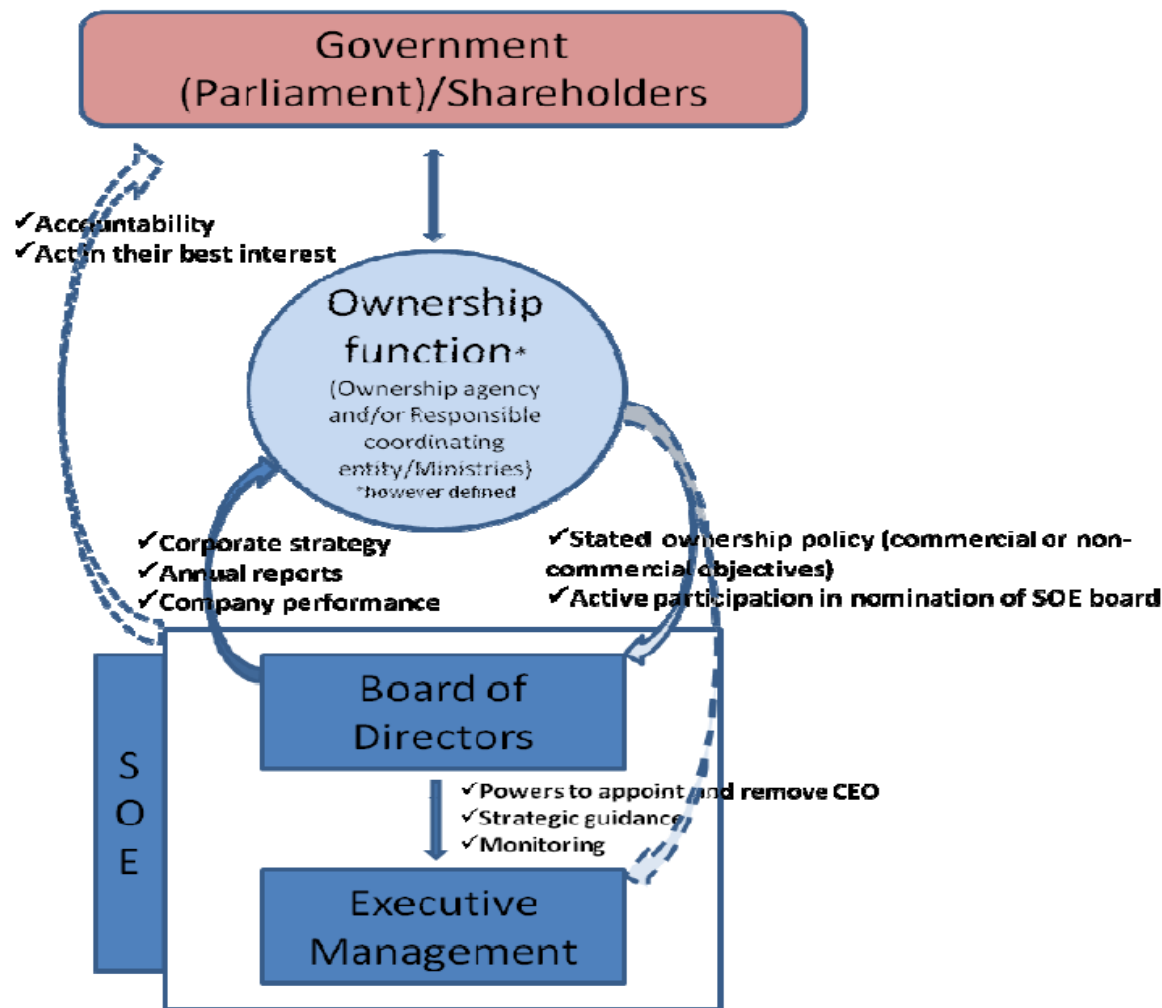
- Presence of state servants/representatives of political parties
- Absence or inadequate remuneration for their service on the board or non-transparent remuneration scheme
- Insufficient qualification and skill mix



LACK OF INDEPENDENT AND OBJECTIVE JUDGEMENT

Role of the Board of Directors/Supervisory Board

Figure 1. The role of the board in a three-layer governance structure

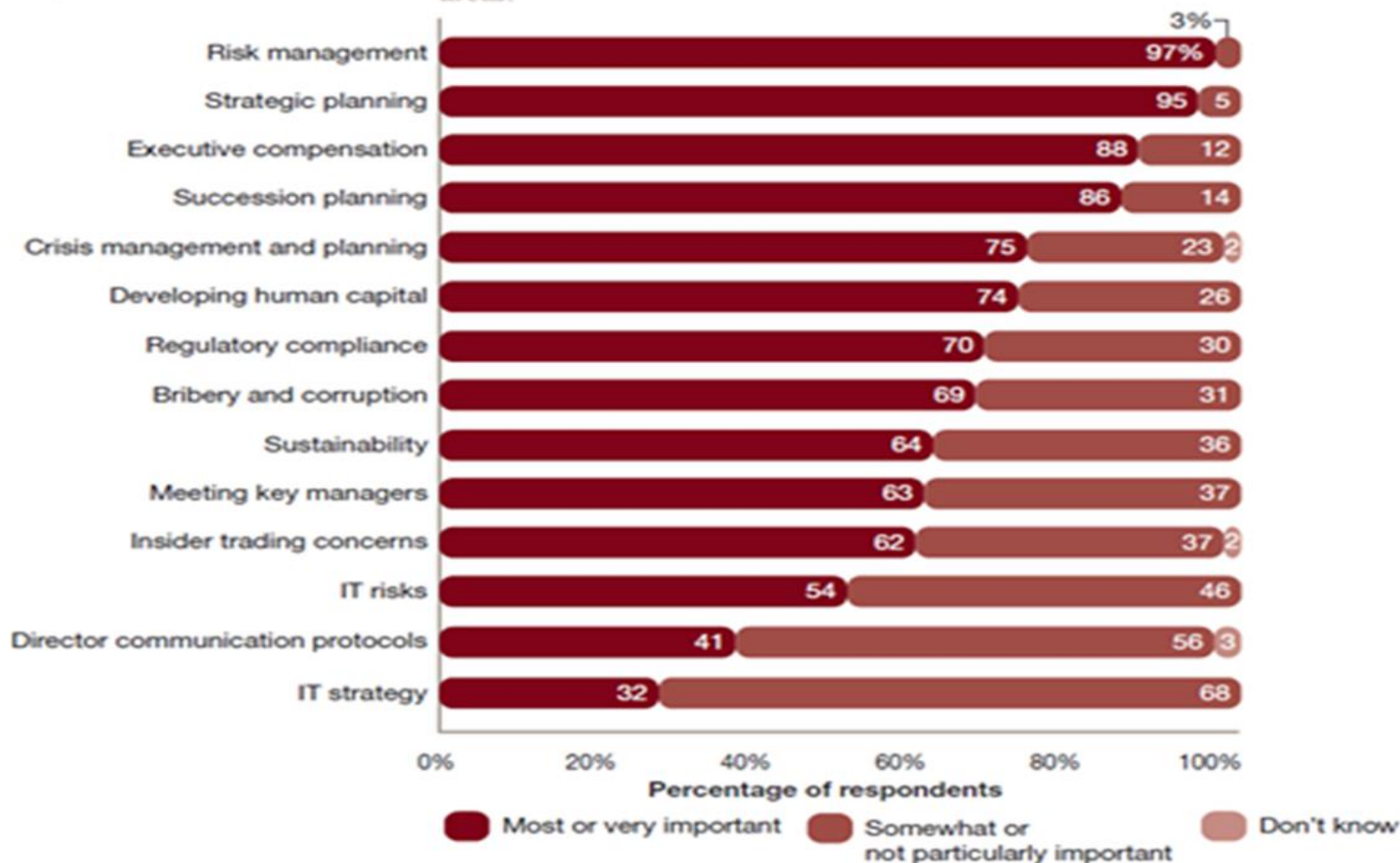


Source: *Board of Directors of SoEs: an Overview of National Practice*, OECD 2012

Expectation towards Boards

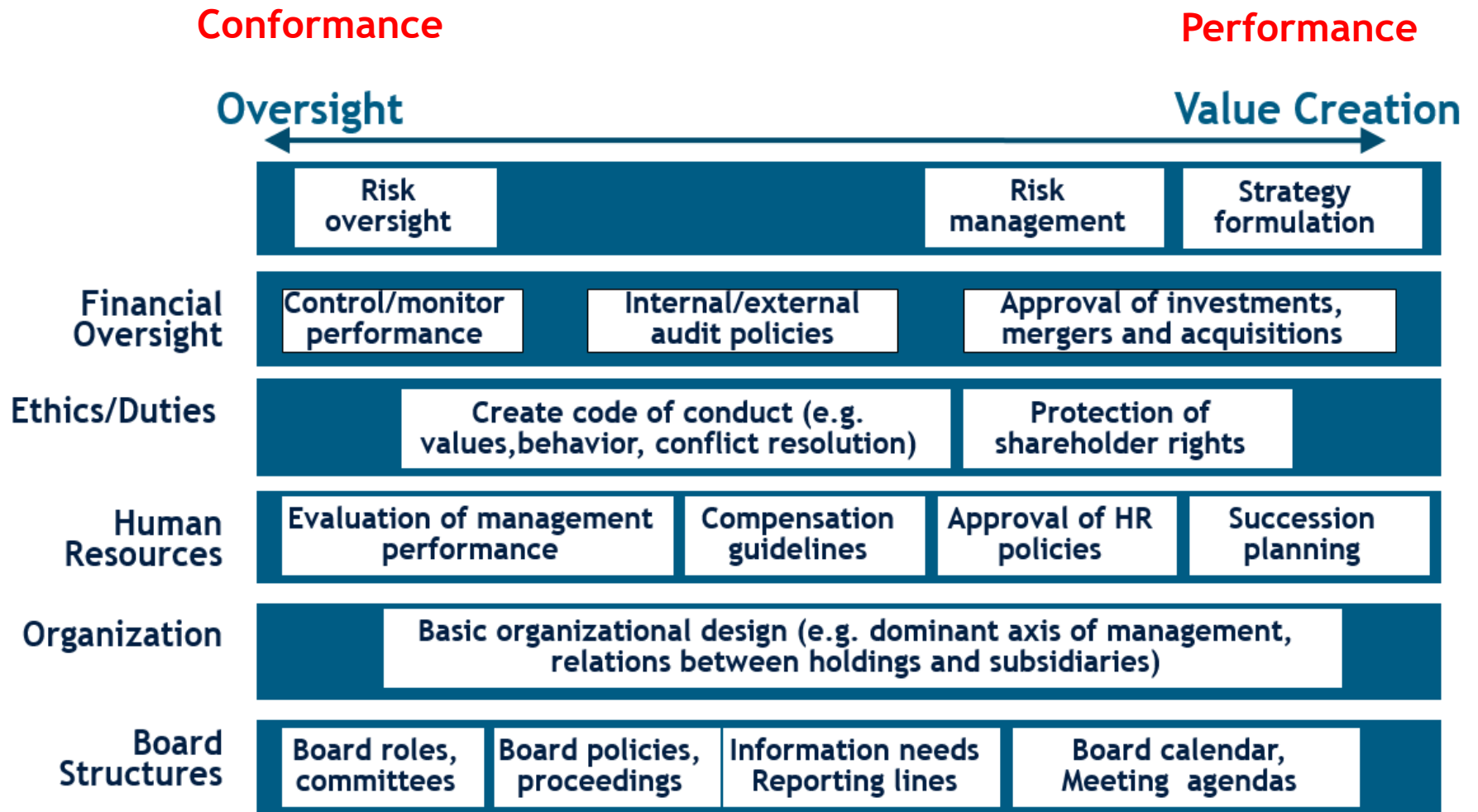
What issues should boards focus on?

Q. Please rank the relative importance you believe boards should place on the following areas:



Source: PwC's 2013 Investor Survey

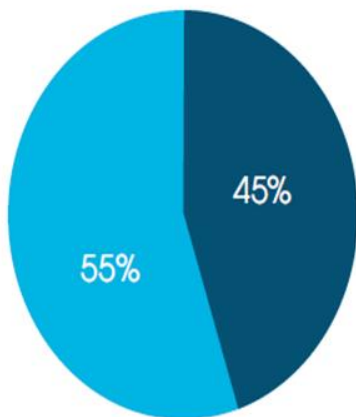
Value-added Board



Independence and Competence of Board Members Matter

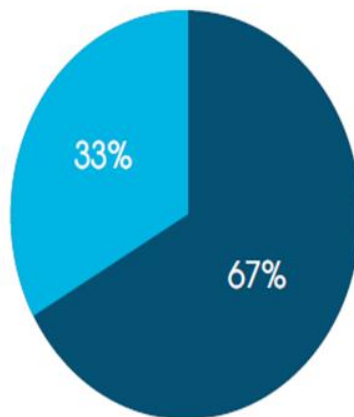
Independence

Independent Directors -
Europe Top 370
Companies



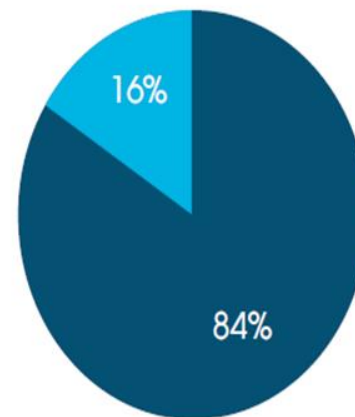
■ Independent Directors
■ Other Directors

Independent Directors -
UK FTSE 150
Companies



■ Independent Directors
■ Other Directors

Independent Directors -
USA S&P 500
Companies

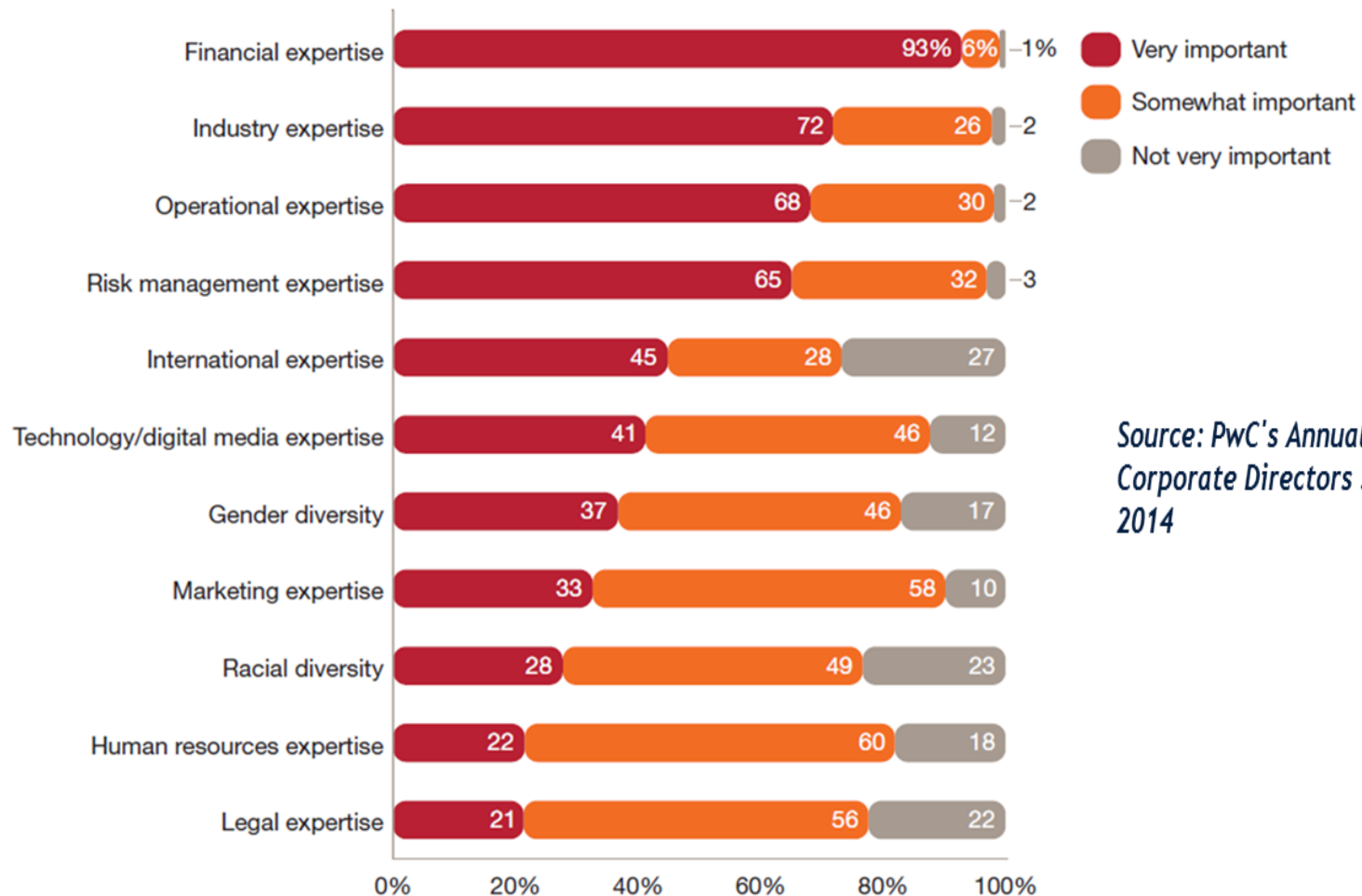


■ Independent Directors
■ Other Directors

DIRECTRORS COUNSEL Corporate Governance & Board Composition, 2013

Competence

How would you describe the importance of having the following attributes on your board?



*Source: PwC's Annual
Corporate Directors Survey,
2014*

Guess the type of the company/industry...

Director A

Age: 64

Private Investor and Former President and Chief Executive Officer of Sotheby's Holdings.

Director B

Age: 73

Retired Chairman of International Business Machines Corporation.

Director C

Age: 77

Theatrical Producer and principal of Berlind Productions since 1981.

Director D

Age: 76

Retired Chairman and Chief Executive Officer of Halliburton Company.

Director E

Age: 60

Rear Admiral, U.S. Navy (Retired). Served as President and Chief Executive Officer of the American Red Cross from August 2002 to December 2005.

Board of Directors

- ✓ Average age: 68 (two board members over 80)
- ✓ 3 new members since turn of the century
- ✓ Others all appointed in 1994 (at time of IPO)
- ✓ Chair of the Board, CEO, and Chair of the Risk and finance committee - all the same person

8 out of 11 directors are independent

Director Skills, Attributes

All Directors	Some Directors
<ul style="list-style-type: none">• Integrity, courage• Commitment to good governance• Sound business judgment• Strategic thinking• Analytical skills• Financial literacy• Leadership attributes, including• Emotional intelligence	<ul style="list-style-type: none">• Chairperson skills, attributes• Senior management experience• Audit & control processes• Risk management, including IT• Accounting & taxation• International & local expertise• Diversity - gender, age, geographic

Effective Board Procedures

40% - strategy; 30% support to CEO on control and supervision; 20% - human resources and talent management; and 10% - routine, administrative and operational issues.

Meeting agendas and supporting materials should be communicated suitably in advance and in an effective manner to enable maximum efficiency at the meetings and for informed discussions and decisions at the meeting.

Preparations for the meetings should be conducted by the appointed person from administration (usually the Corporate Secretary) and involve the Chairman.

Agenda development - Chairman with support of the corporate secretary. Corporate secretary calls the meeting and sends materials.

The Board should have a working plan in addition to a schedule for meetings that includes the topics to be addressed.

The Board should develop an annual calendar of meetings which would allow directors to slot the meetings in their agenda. The calendar should serve as a guide only.

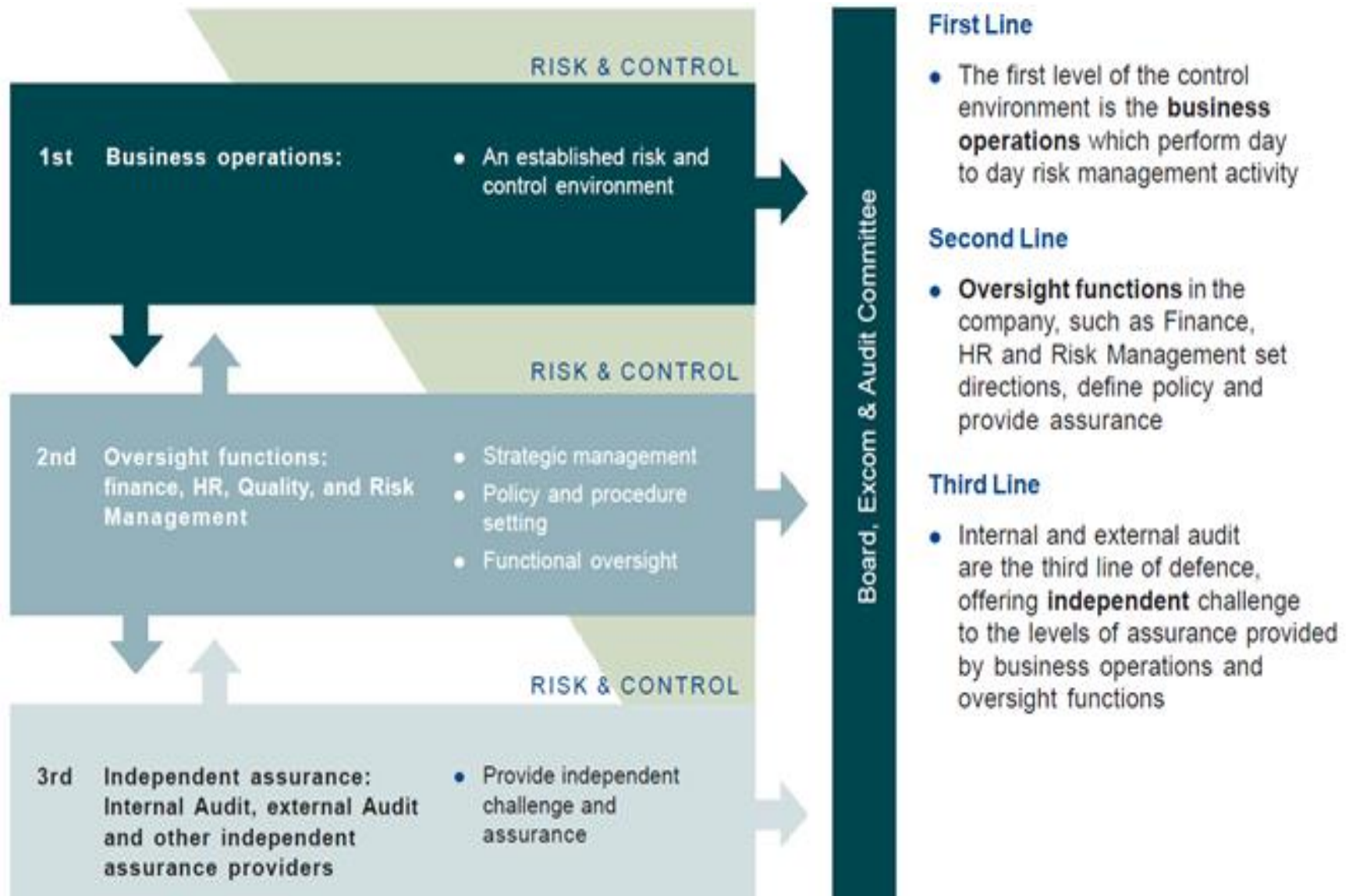
There are no set standards in terms of the number of meetings to be held per year and companies should find the right balance that fits them best.

Finally, at each session, important issues should be placed at the beginning of the agenda.

The same principles should be applicable to Management, especially when there is no Board of Directors/Supervisory Board

- **Clear and transparent principles of selection and appointment**
- **Independence and professionalism**
- **Self-consciousness, accountability, commitment and integrity**

Internal Controls and Risk Management: Three Lines of Defense



Source: KPMG, Three Lines of Defense, 2009

Audit Committee

External audit

- Appoints/ recommends the external auditor and key contact point
 - Recommends the audit fee to the Board and approves any non-audit services provided by the external auditor
 - Discusses with the external auditor, the nature and scope of the audit and reviews the auditors quality control mechanisms
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Internal audit

- Monitors and reviews the activities of internal audit
 - Ensures that the internal audit is adequately resourced and has sufficient standing within the company
 - Maintains the independence of IA and provides necessary resources
 - Considers management response to IA recommendations
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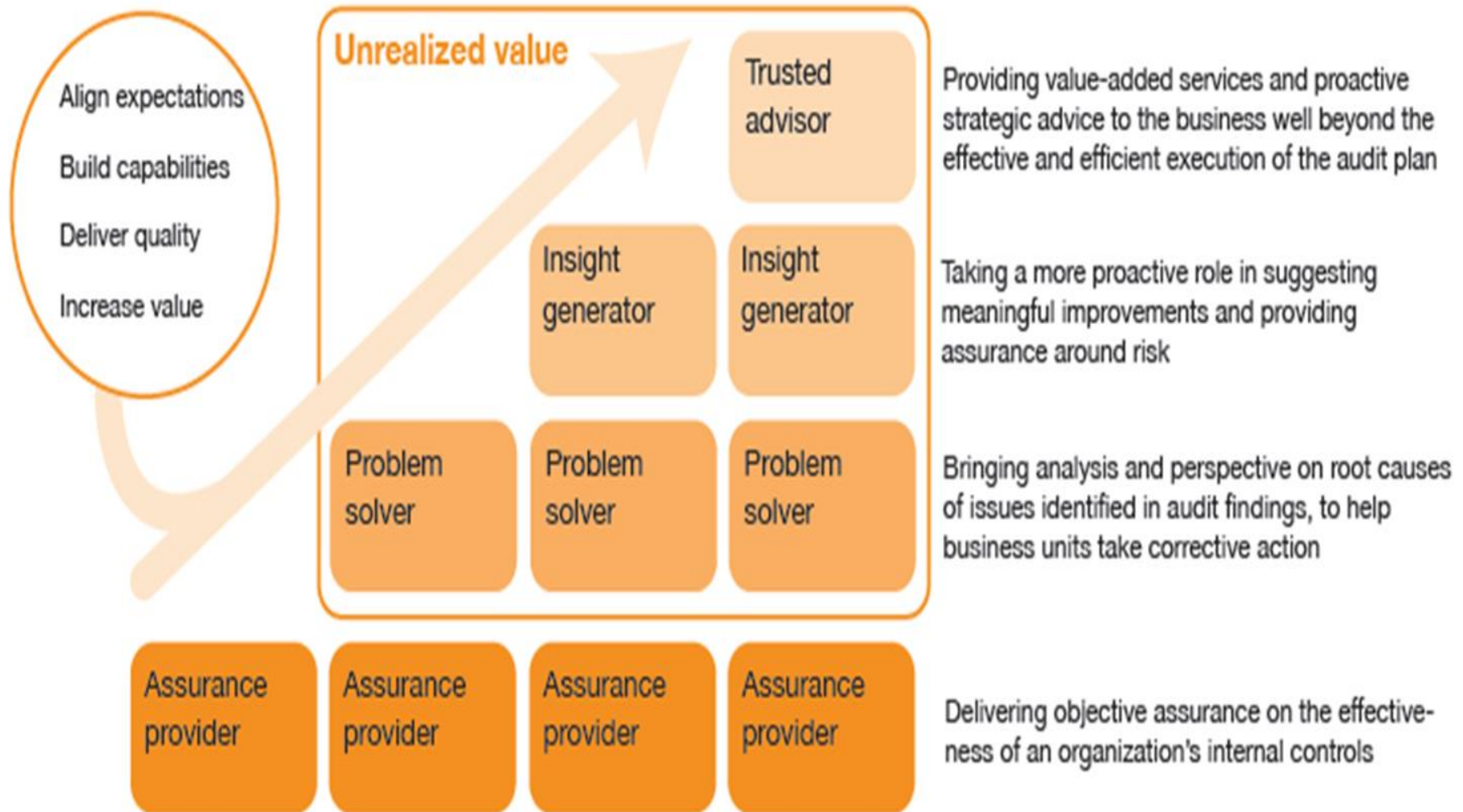
Controls and risk management

- Ensure that a comprehensive internal controls framework in place
 - Ensures the presence of a risk management policy document
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Reporting and disclosure

- Reviews significant reporting issues and accounting policies
- Reviews company's semi-annual and annual financial statements
- Reviews formal announcements made to the shareholders
- Reviews relevant regulatory returns filed and disclosures made by the company
- Reviews the going concern assumption of the company
- Monitors and approves material related-party transactions

Internal Audit



Source: PwC, *State of the Internal Audit Profession Study, 2014*

External Audit

		Area for focus	Performing as expected	Special strength	Evidence, comment or action
Independence, objectivity and the firm					
	Independence & objectivity				
9.1	It is clear from the communications (both written and oral) received from the auditors that the objectives of the FRC's Ethical Standards regarding independence and objectivity have been achieved.				
9.2	Potential conflicts of interest are identified and addressed in an appropriate and timely manner, i.e. as early as practicable.				
Non-Audit Services					
9.3	Our policy on non-audit services has been complied with and, for non-audit related services, threats and safeguards were communicated to us. Any matters of contention arising in relation to the provision of non-audit services are discussed and resolved at the earliest opportunity.				
9.4	The relationship between the auditors and management is appropriate such that there is no perception that the auditors may lack, or appear to lack, the required degree of objectivity.				
Culture					
9.5	Our perception is that this audit firm creates an environment where achieving high quality is valued, invested in and rewarded.				
9.6	There is evidence that this audit firm invests in audit innovation and continuous improvement.				
The Transparency Report					
9.7	The audit firm's Audit Transparency Report shows a robust approach to its own governance and ethics and there is a clear tone set from the very top of the organisation which flows through to audit teams.				
9.8	The audit firm's Audit Transparency Report shows a robust approach to engagement quality control.				

Source: Effectiveness of the External Audit Process, Deloitte, 2013

The State as an Owner

The state should act as an informed and active owner, ensuring that the governance of SOEs is carried out in a **transparent and accountable manner**, with a high degree of **professionalism and effectiveness**.

	Chile	Estonia	Israel	Slovenia
Separation between ownership and other state functions	Most SOEs are overseen by an ownership agency and their reporting monitored by securities regulators. However, some important statutory corporations remain self-regulating ¹ .	SOEs are overseen by sector ministries, some of which retain regulatory functions. Staff involved in regulation has no direct involvement in the SOE ownership function. Competition and public procurement is subject to EU law.	Each SOE is overseen by the Ministry of finance and a line ministry, subject to the advice of an ownership unit. Utilities regulation is sometimes done by ministries involved in the ownership function. Ongoing process of establishing extra-ministerial regulators.	SOEs are overseen by sector ministries (or have been until now) and state investment funds. Regulation is entrusted with autonomous bodies, but some SOEs operate in connection with industrial policy objectives.

THANK YOU!

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