

NOTES

FISCAL POLICY

How to Improve the Financial Oversight of Public Corporations

©2016 International Monetary Fund

Cover Design: IMF Multimedia Services
Composition: AGS, an RR Donnelley Company

Cataloging-in-Publication Data
Joint Bank-Fund Library

Names: Allen, Richard, 1944 December 13- | Alves, Miguel. | International Monetary Fund. Fiscal Affairs Department.
Title: How to improve the financial oversight of public corporations / this note was prepared by Richard Allen and Miguel Alves.
Other titles: Fiscal policy, how to improve the financial oversight of public corporations | How to notes (International Monetary Fund) ; 5
Description: [Washington, DC] : Fiscal Affairs Department, International Monetary Fund, 2016. | How to notes / International Monetary Fund ; 5 | November 2016. | Includes bibliographical references.
Identifiers: ISBN 9781475551983
Subjects: LCSH: Corporate governance—Quality control. | Corporations--Evaluation.

ISBN 978-1-47555-198-3 (paper)

DISCLAIMER: Fiscal Affairs Department (FAD) How-To Notes offer practical advice from IMF staff members to policymakers on important fiscal issues. The views expressed in FAD How-To Notes are those of the author(s) and do not necessarily represent the views of the IMF, its Executive Board, or IMF management.

Publication orders may be placed online, by fax, or through the mail:
International Monetary Fund, Publication Services
PO Box 92780, Washington, DC 20090, U.S.A.
Tel.: (202) 623-7430 Fax: (202) 623-7201
Email: publications@imf.org
www.imfbookstore.org

HOW TO IMPROVE THE FINANCIAL OVERSIGHT OF PUBLIC CORPORATIONS

Public corporations, otherwise known as state-owned enterprises (SOEs), are commercial entities owned or controlled by the government. In this note we discuss the legal, institutional, and procedural arrangements that governments need in order to oversee the financial operations of their public corporations, ensure accountability for the performance of these corporations, and manage the fiscal risks they present. In particular, governments should focus their surveillance on public corporations that are large in relation to the economy, create fiscal risks, are not profitable, are unstable financially, or are heavily dependent on government subsidies or guarantees.

The purpose of the note is to:

- Clarify the definition and classification of public corporations, and explain why their supervision is important to manage a range of potential fiscal risks;
- Propose a policy and a legal and institutional framework for the financial oversight of public corporations, and tests of their economic and social viability;
- Set out the range of financial controls and approvals over public corporations that should be exercised by the government, and indicators for reporting and monitoring their financial performance and quasi-fiscal activities; and
- Recommend a checklist of key measures that a government should consider taking to effectively manage and oversee public corporations' finances, and the possible sequencing of these reforms.

Introduction

Many studies have highlighted how failures of public corporations¹ can result in huge economic and fiscal

This note was prepared by Richard Allen and Miguel Alves. The authors would like to thank Ould Abdallah, Virginia Alonso Albarán, David Amaglobeli, M. Astou Diouf, Israel Fainboim, Suzanne Flynn, Andrea Gamba, Gavin Gray, Alessandro Gullo, Richard Hughes, Yasemin Hürçan, Tom Josephs, Yugo Koshima, Ngouana Lonkeng, Paulo Lopes, Erik Lundback, Maria Mendez, Ken Miyajima, Mario Pessoa, Xavier Rame, Carolina Renteria, Christiane Roehler, Rani Selyodewanti, Niamh Sheridan, Jongsoo Shin, Alejandro Simone, S. Sriramachandran, Eivind Tandberg, Aminata Toure, Hui Tong, Karla Vasquez, and Philippe Wingender for their helpful comments and suggestions.

¹ This note focuses on the oversight of *nonfinancial* public corporations, as defined in the IMF's *Government Finance Statistics Manual*

costs. A recent survey by Bova and others (2016), for example, analyzes a series of episodes in which contingent liabilities materialized over the period 1990–2014. The study concluded that the maximum cost of those episodes involving public corporations was 15.1 percent of GDP, and the average cost was 3 percent of GDP. Public corporations were the second-largest category of fiscal risk after the financial sector (which includes many state-controlled companies). Moreover, the number of episodes involving public corporations and their average fiscal cost doubled between the 1990s and the 2000s.

In order to contain such risks, an effective regime for the financial supervision and oversight² of public corporations should be put in place. This is important for several reasons:

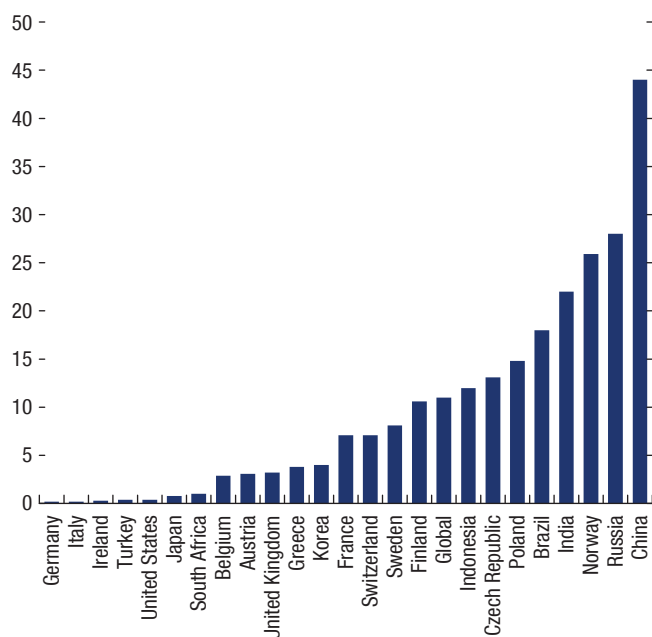
- First, despite the large-scale privatizations that began in the 1980s, companies owned by the government continue to account for a significant share of economic activity and, in many countries, the bulk of public sector assets and liabilities (Figures 1 and 2). Kowalski and others (2013) show that the market value of public corporations accounts for over 11 percent of the market capitalization of listed companies worldwide, and is even higher in many emerging markets (for example, Brazil, 18 percent; India, 22 percent; China, 44 percent). Another study shows that the share of public corporations among Fortune Global 500 companies has grown from 9 percent in 2005 to 23 percent in 2014, driven primarily by Chinese public corporations (PWC 2015). Even in regions such as sub-Saharan Africa, where the public corporation sector is smaller, substantial fiscal risks may arise, and issues relating to privatization and resource revenue management can be important.

² 2014. Due to the specificity of banking supervision and regulatory standards that apply both to private and state-owned banks, these two types of public corporation are not covered in this note. Nevertheless, many of the note's findings and recommendations also apply to financial institutions such as state-owned commercial banks and development banks, which can present significant fiscal risks for government. For this reason, their financial performance should be monitored by both the Ministry of Finance and the relevant financial regulator.

² Oversight of public corporations by government covers many issues other than finance—for example, the monitoring of public corporations' compliance with their legal mandate, management of personnel, security issues, and nonfinancial performance.

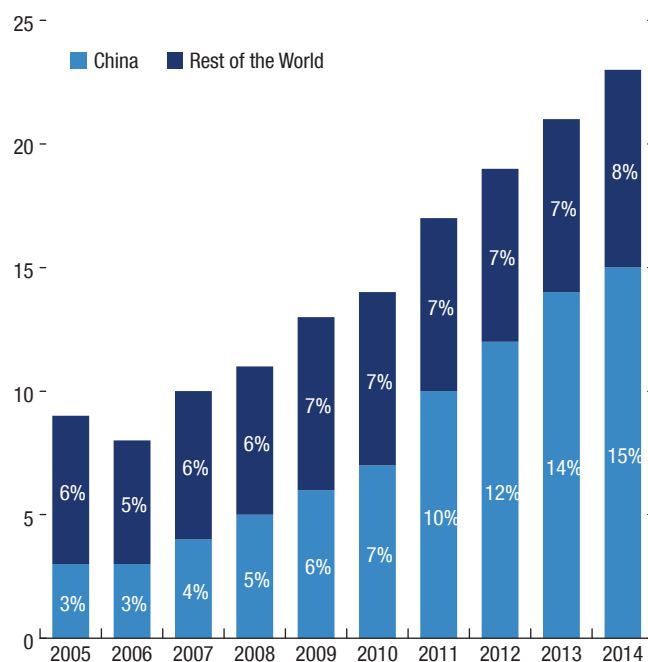
Figure 1. Market Capitalization of Listed State-Owned Enterprises

(Percent of gross national income)



Source: Kowalski and others (2013).

Figure 2. State-Owned Enterprises as a Percentage of Global 500



Source: PWC (2013).

- Second, inefficient or poorly managed public corporations can impose substantial economic and fiscal costs. The existence of public corporations is usually justified by an intention to address potential market failures—for example, the companies are considered natural monopolies, or they operate in markets that are protected from competition for strategic or social reasons. However, in the absence of strong performance incentives, public corporations also often produce at high costs, overcharge customers, and under-provide often essential services such as power, water, and telecommunications.
- Third, loss-making public corporations can be a persistent drag on public finances in the form of government guarantees, subsidies, loans, or capital injections. Public corporations that approach or enter bankruptcy often see their liabilities assumed by government, even where those liabilities are not explicitly guaranteed. A recent survey found that public corporations were perceived by IMF staff to be second only to the central government budget as a source of fiscal risk (IMF 2012). This impression is confirmed by Bova and others (2016) in the study noted above (see also IMF 2016).
- Fourth, many public corporations are pressured or mandated to fulfill political objectives and engage in quasi-fiscal activities that bear little relationship to their core commercial operations and for which the companies are not compensated from the budget, especially in less-developed countries. Such quasi-fiscal activities include, for example, public service obligations that are below cost-recovery, price regulations that imply cross-subsidies, ancillary operations outside the public corporation’s core mandate, or excessive employment levels.
- Finally, public corporations can be used as a mechanism for circumventing traditional fiscal controls, and as a conduit for financial corruption (Allen and Vani 2013). Governments have used public corporations to conduct fiscal operations off-budget or channel political favors and patronage to private individuals and enterprises. These activities undermine the integrity of countries’ public administration, their financial management systems, and the commercial incentives of the companies themselves.

It should be noted that the structure and economic character of public corporations have changed quite radically in the past three decades. Traditionally, many

public corporations were natural monopolies. However, as a result of technological changes, many natural monopolies have disappeared. For instance, such sectors as electricity distribution (due to the opening of the market to competition in many countries) and telecommunications (due to the growth of the Internet and the use of cellular phones, etc.) are no longer natural monopolies. Many of the largest public corporations now operate in the oil, gas, copper, and other mineral sectors, and some are only legal monopolies rather than natural ones.

In this note, we discuss the essential building blocks of an effective framework for the financial oversight of public corporations. These elements include a comprehensive set of definitions and classifications that conforms with international standards; a mechanism by which governments can review periodically the status of public corporations to ensure that they are commercially and economically viable; a policy framework that determines the ownership of public corporations, and their legal and institutional status; a robust system of financial controls and approvals; and arrangements for measuring and monitoring public corporations' financial performance and their quasi-fiscal activities. In addition, the note recommends measures that governments should take to enhance their capacity for overseeing the finances of public corporations—and how such reforms should be sequenced.

Definition and Classification of Public Corporations

Public corporations can take a diverse range of legal and organizational forms, and the terminology used by countries to define such entities can also cause confusion. Public corporations are known by many different names—state-owned enterprises, state-owned entities, state enterprises, parastatals, publicly owned corporations, government business enterprises, crown corporations, and nonprofit organizations (World Bank 2006, 2014; Allen and Vani 2013). In some cases, government entities may be legally incorporated as an enterprise but be largely or entirely engaged in non-commercial activity; in other cases, entities established as government agencies may be primarily or wholly engaged in commercial activity. In many countries, the legal and commercial distinction between public corporations and other public entities engaging in service delivery, regulatory, or quasi-commercial functions is

blurred.³ It is important to ensure that the definition and classification of public corporations and other public entities are clear, transparent, and, to the extent possible, in line with international standards.

Countries should identify and classify public corporations based on their economic nature. Specifically, the IMF's *Government Finance Statistics Manual 2014 (GFSM 2014)*⁴ defines corporations as “entities that are capable of generating a profit or other financial gain for their owners, are recognized by law as separate legal entities from their owners, and are set up for purposes of engaging in market production” (*GFSM 2014*, paragraph 2.31).⁵ A corporation is classified as a *public corporation* if it is controlled by the government (paragraph 2.107). Public corporations in turn can be classified as nonfinancial or financial corporations,⁶ depending on the nature of their primary activity (paragraphs 2.113–2.116). Public corporations may be under the control of either central or subnational governments. Control, which is interpreted broadly as the ability to determine the general corporate policy of the

³ A recent study of the United Kingdom, for example, found that in 2014, more than 3,000 government companies were registered—a number that has been increasing—but there is no unified and reliable source of information on these companies (National Audit Office 2015). In Egypt, public corporations comprise “economic authorities” and “public sector enterprises.” The distinction between these two categories lies with their legal status rather than their commercial nature. Economic authorities are controlled by the government, which approves their budgets and, ultimately, covers any losses, while public sector enterprises have more operational autonomy, are controlled by boards of directors, and are grouped under government holding companies. In Cyprus, a generic category termed “nongovernmental organizations” covers a wide range of entities, including regulatory and sponsorship bodies, non-profit-making educational and cultural entities, and financial and nonfinancial corporations, which may take the legal form of either statutory entities or state-owned enterprises.

⁴ Throughout this note, references to the *GFSM 2014* framework also apply to the *GFSM 2001* framework. Both versions of the *Manual* provide a broadly consistent treatment of public corporations' classification. The treatment of public corporations in the 1986 version of the *Manual* was more limited.

⁵ Different, and somewhat more stringent, definitions of public corporations have been proposed by the OECD's updated *Guidelines on Corporate Governance of State-Owned Enterprises* (OECD 2015) and international public sector accounting standards (IPSAS). For example, the definition contained in IPSAS 1 (Presentation of Financial Statements) requires a government business enterprise (equivalent to a public corporation) “to sell goods and services, in the normal course of business to other entities *at a profit or full cost recovery*” (our emphasis).

⁶ Examples of nonfinancial public corporations are national airlines, electricity companies, and railways. The category could also include nonprofit organizations engaged in market production, such as hospitals, schools, or colleges. Financial corporations are those engaged in providing financial services, such as banks, insurance companies, and pension fund services.

entity, may be assessed by analyzing eight indicators, as proposed in Box 2.2 of *GFSM 2014*.⁷

A government-controlled entity that is legally established as an enterprise may not be a public corporation, from an economic standpoint. Entities that are controlled by the government should be classified as public corporations only if they are *market producers*—namely, if they provide all or most of their output at prices that are economically significant. Although there is no precise numerical formula for determining whether prices are “economically significant,” the orientation of an entity toward market production can be assessed by the so-called market test. *GFSM 2014* proposes that a unit be classified as a market producer if the value of its sales (excluding both taxes and subsidies not directly linked to the volume or value of the output) averages at least half of the production costs (broadly defined as the sum of the compensation of employees, use of goods and services, consumption of fixed capital, and a return on capital), over a period of at least three years. In practice, however, difficulties of valuation may arise. In sectors such as utilities, nuclear energy production, or weapons production, for example, prices are often difficult to determine or are not strongly linked with production costs.⁸

Reviewing the Status of Public Corporations

Policy goals associated with the establishment of public corporations may be achieved in a more efficient way. For example, a tax and regulatory framework enshrined in law may be a more efficient and transparent way to ensure that the government receives its fair share of hydrocarbon revenues, while reducing legal uncertainty for investors. Similarly, providing targeted subsidies may be a more efficient means of making energy more affordable for consumers than

⁷ These eight indicators include, for example, ownership of the majority of the voting interest, control of the board or other governing body, and control of key committees of the public corporation, any of which would be sufficient to determine government control. However, in most cases, a decision on the source of control may require judgment and an assessment of a wider range of indicators. A similar framework, comprising five indicators to assess the commercial orientation and fiscal risks of public enterprises, was proposed earlier by the Fiscal Affairs Department of the IMF (see IMF 2005, 2007).

⁸ Governments sometimes undertake fiscal or quasi-fiscal activities (including the securitization of assets, borrowing, etc.) using special purpose vehicles (SPVs). The classification criteria described above also apply to SPVs, but the special nature of these activities, and the fact that some of them may be established in a different country, requires some elaboration. See *GFSM 2014*, paragraphs 2.136–2.138, for further guidance.

Table 1. Framework for Reviewing the Status of Public Enterprises

		Policy or Strategic Relevance	
		Low	High
Commercial Viability	Low	Close down	Convert into a noncommercial government entity
	High	Privatize	Retain as a public corporation, monitor closely operations and finances

setting up a public corporation. Legislation should require the government to carry out a full assessment of the costs and benefits of each alternative in order to inform policymakers whenever a proposal to establish a new public corporation is put forward.

In addition to undertaking a critical assessment of the economic case for establishing new public corporations, governments should review periodically the status and viability of existing public corporations. Table 1 sets out a stylized framework for undertaking such reviews. Governments should take into account both the economic performance of each entity (for example, whether it is actually or potentially profitable, and whether market conditions are favorable) and its relevance from a strategic or a national security point of view. Such a policy assessment, in turn, may depend on, among other things, the government’s political orientation regarding issues such as the role of the market and state ownership. Reviews of the status of public corporations should also take account of the social context. For example, if a public corporation is a candidate for corporatization or privatization, the impact on income distribution should be considered, given that privatization often results in large employment losses in the short term. Even when privatization is not a viable policy option, public corporations can still be exposed to market discipline through partial listing procedures.

Policy, Legal, and Institutional Frameworks for Public Corporations

An effective framework for the financial oversight of public corporations requires a clearly defined ownership policy backed by strong legal and institutional arrangements.⁹ In some countries, the laws and regulations governing business enterprises will provide much

⁹ A similar framework has been applied by the International Budget Partnership in several recent studies—see, for example, *The State*

of the required legal framework for public corporations. Such laws include those related to the structure and powers of the management board, requirements on financial reporting, and independent audit arrangements. However, for public corporations these laws need to be supplemented by a public sector-specific oversight framework that defines the respective goals, powers, and responsibilities of the corporation, the Ministry of Finance, and any line ministries involved. This framework's three main components are described below. The interactions with financial institutions (for example, the potential domino effect of the financial collapse of a public corporation) and ties with other countries (for example, through foreign shareholding) should be taken into account in the institutional and legal framework for public corporations.

Ownership Policy

The government should develop and publish a comprehensive ownership policy for its corporations. The ownership policy should provide a clear statement of the state's policy and financial objectives as shareholder in each company or group of companies, which may be a mix of financial, economic, and social objectives.¹⁰ It should also state how the government intends to exercise its ownership rights; the main functions carried out by the government as owner of public corporations; the objectives and mandate of each public corporation; the organization of the ownership function; the relationship between financial and nonfinancial oversight; and the main principles and policies to be followed, such as ensuring a level playing field between public corporations and the private sector. The ownership policy should refer to the constitution, laws, regulations, codes, and other documents that define the ownership rights of the state. On financial oversight, the policy should explicitly address the following elements: planning or budgeting requirements; reporting requirements; pricing and tariffs; dividend policy; financial assistance from the government,

of the Art of State-Owned Enterprises in Brazil, June 2014, and similar studies of Korea and South Africa.

¹⁰ In Sweden, for example, the government's overall objective is "to create value for the owners"; in Norway, the state requires SOEs "to take corporate responsibility and uphold our basic values in an exemplary manner"; in the United Kingdom, the objective is "to ensure that Government's shareholdings deliver sustained, positive returns...within the policy, regulatory and customer parameters set by the government, acting as an effective and intelligent shareholder." Examples quoted in OECD (2010).

including guarantees; and contractual commitments. The policy should also ensure that all these elements are included in the government's financial monitoring and reporting framework. More detailed guidance and examples of ownership policies can be found in OECD (2010).¹¹

Legal Framework

To establish clearly the respective roles of the government and its corporations in the area of financial management, many countries have found it helpful to prepare a framework law on public corporations. Such a law may be self-standing (for example, New Zealand, Philippines), or it may comprise a chapter of the public finance law (South Africa, Spain). The legal framework should include the following elements:

1. A clear definition of a public corporation. If there is a special legal form of incorporation only applied to public corporations, then the law should define the parameters of this legal form. If public corporations are incorporated according to commercial law, then the legal framework should refer to these laws and clarify whether they apply in their entirety or include some special provisions for public corporations;
2. A clear definition of the financial oversight function, whether this role would be carried out by the Ministry of Finance, a sector ministry in consultation with the Ministry of Finance, or possibly an independent agency (as in the Swedish model);
3. A statement of the powers of the government to receive, comment on, and approve the financial plans, financial targets, and annual financial statements of public corporations; set financial performance targets; and respond to requests by public corporations for compensation of public sector obligations, capital injections, borrowing, or government guarantees;
4. A statement of the public reporting requirements for all corporations, including a full annual financial statement¹² (containing a statement of operations, a cash flow statement, and a balance sheet) prepared in accordance with national or international accounting standards;

¹¹ The OECD Guidelines provide examples of how ownership policies are exercised in a range of countries, including Finland, France, Norway, Sweden, and the United Kingdom.

¹² Probably also full quarterly statements for large, listed companies, for example, in accordance with stock exchange requirements.

5. A requirement for the government to publish an annual report on whether public corporations are achieving their policy and financial objectives, and complying with their obligations to prepare regular and timely financial reports; and
6. A requirement for the annual accounts of the public corporation to be audited by a reputable, independent auditing body that is recognized internationally, and to publish the audit report.¹³

The role of the sector ministry and the public corporation's management board, in terms of exercising its responsibilities for planning and managing the entity's resources, also needs to be clearly defined in law (OECD 2015).¹⁴ The sector ministry should be responsible for policy issues related to that sector, but it should not be involved in the strategic planning of individual public corporations, especially if there exist private sector competitors that are regulated under the same policy framework. The governance framework should be based on the "arm's length" principle of managing public corporations, which distinguishes the functions of ownership and management. Management boards should be allowed to exercise their responsibilities without interference or pressure from their respective line ministry. Where such independence cannot be guaranteed, as is the case in many less-advanced economies, the Ministry of Finance may need to employ stronger oversight of the financial performance of public corporations.

Finally, the legal framework for public corporations should include sanctions to ensure that the provisions are enforceable and effective. In particular, sanctions may be necessary to meet financial or operational performance targets, in cases of financial distress or insolvency, or in serious cases of fraud and financial mismanagement. Such sanctions may assume various degrees of severity, ranging from additional reporting requirements (for example, monthly

rather than quarterly reports), imposition of additional controls (for example, over staff recruitment, pay, or major investment decisions); administrative measures (for example, steps to dismiss or suspend members of the management board); or, ultimately, imposition by the government of direct control over a public corporation's day-to-day operations. In some countries, sanctions may be applied to members of the public corporation's management board or individuals in government who have been charged with the oversight of public corporations.

Institutional Framework

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

- In some countries, shares in public corporations are held by an autonomous agency, or by a holding company or investment company. Examples include Austria (Österreichische Industrieholding AG), China (SASAC), Finland (Solidium Oy), France (APE), Kenya (Government Investment Corporation, GIC), Malaysia (Khazanah), Peru (FONAFE), Singapore (Temasek), and Spain (SEPI). The management board of the holding company may include representatives of the Ministry of Finance (for example, Austria, Finland, Malaysia, Singapore). The holding company model has the advantage of putting in charge professional asset managers with relevant private sector skills, who can actively manage the portfolio of public corporations. It also helps to insulate the portfolio of public corporations from political interference. Nevertheless, it requires some prerequisites to be in place, such as the harmonization of legal frameworks surrounding ownership and oversight of public corporations, and the adoption in law and publication of a comprehensive corporate governance framework.
- In other countries, Ministry of Finance staff often lack sufficient sector knowledge to exercise effective

¹³ Audit standards vary from country to country, and depend on the legal status of the public corporation. If the public corporation is subject to commercial law, audit requirements are likely to be prescribed. The right to decide on who should audit a public corporation may rest with the country's supreme audit institution, the Ministry of Finance, or the public corporation itself.

¹⁴ Public corporations may take a variety of legal forms. Some of these entities may not include a management board in their governance structure. In some countries, public corporations have been converted into corporations with modern board structures, with the aim of ensuring the independence of the public corporations' day-to-day management from the government's ownership functions.

Box 1. Central Oversight of Public Enterprises in South Africa

The Public Finance Management Act of 1999 and Treasury regulations require public enterprises to submit on an annual basis: (1) strategic plans, (2) financial plans, and (3) risk management plans.

The Department of Public Enterprises (DPE) enters into a Shareholder Compact (a form of Performance Agreement) with six of the largest commercial state enterprises, in which key performance indicators and other performance data are formalized. The DPE is responsible for approving significant transactions into which the enterprise enters. The Minister of the DPE is also responsible for nominating the board members of most public enterprises, who must then be approved by the Cabinet.

Source: Adapted from IMF (2016, Box A1.5).

Public enterprises are required to submit multiyear budgets to the DPE at least one month before the start of their financial year. The National Treasury imposes annual limits on the borrowing, guarantees, and other contingent liabilities of the enterprises.

The Fiscal Liability Committee in the National Treasury advises the Minister on short- and medium-term contingent liabilities and guarantees related to public enterprises.

Public enterprises are required to prepare annual financial statements in line with generally accepted accounting practices within five months of the end of each year. They are also required to submit quarterly financial reports to the DPE, or the supervising ministry when they are not subject to DPE oversight.

oversight of a public corporation.¹⁵ In such cases, line ministries often assume the policy/ownership role, subject to a framework established and supervised by the Ministry of Finance or some other central agency. Such a model is prevalent in countries with a large and diverse portfolio of public corporations, where full centralization of the ownership function may be difficult. Examples include Mexico, South Africa, and Thailand. These decentralized approaches call for close coordination between the Ministry of Finance and the ministry or agency that holds the shares.

Analyzing the financial performance of public corporations requires specialized and advanced skills that in many countries are vested in a dedicated oversight unit. In some advanced economies and middle-income countries, this unit is located in the Ministry of Finance, as for example in Chile, France, New Zealand, South Africa, and Sweden; or in the Prime Minister's Office, as in Finland; or in the Ministry of Planning, as in Brazil. In less-advanced economies, which frequently lack expertise in corporate finance

¹⁵ There are exceptions, however. In Honduras, for example, a Directorate of the Secretariat of Finance (the Ministry of Finance) provides financial oversight of public corporations. The Directorate produces quarterly reports on the financial performance and human resources of public corporations, using a range of indicators, and advises the government on policies for public corporations.

and other required skills, the case for centralizing resources in a single entity such as the Ministry of Finance is strong. The monitoring units require a mix of expertise in financial analysis, corporate governance, corporate finance, and law, and their staff may represent or support the representatives of the government on the boards of public corporations. Box 1 provides an example of how the central oversight mechanism works in South Africa.

Public corporation monitoring units frequently publish annual monitoring reports on the financial and operational performance of the public corporation sector and the fiscal risks they create.¹⁶ The tasks of the

¹⁶ For South Africa, see *Analysis of the Financial Performance of State-Owned Enterprises* (<http://www.gov.za/documents/analysis-financial-performance-state-owned-enterprises>); for Lithuania, *Annual Review of Lithuanian State-Owned Commercial Assets* (http://www.euroinvestor.dk/pdf/cse/11176061_17359.pdf); for Finland, *Annual Report of the State's Ownership Steering* (http://vnk.fi/documents/10616/1221497/2014_OO+vuosikertomus_eng.pdf/1f84341c-ddb7-4a04-9de6-3fb50013c606); for France, *French State as Shareholder* (http://www.economie.gouv.fr/files/files/directions_services/agence-participations-etat/Documents/Rapports-de-l-Etat-actionnaire/2013/Overview_2013.pdf); for Brazil, *Profile of State Companies (Perfil das Empresas Estatais)* (<http://www.planejamento.gov.br/assuntos/empresas-esatais/publicacoes/perfil-dasempresas-estatais>); for New Zealand, *Annual Portfolio Report* (<http://www.treasury.govt.nz/statesector/commercial/portfolio/reporting/annual/2013/apr-13.pdf>); and, for Sweden, *Annual Report: State-Owned Companies* (<http://www.government.se/contentassets/0126b664c843479d8696d1be546fe4b6/annual-report-state-owned-companies-2014>).

monitoring unit include analyzing the financial plans of public corporations, setting appropriate financial targets, monitoring performance against quarterly and annual financial reports, and assessing the cost and impact of public service obligations and other quasi-fiscal activities. The unit may also advise the government on the appointment of board members and on decisions of whether to provide the company with more capital or increase the annual dividend, in accordance with the government's ownership policy. Monitoring units need to work closely with the macroeconomic unit and the budget office of the Ministry of Finance to ensure that any transfers provided to public corporations made through the budget,¹⁷ together with government guarantees and the cost of public service obligations, are correctly estimated and disclosed in the budget, the medium-term fiscal strategy, or a fiscal risk statement.

Central Financial Control and Approvals

In exercising their ownership functions, governments need to strike a balance between maximizing the operational autonomy of public corporations and minimizing fiscal risks to government. Although financial control mechanisms vary from country to country, they typically include some or all of the following elements:

- *Financial and policy objectives:* Good financial management depends critically on a clear and operational statement of the government's financial and policy objectives related to each public corporation. The former may be expressed in terms of the public corporation's dividend, profit, return on equity, or other indicators discussed below. The latter may include the maintenance of universal access to infrastructure services, provision of certain strategic outputs, or provision of services at below market prices, all of which should be compensated through transfers from the government's budget;
- *Financial plans:* The ownership of the majority of the voting interest gives the government a veto power on all major decisions regarding corporate policy and financial plans.¹⁸ When assessing a public

corporation's financial plan, governments should ensure that, among other things, (1) financial targets, prices and tariffs, capital levels, and targets for dividends are appropriate; (2) the balance between commercial objectives and any public service obligations is adequate; (3) investment plans take government priorities and related activities into account; (4) financial and operational risks are actively managed; and (5) public corporations do not create subsidiaries as a means of transferring the control of public assets to private interests;

- *Borrowing:* The government—in some countries with the formal approval of the legislature—may establish ceilings on the borrowing of public corporations as a whole and/or individually to limit the contingent liability to government itself and the impact on the wider economy;
- *Guarantees:* Governments in some cases either prohibit entirely or strictly control the issuance of guarantees by public corporations to third parties, as this impairs the government's equity in the corporation and is typically more expensive than extending the guarantee directly from government;
- *Sale/pledging of assets:* Public corporations' nonfinancial assets, such as land or buildings, are often provided to them by the government free of charge (in some cases, the legal ownership of the assets remains with the government, rather than with the public corporation itself). For this reason, and to protect its equity in the corporation, the government may restrict the sale of these assets or their use as collateral in financial transactions. It may similarly restrict the pledging or securitization of future revenue streams;
- *Mergers/acquisitions:* Given the impact that mergers and acquisitions may have in terms of the public corporations' operations and finances, as well as the environment for competition, governments typically require their approval before a corporation can merge with or acquire another enterprise; and
- *Corporate governance:* public corporations should establish professional management and a strong corporate governance framework that can operate effectively without government interference, in line with international standards (OECD 2015). While the government, as owner, has a direct responsibility for selecting board members, the selection of chief executive officers and other key personnel should be performed by the board without government interference. Because of operational autonomy

¹⁷ Some governments (for example, Turkey in the 1990s) have issued bonds to cover the losses or quasi-fiscal activities of public corporations, without making transfers through the budget. Such practices are nontransparent and can be prevented by appropriate provisions in the public finance law.

¹⁸ In countries where the government owns "golden shares" or share purchase options in public corporations, these powers can also be exercised when the government is a minority shareholder.

considerations, the formal feedback (and reporting of potential risks) to the government should be undertaken by the management board, rather than by personnel of the public corporations concerned.¹⁹ In addition, all public corporations should establish an audit committee and a well-functioning internal audit regime.

Monitoring Public Corporations' Financial Performance

Financial Reporting and Auditing Standards

Monitoring the financial performance of public corporations is greatly facilitated if public corporations follow International Financial Reporting Standards (IFRS) for financial reporting and auditing. Compliance with IFRS²⁰ ensures a high-quality source of primary data on public corporations, including for the purposes of their financial oversight. By providing a true and fair view on the accounting for assets and liabilities, IFRS enhances the reliability of financial information, which is also more readily understood and comparable, both domestically and worldwide. Independent audit of public corporations' financial statements, conducted in line with the International Standards on Auditing, further enhances their reliability and is an important prerequisite of sound financial governance, especially for large public corporations. In less-advanced economies, the adoption of IFRS and contracting of international accounting firms can involve large costs that may exceed their financial resources. In such cases, a prudent policy may be to require only the largest public corporations—or those with a substantial exposure to fiscal risk—to comply with IFRS and international audit standards.

Compliance with IFRS also facilitates the consolidation of financial data on public corporations with

data on the general government sector in countries that follow IPSAS, *GFSM 2014*, or related standards. Under IFRS, the recording of government support to public corporations should reflect the economic nature of the transaction, rather than its instrumental or legal form. This is consistent with the treatment prescribed in IPSAS and *GFSM 2014*, thus allowing for an accurate elimination of intra-governmental transactions and stock holdings, for the purpose of consolidating financial statements. Particular attention should be paid to so-called financial transactions such as capital injections, loans, and debt assumptions. If these transactions create a true financial claim of the government on the public corporation, then they should be regarded as purchases of financial assets by the government and not count against its reported surplus/deficit. If not, they should be recorded as capital transfers with a positive impact on the net worth of the public corporation and a negative impact on the government's surplus/deficit and net worth. *GFSM 2014* (Figures A3.1 and A3.2) presents decision trees to help determine the economic nature of financial transactions, which are broadly consistent with IFRS/IPSAS.

Public Corporation Monitoring Reports

Monitoring reports on public corporations should summarize the overall financial performance of the sector as well as provide information on individual companies. Well-designed reports (note 16 has links to good examples from several countries, and Box 2 outlines an example from Sweden) usually encompass five main sections:

- *An overview of the sector and highlights of public corporation activities during the year*, including information on policy decisions or transactions that had a material impact on the financial position of the sector;
- *A full list of the companies owned by the government*, broken down by industry, size, and type of ownership (for example, majority- or minority-owned companies, strategic companies, or candidates for privatization);
- *An overview of how the government has exercised its ownership policy*, including the appointment of board members, dividend policy, organizational and governance arrangements, and the announcement of financial and public policy targets;²¹

¹⁹ Boards may need to be given guidance on issues such as (1) how management autonomy can be assured, (2) how management skills can be developed and sustained, (3) how board members should be selected and remunerated, and (4) how to avoid pressures to exempt certain public corporations from good governance principles in cases where vested interests are strong.

²⁰ Depending on the country, the corporate legal framework may require reporting rules other than IFRS. In some jurisdictions, only listed companies are required to comply with IFRS, while other corporations have to comply with national or regional standards (see PwC, "IFRS Adoption by Country," at <http://www.pwc.com/us/en/issues/ifrs-reporting/publications/ifrs-status-country.html> for more information). Recently, the IPSAS Board revised the applicability of IPSAS, making these standards applicable for enterprises other than commercial public sector entities.

²¹ In Brazil, the government prepared a guidance manual (Manual do Conselheiro de Administração) for members of the management

Box 2. Content of Sweden's 2014 Annual Report of State-Owned Companies

1. Financial overview
2. Events in brief
3. Ownership issues
 - a. Ownership model
 - b. Company cases
 - c. Nominations to company boards
 - d. Financial targets
 - e. Sustainability business models
 - f. Public policy targets
 - g. Remuneration and terms of employment
 - h. Company portfolio, including its valuation
 - i. Effect of company divestments and dividends in government finances
4. Individual company data
 - a. Description of company's mandate and operations
5. General information
 - a. State's ownership policy
 - b. Accounting principles and definitions
 - c. Legislation
 - d. Summary of changes in executive boards
 - e. Assessment of reporting practices
 - f. Guidelines for reporting
 - g. Guidelines for terms of employments for senior executives
 - h. Management responsibility for companies

Source: Department for Innovation and State-Owned Companies (2015).

- *Special topics*, including a more thorough explanation of issues related to the government's ownership policy: for example, changes in the policy framework for public corporations, remuneration policy, the valuation of companies, issues of organization and management, and the impact of public corporations on government finances and the economy more broadly; and
- *Information on individual companies*, comprising a summary of their operations, abridged financial statements, and indicators of financial performance for the current year and previous years. The report should also provide a list of board members, key personnel, and auditors, as well as information on the government's shareholding and financial targets, if applicable, together with data on key performance indicators. This information could draw on a central database of public corporations at the national and subnational levels.

boards appointed by the Ministry of Planning. This manual covers issues related to governance, coordination between the board and the government, the role and responsibilities of management and board members, conflicts of interest, and remuneration. See <http://www.planejamento.gov.br/assuntos/empresas-estatais/publicacoes/manual-do-conselheiro-de-administracao-dest-mp.pdf/view>.

Indicators of Public Corporations' Financial Health

Analysis of the financial performance of public corporations should include a range of indicators of the profitability, risks, and financial relations with the government. The choice of specific indicators depends on country circumstances, including the type of industry a public corporation is representing, the level of risk, and comparability with the private sector. However, financial surveillance by the government typically focuses on indicators of:

- *Financial performance* as measured by indicators such as the profit margin (earnings/revenue), the return on equity (earnings/equity), and the return on assets (earnings/assets);
- *Financial risk* as measured by indicators such as liquidity (current assets/current liabilities), leverage (assets/equity), solvency (liabilities/revenue), or the probability of default;²²

²² There is a broad range of indicators of firm default risk, such as Altman (1968) Z-Score measures, Ohlson (1980) O-Score measures, and Black-Scholes-Merton (1973) default probabilities, which take into account broader firm characteristics such as profitability and size. In the case of public corporations, for which an implicit bailout guarantee often exists, this probability of default can be used to measure the implicit risk.

Table 2. Australia: Financial Performance Indicators for Government Enterprises

Financial performance (indication of the commercial viability of the enterprise)	Financial risk (information on the risk of an enterprise not being able to meet its financial obligations)	Transactions with government (impact of the transactions with the government in the enterprise's finances)
Profit before tax = Revenue – Total expenses (excluding income tax)	Debt to equity = $\frac{\text{Debt}}{\text{Equity based on operating assets and liabilities}} \times 100$	Dividend to equity = $\frac{\text{Dividend paid or provided for}}{\text{Average equity based on operating assets and liabilities}} \times 100$
Operating profit margin = $\frac{\text{Earnings before interest and tax from operation}}{\text{Operating revenue}} \times 100$	Debt to operating assets = $\frac{\text{Debt}}{\text{Average operating assets}} \times 100$	Dividend payout ratio = $\frac{\text{Dividends paid or provided for}}{\text{Operating profit after tax}} \times 100$
Cost Recovery = $\frac{\text{Operating revenue}}{\text{Operating expenses}} \times 100$	Total liabilities to equity = $\frac{\text{Total liabilities}}{\text{Total equity}} \times 100$	Income tax expense = the value of income tax or income tax-equivalent expenses payable to government
Return on operating assets = $\frac{\text{Earnings before interest and tax}}{\text{Average operating assets}} \times 100$	Operating liabilities to equity = $\frac{\text{Operating liabilities}}{\text{Equity based on operating assets and liabilities}} \times 100$	Grants revenue ratio = $\frac{\text{Grants to cover deficits in operations}}{\text{Revenue}} \times 100$
Return on total equity = $\frac{\text{Operating profit after tax}}{\text{Average total equity}} \times 100$	Interest Coverage = $\frac{\text{Earnings before interest and tax}}{\text{Gross interest expense}}$	Public service obligations = the sum of payments by governments to public corporations for the specific noncommercial activities that they direct public corporations to undertake
Return on equity based on operating assets and liabilities = $\frac{\text{Operating profit after tax}}{\text{Average equity based on operating assets and liabilities}} \times 100$	Current ratio = $\frac{\text{Current operating assets}}{\text{Current operating liabilities}} \times 100$	
Operating cash flow to sales = $\frac{\text{Operating cash flow}}{\text{Operating revenue}} \times 100$	Leverage ratio = $\frac{\text{Total operating assets}}{\text{Equity based on operating assets and liabilities}} \times 100$	
	Short term debt coverage = $\frac{\text{Operating cash flow}}{\text{Current liabilities}} \times 100$	

Source: Australian Government, Productivity Commission, "Financial Performance of Government Trading Enterprises" (<http://www.pc.gov.au/research/completed/government-trading-enterprises>).

- *Transactions with the government*²³ in the form of dividends, taxes, grants, compensation for quasi-fiscal activities (see below), and other subsidies; changes in government equity holdings in the public corporation;²⁴ and guarantees given or called; and
- *Foreign linkages* as measured by indicators such as the relative weight of debt to foreign creditors, the currency composition of debt, or the hedging of currency risk.

²³ Ideally, comprehensive information on these transactions should be included in the government's annual financial statements and other fiscal reports.

²⁴ Government equity holdings are reflected in the government's balance sheet and may represent a substantial share of the assets and liabilities under its control. Explaining the changes in equity holdings requires a disclosure of transactions, valuation changes, or other economic flows related to those assets and liabilities.

Table 2 provides examples of the specific indicators monitored by the Australian government.²⁵

From a fiscal risk management perspective, the analysis of individual company information is as important as aggregated data for the public corporation sector.²⁶

²⁵ Another good example is Indonesia, where the ownership entity uses eight financial indicators to assess the financial health of nonfinancial public enterprises. These indicators include: the return on equity, the return on investment, the ratio of current assets to current liabilities, inventory turnover, total asset turnover, and the equity to total asset ratio. A weighted average of the indicators is also constructed in order to classify enterprises as "healthy," "less than healthy," and "not healthy."

²⁶ It would be good practice for a summary of fiscal risks from the public corporation sector (drawn from relevant monitoring reports) to be included in any wider fiscal risk statement produced by the country. Bachmair (2016) presents a framework for the quantification, management, and mitigation of risks stemming from government guarantees and on-lending, and demonstrates how it is applied in Colombia, Indonesia, Sweden, and Turkey.

Box 3. Fiscal Risks Related to Public Corporations: Segmentation and Mitigating Measures

The segmentation of public corporations according to risk can be done through a composite indicator¹ (for example, a linear combination of business ratios, weighted by coefficients) or a simple count of the number of indicators on which the enterprise exceeds an established (safe) threshold. The government can also stipulate that a public corporation be considered a high-risk entity if a particular indicator reaches a level that imposes an unacceptable fiscal risk. Enterprises with higher risk should be subject to a stricter oversight regime (more frequent reporting, stricter targets, tighter controls, etc.) and should be required to implement risk-mitigating measures.

Source: IMF (2016, Table 3).

¹ Efforts to build composite indicators of risk of individual enterprises have a long history. One early example is the Z-Score, which measures the probability that an enterprise will go bankrupt in the next two to three years. See Altman 2000, 2005.

In a recent paper (IMF 2016, Table 3), the IMF has proposed a number of measures and techniques to mitigate the risks arising from public corporations; they can be summarized as follows:

- Direct controls to limit fiscal exposure, for example, by reducing the size of the public corporation sector, or by imposing caps on the liabilities that public corporations can accumulate;
- Regulations and charges to reduce risky activities, for example, by holding public corporation boards to account for financial performance; and
- The transfer or sharing of risks, for example, by introducing explicit no-bailout clauses.

The government should consider provisioning for those risks that are not mitigated. This could take the form of expensing the costs of expected subsidies (for example, compensation for quasi-fiscal activities) in the budget, or setting aside financial assets to meet the costs of potential restructuring of public corporations.

Given that the profits of public corporations are not fungible, the likelihood of fiscal risks materializing from their activities (in the form of higher subsidies, increased borrowing costs, or outright bailouts) depends on individual companies' performance. In this sense, the government should assess the financial performance of each public corporation, segment them according to the level of risk, and apply appropriate levels of control and risk-mitigating measures to each segment (see Box 3). Taking account of their macro-criticality, larger public corporations should be subject to stricter oversight regimes, even if the level of risk they pose is low (the indicators most commonly used for measuring the size of public corporations include the level of sales, assets or liabilities, or income tax paid). Special challenges in monitoring performance and risk may arise where a public corporation has a complex corporate structure that involves a large number of subsidiaries and shell corporations, and where the information provided by the parent company is unreliable or nontransparent.

Quasi-Fiscal Activities

Quasi-fiscal activities are operations carried out by public corporations to further a public policy objec-

tive that worsens their financial position relative to a strictly commercial profit-maximizing level. Quasi-fiscal activities can take a variety of forms, the most common of which include:

- *Public service obligations*: charging less than commercial cost (cost-recovering) prices for the provision of goods and services to the general public or target groups (for example, setting artificially low prices for public utilities, such as energy and water, thus providing an implicit subsidy to consumers);
- *Noncore functions*: obligations imposed by the government for the public corporation to provide goods and services, or undertake capital investments, that are unrelated to their core functions;
- *Subsidized purchases*: paying above commercial prices to particular suppliers of goods and services or assets (for example, agricultural inventories purchased from domestic farmers);
- *"Super-dividends"*: withdrawal of own funds in excess of the distributable income of the accounting year, normally as a consequence of sales of assets or payments out of accumulated reserves; and
- *Pricing for short-term budget revenue purposes*: setting a higher price for goods and services so as to increase a public corporation's profits and divi-

Box 4. EU Regulatory Framework for Public Service Obligations in the Transportation Sector

Transportation services in the European Union (EU), typically engage in three different types of public service obligations:

- Obligations to operate a service (for example, a low-density branch line) or a particular service level (for example, services at night or on weekends/holidays);
- Obligations to transport customers at specified fare levels (a regulated fare structure below cost recovery or with restrictions on fare increases); and
- Obligations to offer concessional fares to specific groups, such as students, the elderly, disabled riders, military personnel, civil servants, etc.

Under EU legislation, government units must establish a public service contract with any passenger transport operator that has been granted an exclusive right of operation, or compensation for public service obligations, or both. These contracts mandatorily:

Sources: World Bank (2011); and European Union (2007).

- Define in a clear way the public service obligations with which the operator needs to comply, and the geographic areas concerned.
- Establish, in an objective and transparent manner, the basis on which compensation payments, if any, are to be calculated, and the nature and extent of any exclusive rights granted, in a way that prevents overcompensation and distortion of competition.
- Determine the arrangements for the allocation between the operator and the public authority of (1) costs connected with the provision of services, and (2) revenue from the sale of tickets.

For contracts awarded without competitive tendering, the legislation further stipulates that the compensation should not exceed the net financial cost of contractual obligations. To increase transparency and avoid cross-subsidies, the legislation also requires that accounts of public services be separated from accounts of other (noncompensated) activities.

tends in the short term, even if this risks reducing the company's market share and its profits in the medium term.

The cost of delivering public service obligations and subsidized purchases should be fully funded through the budget, and it should be disclosed separately in the financial statements of both the government and the public corporation. This disclosure of information should describe the type of activity; the rationale for performing it through the public corporation, rather than directly through the state budget; the opportunity cost of the activity; and the mechanism designed to compensate the public corporation for the negative impact on its financial position, if applicable. Such an approach is transparent and holds the government accountable for the performance of its companies and the delivery of public services. It also prevents the government from using public corporations to hide activities that are essentially fiscal, by requiring their full costs to be recognized in the budget and the government's financial statements. In addition, disclosure allows for comparisons with the financial performance and

efficiency of private corporations that are competing in the same markets as public corporations. Box 4 presents examples of how public service obligations in the transport sector are disclosed and managed in the European Union.

There are several methods of estimating the costs of quasi-fiscal activities, depending on their nature.²⁷ For targeted reduced-tariff regimes or above-market-price payments to suppliers, the cost of the quasi-fiscal activity can be estimated as the difference between sales of output at observable market prices and the prices specified by the government for the specific target groups. Other types of public service obligation, such as obligations to operate low-density transportation services (for example, little-used bus or rail routes, or night/weekend/holiday services) or generalized low-tariff regimes, where market prices are not directly observable, can be estimated through indirect methods, for example, using the actual cost of providing the

²⁷ The literature refers to different methods for such estimations (see, for example, OECD 2010, Box 1.10). While there is no preferred method, the government should develop an approach that removes inconsistencies in measuring the financial performance of public corporations.

Box 5. Illustrative Examples of Quasi-Fiscal Activity Cost Estimation

Example A: Reduced rail tariff for students

The government requests that the Public Railway Corporation transport college students from the Central Station to the University Station at a quarter of the regular fare (\$1 per trip). In 2015, the Railway Corporation sold 23,000 student fare tickets.

Cost of 2015 quasi-fiscal activity = \$17,250 = 23,000 × \$0.75 (assumes a price elasticity equal to zero)

Example B: Subsidized bus route to a rural community

The government requests that the Public Bus Corporation maintain in operation a loss-making route between the capital city and a rural community, without raising fares charged to passengers. The government allowed the corporation to borrow in order to cover the underlying deficit, and it has agreed to pay compensation sufficient for the corporation to achieve a financial surplus on this route comparable to the surplus obtained on other routes it operates. Details of the operations of the loss-making route in 2015 were as follows: operating costs, \$56 million; interest paid, \$4 million; ticket sales, \$20 million. The average

surplus obtained on other routes was 10 percent of ticket sales.

Estimated economic cost of 2015 quasi-fiscal activity (millions) = \$40 = \$56 + \$4 – \$20

Compensation paid in 2015 (millions) = \$46 = (\$56 + \$4) × 1.1 – \$20

Example C: Super-dividend from national energy company

The Board of the National Energy Company (totally owned by government) determined the distribution of \$100 million in dividends, in relation to the operations of 2015. The \$100 million resulted from a distributable income of \$60 million, a sale of land of \$30 million, and a draw down on accumulated reserves of \$10 million.

Cost of 2015 quasi-fiscal activity (millions): \$40 = \$30 + \$10

The government accounts should record this amount as a financial transaction (exchange of equity for cash), rather than as revenue.

additional noncommercial services. “Super-dividends” can be measured by the amount in excess of distributable income²⁸ that has been paid by the public corporation as a dividend to government. Box 5 provides illustrative examples of the estimation of quasi-fiscal activity costs.

Building Capacity for Overseeing Public Corporations

Putting in place a system for overseeing public corporations that meets all the requirements discussed above can be challenging for developing or emerging market economies, and takes time and resources. Advanced economies have spent many years building and refining these systems. In less-advanced economies,

a cautious step-by-step approach is required. In many countries, however, inefficiencies and fiscal risks are concentrated in a relatively small number of public corporations, which should be subject to the most intensive monitoring. Moreover, many of the “best practice” solutions discussed above have a substantial cost and require a high degree of competence within the government and the public corporations. Some of these reforms may not be practicable in the short term in low-capacity countries. In such cases, a risk-based and sequenced approach to building an oversight regime for public corporations is strongly recommended. Table 3 provides a checklist of the main elements of such a system and a possible prioritization of the underlying reforms:

- In the *short term* (up to one year), the government could ensure that a full inventory of public sector entities with commercial or quasi-commercial functions is taken and that these entities are classified according to the latest international standards

²⁸ Equivalent to the net result of current activity (“continuing” under IFRS), before distribution and income tax, excluding any exceptional transactions generating holding gains or losses.

Table 3. Implementation of an Oversight Regime for Public Corporations

System Elements	Suggested Prioritization		
	Short Term	Medium Term	Long Term
1. Definition/classification/status of public corporations			
1.1 Inventory of public corporations	•		
1.2 Classification of public corporations in line with <i>GFSM 2001/2014</i>	•		
1.3 Periodic review of classification and optimal status of public corporations		•	
2. Broad ownership policy, comprising:			
2.1 Government's objectives as owner of public corporations		•	
2.2 Organization of ownership function		•	
2.3 Mandate of entities exercising ownership role		•	
2.4 Main principles and policies to be followed		•	
2.5 Information disclosure requirements		•	
2.6 Dividend policy		•	
2.7 Modalities for financial assistance from the state		•	
2.8 Policy on quasi-fiscal activities			•
3. Disclosure of mandate for each public corporation		•	
4. Legal framework for public corporations		•	
5. Public corporation oversight unit in Ministry of Finance, with the following functions:			
5.1 Advice on financial support to public corporations	•		
5.2 Analysis of financial health of public corporations	•		
5.3 Estimation of fiscal and budgetary impact of public corporations	•		
5.4 Advice on appointment of board members		•	
5.5 Advice on annual dividends		•	
5.6 Central financial controls and approvals		•	
5.7 Monitoring of financial reports and performance indicators		•	
5.8 Drafting of annual public corporation monitoring reports		•	
5.9 Estimation of costs of current and future quasi-fiscal activities			•
6. Central financial control and approvals, comprising:			
6.1 Review and approval of financial plans	•		
6.2 Approval of new borrowing and of concession of guarantees	•		
6.3 Approval of sales or pledging of assets	•		
6.4 Approval of mergers or acquisitions		•	
6.5 Review staffing and remuneration policies			•
7. Publication of annual Public Corporation Monitoring Report, comprising:			
7.1 An overview of the sector and highlights of activities	•		
7.2 A full list of companies owned by government	•		
7.3 Information on individual public corporations' financial performance, public service obligations, fiscal risks, etc.		•	
7.4 An overview of how the government exercised its ownership policy			•
7.5 Financial impact of transactions between public corporations and government			•

(*GFSM 2001/2014*); that a basic reporting framework for public corporations that are high risk or have a large fiscal or budgetary impact is established; and that the role and responsibilities of the President's Office, the Ministry of Finance, and line

ministries participating in the oversight of public corporations are determined.

- In the *medium term* (up to three years), the legal framework relating to public corporations could be established (or revised), providing the Ministry

of Finance (or another approved entity) with the required powers to review the financial plans of public corporations and monitor their performance; a public corporation ownership policy should be developed; the Ministry of Finance should strengthen its capacity to supervise public corporations; and the financial oversight unit could start to publish a consolidated annual report on public corporations.

- In the *long term* (more than three years), the government could further enhance the framework for monitoring the financial performance of public corporations, by developing a more elaborate set of performance indicators and targets; the cost of delivering public service obligations and other quasi-fiscal activities should be fully funded in the budget and disclosed in financial reports prepared by the government and the public corporations; and the government could carry out a review of the economic and financial status of business enterprises and whether they should continue to be classified as public corporations.

Successful oversight regimes are likely to require the building of strong support among the various stakeholders and the public. Given the many failures of public corporations over the past years, it is important for governments to prepare an effective communication strategy that clearly outlines the objectives of oversight and its potential outcomes, and to develop a change management plan that effectively eliminates or reduces the opposition to reform from individuals or groups.

References

Works Cited

- Allen, R., and S. Vani. 2013. "Financial Management and Oversight of State-owned Enterprises." In *The International Handbook of Public Financial Management*, edited by R. Allen, R. Hemming, and B. H. Potter, Chapter 32. New York: Palgrave Macmillan.
- Altman, E. 1968. "Financial Ratios, Discriminant Analysis and the Prediction of Corporate Bankruptcy." *The Journal of Finance* 23(4): 589–609.
- Altman, R. 2000. "Predicting Financial Distress of Companies: Revisiting the Z-Score and Zeta Models." Working Paper, Department of Finance, New York University. Also available in *Handbook of Research Methods and Applications in Empirical Finance*, edited by A. Bell, C. Brooks, and M. Prokopczuk, Chapter 17, pp. 428–56 (Northampton, MA: Edward Elgar, 2013).
- . 2005. "An Emerging Market Credit Scoring System for Corporate Bonds." *Emerging Markets Review* 6: 311–23.
- Bachmair, F. 2016. "Contingent Liabilities Risk Management: A Credit Risk Analysis Framework for Sovereign Guarantees and On-Lending." World Bank Policy Research Working Paper WPS7538, World Bank, Washington.
- Black, F., and M. Scholes. 1973. "The Pricing of Options and Corporate Liabilities." *Journal of Political Economy* 7: 637–54.
- Bova, E., M. Ruiz-Arranz, F. Toscana, and H. Elif Türe. 2016. "The Fiscal Costs of Contingent Liabilities: A New Dataset." IMF Working Paper 16/14, International Monetary Fund, Washington.
- European Union. 2007. Regulation (EC) No. 1370/2007 of the European Parliament and of the Council on Public Passenger Transport Services by Rail and by Road and Repealing Council Regulations (EEC) Nos. 1191/69 and 1107/70. Luxembourg: Publications Office of the European Union.
- International Monetary Fund. 2005. "Public Investment and Fiscal Policy—Lessons from Pilot Case Studies." FAD Board Paper SM/05/118, Washington.
- . 2007. "Public Enterprises and Fiscal Risk—Lessons from the Pilot II Country Studies." FAD Board Paper SM/07/368, Washington.
- . 2012. *Fiscal Transparency, Accountability and Risk*. Washington.
- . 2014. *Government Finance Statistics Manual, 2014*. Washington.
- . 2016. "Analyzing and Managing Fiscal Risks: Best Practices." IMF Policy Paper, Washington.
- Kowalski, P., M. Büge, M. Sztajerowska, and M. Egeland. 2013. "State-Owned Enterprises: Trade Effects and Policy Implications." OECD Trade Policy Paper 147, Organisation for Economic Co-operation and Development, Paris.
- Merton, R. 1973. "On the Pricing of Corporate Debt: The Risk Structure of Interest Rates." *Journal of Finance* 29: 449–70.
- National Audit Office. 2015. *Companies in Government*. London: NAO Communications.
- Ohlson, J. 1980. "Financial Ratios and the Probabilistic Prediction of Bankruptcy." *Journal of Accounting Research* 18: 109–31.
- Organisation for Economic Co-operation and Development (OECD). 2010. *Accountability and Transparency: A Guide for State Ownership*. Paris.
- . 2015. *Guidelines on Corporate Governance of State-Owned Enterprises*. Paris.
- PWC. 2015. *State-Owned Enterprises: Catalysts for Public Value Creation?* Arlington, VA: Public Sector Research Centre.
- Sweden, Department for Innovation and State-Owned Companies. 2015. *Annual Report State-Owned Companies 2014*. Stockholm: Ministry of Enterprise and Innovation.
- World Bank. 2006. *Held by the Invisible Hand: The Challenge of SOE Corporate Governance for Emerging Markets*. Washington.
- . 2011. *Railway Reform: Toolkit for Improving Rail Sector Performance*. Washington.
- . 2014. *Corporate Governance of State-Owned Enterprises: A Toolkit*. Washington.

Additional Reading

- Cebotari, A., J. Davis, L. Lusinyan, A. Mati, P. Mauro, M. Petrie, and R. Velloso. 2009. *Fiscal Risks: Sources, Disclosure, and Management*. Washington: International Monetary Fund.
- Crown Ownership Monitoring Unit. 2013. *Annual Portfolio Report*. Wellington: New Zealand Treasury.
- Department for Business, Innovation and Skills. 2014. *Shareholder Executive Annual Review 2013–14*. London: HM Government.
- Government Shareholding Agency (APE). 2014. *The French State as Shareholder—2013 Report*. Paris: Ministry for the Economy and Finance and Ministry for Economic Regeneration.
- inno-V, KCW, RebelGroup, TØI, SDG, and TIS.PT. 2008. *Contracting in Urban Public Transport*. Amsterdam: inno-V.
- Organisation for Economic Co-operation and Development (OECD). 2014. *Financing State-Owned Enterprises: An Overview of National Practices*. Paris.
- Ownership Steering Department. 2015. *2014 Annual Report of the Ownership Steering Department*. Helsinki: Prime Minister's Office.

ISBN: 978-1-47555-198-3



9 781475 551983