

# Corporate Governance of State-Owned Enterprises

IN SOUTH ASIA

*A Regional Stocktaking*

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December 2017

# South Asia

## *Regional Stocktaking of the Corporate Governance of State-Owned Enterprises*



## Foreword

In many countries around the world, state-owned enterprises (SOEs) remain an important presence and account for approximately one-fifth of the world's total stock market capitalization. South Asia, currently one of the fastest-growing regions in the world, is no exception. SOEs remain a strong pillar of the economy in the region across large and small economies—even after successive waves of privatization starting in the 1980s. As SOEs often play a vital role in delivering basic services such as water and energy, their performance is critical for citizens and the broader development agenda. SOEs also operate in strategic sectors that are associated with national security and the development of public infrastructure. Beyond their significance in the economy, SOEs can also be critical for a country's fiscal space, competitiveness, and governance.

Countries' SOE portfolios may generate important fiscal implications. Established with a mandate to provide public goods and services, SOEs are not always able to recover their operational costs from beneficiaries. As a result, governments may be required to subsidize the provision of certain public goods and services through financial support to SOEs. In South Asia, as in other regions of the world, government financial support to SOEs has often risen to a substantial share of public expenditure, thereby limiting fiscal space. SOEs may also generate contingent liabilities, which can pose fiscal risks for government budgets, dampen national and international competitiveness, and affect the “level playing field” between public and private firms.

Recognizing the continued importance of SOEs while also considering the challenges of limited fiscal space and competitiveness, many countries have undertaken significant SOE reforms over the past two decades. Rather than focusing narrowly on privatization, many governments have concentrated their reform efforts on strengthening SOE corporate governance to

improve SOE performance. Meanwhile, compared to other policy areas and budget entities, there is relatively limited information—and even less regional exchange—on existing SOE corporate governance practices in South Asia. Countries in the region have therefore taken the initiative to fill this knowledge gap through this Regional Stocktaking on SOE Corporate Governance, conducted in partnership with the World Bank. The present report is the culmination of this regional cooperation. Prepared with contributions from SOE ownership entities, the stocktaking summarizes current practices in each of the eight South Asian countries regarding the legal framework for SOEs, ownership arrangements, performance monitoring, boards of directors, and transparency and disclosure, drawing out regional commonalities and distinct features. At the request of South Asian governments, this experience is complemented by a review of interesting lessons from selected countries in East Asia, opening additional perspectives on the potential that SOE corporate governance reforms may have for performance and economic growth.

The study lays no claim to recommending best practices. Given the diverse structure, levels of development, and institutional legacies of Asian economies, no single approach or model can be expected to work for all countries. It is our hope, however, that the study will inspire South Asian and other countries to develop their own strategies for a longer term approach to the state's ownership and oversight function, thus maximizing the benefits to citizens while effectively managing the risks of their SOE portfolios.

## Main Abbreviations and Acronyms

AC	Audit Committee
ACA	Annual Compact Agreement (BH)
ADB	Asian Development Bank
AGO	Auditor General's Office
AFN	Afghanistan Afghani (currency)
AGM	Annual General Meeting
ALIO	All Public Information in One (KO)
APA	Annual Performance Agreement (BA)
BAS	Bangladesh Accounting Standards
BDT	Bangladesh Taka
BTN	Bhutan Ngultrum
CAG	Comptroller and Auditor General
CCD	Corporation Coordination Division (NE)
CCG	Code of Corporate Governance
CEO	Chief Executive Officer
CIC	China Investment Corporation
CGC	Corporate Governance Code
CMDA	Capital Market Development Authority (MV)
CNY	Chinese Yuan
COPE	Committee on Public Enterprises (SL)
CPSE	Central Public Sector Enterprise (IN)
DCC	DHI-Controlled Company (BH)
DFI	Development Finance Institution (PK)
DGPC	Druk Green Power Corporation (BH)
DHI	Druk Holding and Investments (BH)
DISCO	Distribution Company (PK)
DLC	DHI-Linked Company (BH)
DOC	DHI-Owned Company (BH)
DPE	Department of Public Enterprises (IN)
FA	Federal Authority
GAAP	Generally Accepted Accounting Principles

GDP	Gross Domestic Product
GLC	Government-Linked Company (MY, SI)
GLIC	Government-Linked Investment Company (MY)
HPC	High Power Committee on MoUs (IN)
ICGD	Investment and Corporate Governance Division (BH)
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
INR	Indian Rupee
INTOSAI	International Organization of Supreme Audit Institutions
IPSAS	International Public Sector Accounting Standards
KEPCO	Korea Electric Power Corporation
KPI	Key Performance Indicator
KRW	Korean Won
LKR	Sri Lankan Rupee
MAA	Memorandum and Articles of Association (NE)
MIFCO	Maldives Industrial Fisheries Company
MINDA	Malaysian Directors Academy
MOF	Ministry of Finance
MOFT	Ministry of Finance and Treasury (MV)
MOSF	Ministry of Strategy and Finance (KO)
MoU	Memorandum of Understanding
MTCC	Maldives Transport and Contracting Company
MTDC	Maldives Tourism Development Company (MV)
MVR	Maldives Rufiyaa
MYR	Malaysian Ringgit
NC	Nomination Committee
NEPRA	National Electric Power Regulatory Authority (PK)
NPR	Nepalese Rupee
OAG	Office of the Auditor General
OECD	Organisation for Economic Co-operation and Development
PBVA	Performance-Based Variable Allowance
PCB	Privatization and Corporatization Board (MV)
PCG Committee	Putrajaya Committee on GLC High Performance (MY)
PE	Public Enterprise
PED	Public Enterprises Department (SL)
PEMEB	Public Enterprises Monitoring and Evaluation Board (MV)
PESB	Public Enterprises Selection Board (IN)
PI	Public Institution
PKR	Pakistani Rupee
PRP	Performance-Related Pay
PSC	Public Sector Company
RA	Results Agreement
RC	Remuneration Committee
RCSOE	Research Center for State-Owned Entities

RGOB	Royal Government of Bhutan
SASAC	State-Owned Assets Supervision and Administration Commission (CN)
SBP	State Bank of Pakistan
SCI	Statement of Corporate Intent (SL)
SEBI	Securities and Exchange Board of India
SEC	Securities and Exchange Commission
SECP	Securities and Exchange Commission of Pakistan
SGD	Singapore Dollar
SLPSAS	Sri Lankan Public Sector Accounting Standards
SOBE	State-Owned Business Enterprise (SL)
SOC	State-Owned Corporation (AF)
SOCB	State-Owned Commercial Bank (AF, BA)
SOE	State-Owned Enterprise
SOEC	State-Owned Enterprises and Corporation (AF)
SONCE	State-Owned Noncommercial Enterprise (SL)
SSA	Singapore Standards on Auditing
STELCO	State Electric Company Limited (MV)
STO	State Trading Organization (MV)
TSR	Total Shareholder Return
UNIDO	United Nations Industrial Development Organization
UNPAN	United Nations Public Administration Network
USD	United States Dollar
WBG	World Bank Group

*Note:* AF = Afghanistan; BA = Bangladesh; BH = Bhutan; CN = China; IN = India; KO = Republic of Korea (South Korea); MV = The Maldives; MY = Malaysia; NE = Nepal; PK = Pakistan; SI = Singapore; SL = Sri Lanka.





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## Acknowledgments

This regional stocktaking was prepared by a World Bank team in partnership with government counterparts from all eight South Asian countries, as well as the Korea Institute of Public Finance (KIPF) and the Republic of Korea's Ministry of Strategy and Finance (MOSF) which funded the publication.

### **World Bank**

The World Bank team was led by Alexandre Arrobbio, with Immanuel Steinhilper and Saw Young (Sandy) Min. The core team was comprised of Federico Guala, Bernard Haven, Kyoungsun Heo, Clelia Rontoyanni, Charlotte Suc, and Na Zhu.

The extended team includes colleagues who served as country focal points and contributed during different phases of the preparation: Atiqullah Ahmadzai, Syed Khaled Ahsan, Sheikh Tanjeb Islam, Veronique Kabongo, Fabian Seiderer, Timila Shrestha, and Ralph Van Doorn. Also directly contributing to individual chapters were: Aaron Badway, Hejin Cao, Xiang Chen, Shreya Dutt, Hua Li, Ritvik Mishra, Izzah Akram Malik, Ji-Seon Park, Hejin Wang, and Xinze Yao.

The team thanks World Bank senior management for strategic guidance and support: Junaid Ahmad (Country Director, India), James Brumby (Director, Governance), Shubham Chaudhuri (Country Director, Afghanistan), Qimiao Fan (Country Director, Bangladesh, Bhutan, and Nepal), Bert Hofman (Country Director, China, Republic of Korea, and Mongolia), Patchamuthu Illangovan (Country Director, Pakistan), Idah Pswarayi-Riddihough (Country Director, Sri Lanka and the the Maldives), Martin Rama (Chief Economist, South Asia Region), Jyoti Shukla (Director,



Singapore), and Ulrich Zachau (Country Director, Malaysia). The team is also grateful for the support of the country managers, practice managers, program leaders, and colleagues from the regional vice presidency unit and country management units: Gabi Afram, Rajni Bajpai, Ismaila Ceesay, Christian Eigen Zucchi, Alex Ferguson, Adrian Fozzard, Faris Hadad-Zervos, Arturo Herrera Gutierrez, Fatouma Toure Ibrahima Wane, Yoichiro Ishihara, Guillemette Sidonie Jaffrin, Takuya Kamata, George Larbi, Yasuhiko Matsuda, Shabih Ali Mohib, Joyce Msuya, Emanuel Salinas Munoz, Tatiana Nenova, Bigyan B. Pradhan, Amena Raja, Fily Sissoko, Hoon Sahib Soh, Robert Taliercio, and Charles Undeland.

The team thanks the peer reviewers Henri Fortin, Sudarshan Gooptu, Kjetil Hansen, Dr. Hanjoon Park, and Marijn Verhoeven for their helpful comments, as well as the many World Bank Group colleagues who provided valuable inputs and supported the program and publication: A.K.M. Abdullah, Luiz Almeida, Priyantha Jayasuriya Arachchi, Roshan Darshan Bajracharya, Jin Gyu Choi, Savita Dhingra, Yousif Mubarak Elmahdi, Shenghui Feng, Amanda Green, Qurat ul Ain Hadi, Towfiqua Hoque, Zahid Hussain, Patricia Katayama, Markus Kitzmuller, Anoma Kulathunga, Tenzin Lhaden, Gladys Lopez-Acevedo, Xavier Cledan Mandri-Perrott, Vikram Menon, Mohan Nagarajan, Claudia Nassif, Korotoumou Ouattara, Manuella Lea Palmioli, Amani Rahman, Richard Record, Saadia Refaat, Furqan Ahmad Saleem, Lynn Yeargin, Namoos Zaheer, Sanan Isaba Zaman, and Suraiya Zannath.

## **Government Partners**

This regional stocktaking would not have been possible without close cooperation with government counterparts. The World Bank team would like to express its gratitude to the following partners and their staff for their leadership and time during the preparation of the report:

*Afghanistan:* Ibrahim Shams (SOE's General Directorate, Ministry of Finance, Afghanistan) and Moheb Jabarkhail (Focal Point, World Bank Portfolio, Aid Management Directorate, Ministry of Finance).

*Bangladesh:* Arfin Ara Begum (Director General, SOE Monitoring Cell and Additional Secretary, Finance Division, Ministry of Finance), Parag (Additional Secretary, Ministry of Industry), Safique Ahmed Shibly (Additional Director General, SOE Monitoring Cell and Joint Secretary, Finance Division, Ministry of Finance) and his staff.

*Bhutan:* Norbu Dendup (Deputy Chief Program Officer, Public Enterprise Division, Ministry of Finance) and Damber Singh Kharka (Director, Druk Holding and Investments).

*India:* Dr. Madhukar Gupta (Additional Secretary, Department of Public Enterprises, Ministry of Heavy Industries, Government of India) and his staff.

*The Maldives:* Mohamed Nizar (President, Privatization and Corporation Board) and Ahmed Siraj (Secretary General, Privatization and Corporatization Board, Ministry of Finance and Treasury) and their staff.

*Nepal:* Mohan Singh Basnet (Under Secretary, Ministry of Finance).

*Pakistan:* Fozia Abid (Deputy Secretary, Economic Reform Unit, Ministry of Finance).

*Sri Lanka:* J.M.U.P. Jayamaha (Additional Director General, Ministry of Finance), Dr. Roshan Perera (Additional Director, Central Bank of Sri Lanka, Ministry of Public Enterprise Development), and A. Lakkathas (Additional Secretary Ministry of Public Enterprise Development).

*Republic of Korea:* Kyoungsun Heo (Research Fellow), Hanjun Park (Head of SOE Policy Research Team), Sejeong Ha (Head of SOE Management Research Team), and Kyeongseok Min (Research Analyst) from the Korea Institute of Public Finance.



# Overview

**In South Asia, as in other regions of the world, state-owned enterprises (SOEs) remain important economic players despite a strong wave of privatizations in the 1990s and 2000s.** SOEs in South Asia have historically played a significant role in driving economic growth and delivering basic services by operating in strategic sectors such as electric utilities, oil and gas, financial services, and transportation. They have contributed significantly to gross domestic product (GDP), and SOE employment represents a significant share of public employment. At the same time, development challenges and increased global competition have prompted governments to take steps to improve SOE performance and efficiency. International experience over the past two decades has given rise to a growing consensus that reforms to strengthen government ownership and oversight policies, together with the regulatory framework for corporate governance of SOEs, are necessary for improving SOE performance.

**In this context, South Asian governments requested a systematic compilation of existing practices through a “Regional Stocktaking on Corporate Governance of SOEs.”** Comprehensive and systematic information on the SOE sector and corporate governance arrangements in South Asia is not readily available at this time. This data gap exists despite a

multitude of important practices and experiences in the region that could be of interest to policy makers. Government counterparts in South Asian countries therefore requested the World Bank to prepare a Regional Stocktaking on SOE Corporate Governance to contribute to exchanging knowledge, facilitating cross-country cooperation, and promoting dissemination of good practices among SOE stakeholders.

**This stocktaking is the first attempt to collect—in a structured, systematic, and collaborative manner—fundamental data on SOEs in South Asia.** Prepared in partnership with representatives of SOE ownership institutions in South Asian countries, the stocktaking seeks to create a single source of robust knowledge on SOE corporate governance in South Asia. It is based on publicly available information and data collected during several regional workshops and country missions. The stocktaking thus lays the foundation for strategic and evidence-based analysis on corporate governance of SOEs, seeking to contribute to a better understanding of actual practices and the potential impact of SOEs on growth and development in a dynamic and rapidly growing region. It has also fostered stronger links among SOE ownership institutions in South Asia, which could pave the way for future research and knowledge exchanges within and beyond the region.

**The stocktaking is based on *the World Bank Toolkit on Corporate Governance of SOEs and the Organisation for Economic Co-operation and Development (OECD) Guidelines*.**<sup>1</sup> Following this overall framework, the study covers the following dimensions of SOE corporate governance: legal and regulatory framework; ownership arrangements; SOE performance monitoring; boards of directors; and transparency and disclosure.<sup>2</sup> The stocktaking also provides a panorama describing the economic and social significance of the SOE portfolio in each country. Consistent with the Toolkit and the OECD Guidelines, the stocktaking analysis focuses on SOEs owned by central governments.

**The first part of the stocktaking covers current practices and experiences in South Asia.** It consists of eight country chapters covering Afghanistan, Bangladesh, Bhutan, India, the Maldives, Nepal, Pakistan, and Sri Lanka. Each country case is presented in two sections: a snapshot of the SOE sector and a description of the corporate governance of SOEs.

**The second part of the stocktaking presents examples of SOE reform experiences from selected East Asian countries.** Upon the request of government counterparts in South Asian countries, the second part of the study

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1 World Bank (2014a) and OECD (2015).

2 Additional background on the methodology and conceptual framework is provided in Annex 3.

presents key elements of SOE ownership and oversight models, as well as corporate governance policies, in China, Malaysia, Singapore, and South Korea.<sup>3</sup> The focus is on key SOE reforms and good corporate governance practices.

**The descriptive focus of the analysis reflects the diversity of experiences in South Asia.** Different political and economic agendas have led countries in South Asia to establish and use SOEs for different objectives. Furthermore, countries in the region differ significantly in terms of size, GDP, and institutional arrangements and traditions, which renders direct comparisons more difficult. The absence of an internationally tested and agreed quantitative framework for diagnosing SOE corporate governance practices<sup>4</sup> also implies being cautious with absolute conclusions. Rather than attempting a potentially subjective benchmarking or ranking among practices, therefore, the regional stocktaking remains deliberately descriptive and informative while also presenting international good practices— notably from East Asia—for additional reference.

## **SOE Sector in South Asian Countries**

**SOEs are key economic players in the vast and diverse region of South Asia, one of the world’s fastest-growing regions today.** SOEs contribute significantly to the regional economic output of South Asia, where GDP has been growing rapidly at an annual average of nearly 7 percent since 2014. Available data indicate that, in India, the region’s largest country and a leader in economic growth among large emerging market economies, SOEs contributed 14 percent of GDP in 2015 and are present in key sectors such as manufacturing, mining, and services. Some of them have become well-known multinational giants and contribute significantly to capital markets, representing approximately 12 percent of total market capitalization of the Bombay Stock Exchange. In the small countries of the region, the SOE sector appears to be the main economic driver, contributing 43 percent of GDP in Bhutan and 53 percent of GDP in the Maldives. In fact, in only two of the eight South Asian countries included in this study—Afghanistan and Bangladesh—did SOEs account for less than 10 percent of GDP (Figure 1).<sup>5</sup>

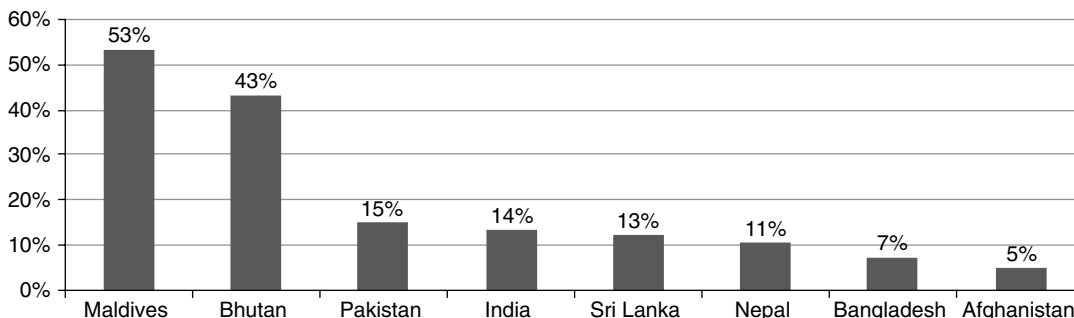
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3 For information on the corporate governance of SOEs in the Latin America and Caribbean region, see World Bank (2014b).

4 OECD guidelines refer to “internationally agreed benchmarks and good practices.”

5 SOEs’ aggregated gross revenues (or similar data), have been used as a proxy to illustrate the overall size of the SOE sector in each country, bearing in mind that there may be other proxies.

**FIGURE 1: Estimated SOE Contribution to GDP in South Asia (SOE gross revenues/GDP)**



Source: Estimates compiled by World Bank team based on available data (2014–2016) for central-level SOEs. See Annex 2 for detailed references.

**In South Asia, SOEs play a critical role in delivering essential public services to citizens, particularly in the energy, transport, and financial sectors.** In most of the eight countries, a significant share of total SOE assets and revenues are in the energy, transport, and financial services sectors. SOEs also provide telecommunications and water and sanitation services in these countries (Annex 1). Large SOEs are commonly found in the transport sector, such as the national airlines of Afghanistan, India, Pakistan, and Sri Lanka; the railways in Bangladesh, India, and Pakistan; and ferry services between Malé, the capital of the Maldives, and nearby islands. State-owned banks and financial institutions are significant market players in all South Asian countries. The region faces important service delivery challenges, however. For instance, more than 20 percent of the population in Bangladesh lacked access to electricity in 2016,<sup>6</sup> and disruptions in electricity supply—albeit reduced—remain an issue in Pakistan.<sup>7</sup>

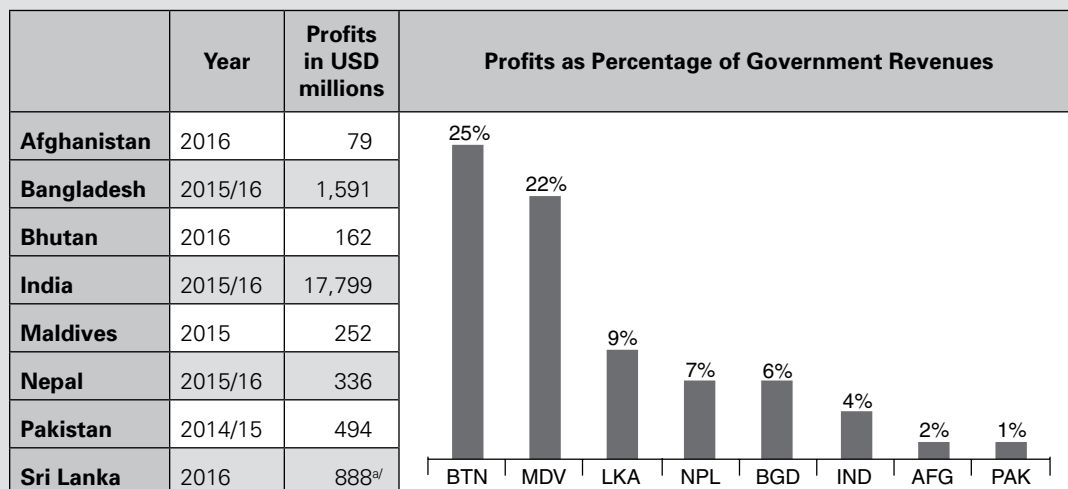
**In aggregate terms, all eight countries' SOE portfolios report profits on their balance sheets.** While all countries' portfolios comprise both profitable and loss-making SOEs, the most recent available data indicate that, in most South Asian countries, the SOE sector is profitable on aggregate—that is, when summing up the reported profits and losses of all SOEs in a country's portfolio. SOEs also contribute taxes and dividends to central

<sup>6</sup> While access to electricity in Bangladesh increased from 48 percent of the population in 2010 to 78 percent in 2016, including 10 percent with access to electricity from off-grid renewable sources, there is room for improvement (Bangladesh Power Development Board 2017).

<sup>7</sup> The average duration of interruptions in electricity supply in Pakistan has come down by over 40 percent, from 4.81 hours a day in 2012 to 2.87 hours in 2016 (NEPRA 2016).

BOX 1

## SOE Sector Aggregate Profit in South Asia



<sup>a/</sup> Profit before tax.

Source: World Bank compilation, based on available information. See Annex 2 for detailed references.

government revenues. At the same time, several SOEs would not have been able to report profits in the absence of government support.<sup>8</sup>

**Meanwhile, SOE balance sheet profits are offset by government subsidies allocated to SOEs.** Several SOEs face financial challenges and rely on financial support from the government in the form of capital injections, direct subsidies, soft loans, grants, and loan guarantees. The main rationale for budget subsidies to SOEs is to reduce fluctuations in prices and/or service provision levels in sensitive areas such as fuel, electricity, and/or water supply and transportation. SOE investments—and, in some cases, also operating costs—often require support from the government. Box 2 illustrates tax and dividend receipts from SOEs, as well as direct subsidies to SOEs. Due to incomplete data, the financial net impact of SOEs on the government budget cannot be monitored systematically for all countries.

<sup>8</sup> While showing SOEs' financial situation at a specific point in time, reported profits are a measure that should be considered with caution, as profits (or losses) may be affected by public service obligations, can be volatile over time, and do not capture other risks such as high or rising debt and subsidy levels.



**BOX 2****Interactions of SOEs and Government, USD millions**

	<b>AFG 2016</b>	<b>BGD 2015/16</b>	<b>BTN 2016</b>	<b>IND 2015/16</b>	<b>MDV 2015</b>	<b>NPL 2015/16</b>	<b>PAK 2014/15</b>	<b>LKA 2016</b>
<b>Taxes</b>	95 <sup>a/</sup>	187	108	42,754	n.a.	n.a.	n.a.	601 <sup>b/</sup>
<b>Dividends</b>	n.a.	780	63	6,723	30	75	626	103
	<b>AFG 2016</b>	<b>BGD 2015/16</b>	<b>BTN 2016/17</b>	<b>IND 2013/14</b>	<b>MDV 2015</b>	<b>NPL 2014/15</b>	<b>PAK 2014/15</b>	<b>LKA 2016</b>
<b>Subsidies</b>	n.a.	208	9	26,753	74	n.a.	2,177	151

<sup>a/</sup> Tax and dividends, <sup>b/</sup> Levies.

Source: World Bank compilation, based on available information. See Annex 2 for detailed references.

**Furthermore, SOEs may pose potential fiscal risks for governments.**

These fiscal risks result from both explicit (such as the high stock of debt outstanding issued by some SOEs in Sri Lanka and the Maldives) and implicit contingent liabilities.<sup>9</sup> Implicit liabilities may result from multiple sources, including: SOE debt without sovereign guarantees; unfunded liabilities of SOE pension funds, as in Nepal; and nonperforming loans of state-owned banks when combined with low levels of capitalization, as in Bangladesh. Potential sources of implicit contingent liabilities could also be related to limited identification of the actual costs of SOE transactions—for example, those arising from the high level of interconnectedness across SOEs in the Maldives in the form of cross-subsidies, cross-debts, and discounted sales, or possible underreporting of SOEs’ financial costs and losses due to limited oversight and financial data availability in Afghanistan.

## **SOE Corporate Governance in South Asia**

**In South Asia, several prevailing features of SOE corporate governance can be distinguished.** Regarding the ownership model, decentralized or dual ownership structures tend to be more prevalent, involving both central and sector ministries. Meanwhile, SOE performance monitoring systems are established in some countries and emerging in others. Direct participation of

<sup>9</sup> For more information on fiscal risks from SOE operations, please refer to Brixi and Schick (2002) and IMF (2016).

government representatives in SOEs' boards of directors is a common practice. In the area of transparency and disclosure, regulatory requirements exist for external audit and annual reporting, with varying levels of compliance.

**In the East Asia cases studied, several key corporate governance characteristics can be observed.** China, Malaysia, Singapore, and South Korea exercise their ownership function through a centralized ownership model at the level of government or through a holding company. Performance monitoring of SOEs is conducted through an SOE performance monitoring system or SOE boards. The East Asian case countries have also emphasized the professionalization of SOE boards of directors through dedicated training and the development of clear criteria and guidelines for the selection of SOE board members. Transparency of SOEs has increased through annual aggregate portfolio reports by the ownership entity and the regular publication of SOE financial information, complemented by strong requirements for disclosure and external audits.

## **Legal and Regulatory Framework**

**There is no common definition or term for SOEs in South Asia.** SOEs are called by different terminologies depending on their legal definition (Box 3). In India, for example, the central public sector enterprises (CPSEs) are defined as entities in which the government holds 51 percent or more of the capital. In the Maldives, an SOE is defined as an entity in which the state holds at least 5 percent ownership.<sup>10</sup> In Nepal, public enterprises are entities in which the government owns more than 50 percent of shares. In Sri Lanka, state-owned business enterprises (SOBEs) are the 55 large SOEs that are strategically important business-related commercial enterprises.

**The legal framework for SOEs in South Asia is heterogeneous and relatively fragmented, with different laws and regulations governing different SOEs in most countries.** Overarching SOE legislation is not common, and SOEs governed by a Companies Act coexist with SOEs established under a statute specific to the SOE. In Afghanistan, SOEs are governed by a distinct legal framework depending on the type of SOE (SOEs under the State-Owned Enterprises Law, state-owned corporations (SOCs) under Corporations and Limited Liability Companies Law and the Commercial

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<sup>10</sup> Thus, not all SOEs as defined in the Maldives correspond to the OECD definition of SOEs: “any corporate entity recognized by national law as an enterprise in which the state exercises ownership and any public-sector entity carrying out predominantly commercial activities” (OECD 2015).

**BOX 3****Terms Used for State-Owned Enterprises (SOEs)**

Country	SOE Terms
<b>Afghanistan</b>	State-Owned Enterprise (SOE), State-Owned Corporation (SOC), State-Owned Commercial Bank (SOCB)
<b>Bangladesh</b>	State-Owned Enterprise (SOE), Public Enterprise
<b>Bhutan</b>	State-Owned Enterprise (SOE)
<b>India</b>	Central Public Sector Enterprise (CPSE)
<b>Maldives</b>	State-Owned Enterprise (SOE)
<b>Nepal</b>	Public Enterprise (PE)
<b>Pakistan</b>	Public Sector Company (PSC), Federal Authority (FA), Development Finance Institution (DFI)
<b>Sri Lanka</b>	State-Owned Business Enterprise (SOBE), State-Owned Noncommercial Enterprise (SONCE), Public Enterprise, Government-Owned Company, Commercial Corporations, Statutory Boards

Code, and state-owned commercial banks (SOCBs) under central bank laws and regulations). Similarly, in Sri Lanka, government owned companies are under the Companies Act, but commercial corporations and statutory boards are under specific Acts of the Parliament. In Bangladesh, SOEs with the status of joint-stock companies are established under the Companies Act, and statutory corporations are set up under specific Acts of Parliament. In India, Nepal, and Pakistan, many SOEs are governed under the Companies Act, but the legal framework for the remaining SOEs is fragmented. Bhutan and the Maldives, in turn, are exceptions, as their SOEs are all (in Bhutan) or mostly (in the Maldives) corporatized and governed under the Companies Act, and thereby subject to the same regulatory requirements as private companies.

### **Ownership Arrangements**

**SOE ownership arrangements in South Asia are characterized predominantly by decentralized or dual models, with line ministries playing an important role in the SOE ownership function.** In Bangladesh and Pakistan, a largely decentralized model of SOE ownership applies, whereby line ministries exercise the state’s ownership function for SOEs that are active in

their respective sectors. In Afghanistan, Nepal, and Sri Lanka, ownership arrangements correspond to the dual model of SOE ownership, with the finance ministry playing an active role in monitoring the performance of SOEs and nominating board members in conjunction with line ministries. India, with more than 200 SOEs held by the central government, also has a version of the dual model, which may best be described as an advisory model of SOE ownership. Under this model, line ministries exercise ownership functions on behalf of the state, while the Department of Public Enterprises of the Ministry of Heavy Industries and Public Enterprises has an advisory but not a direct oversight or monitoring role. The Maldives and Bhutan<sup>11</sup> are the only countries in the region that follow a centralized model.

#### BOX 4

### SOE Ownership Models in South Asia

Country	Predominant Model Features	Responsible Institutions
<b>Afghanistan</b>	Dual	Ministry of Finance, Line Ministries
<b>Bangladesh</b>	Decentralized	Line Ministries, emerging monitoring role of Ministry of Finance
<b>Bhutan</b>	Centralized	Ministry of Finance, Druk Holding and Investments (DHI)
<b>India</b>	Advisory	Department of Public Enterprises of the Ministry of Heavy Industries and Public Enterprises, Line Ministries
<b>Maldives</b>	Centralized	Privatization and Corporatization Board, Ministry of Finance
<b>Nepal</b>	Dual	Ministry of Finance, Line Ministries
<b>Pakistan</b>	Decentralized	Line Ministries, emerging monitoring role of Ministry of Finance
<b>Sri Lanka</b>	Dual	Ministry of Finance, Line Ministries

**On the contrary, an increasing number of countries around the world have moved toward a centralized model of SOE ownership.** In the 1970s, decentralized arrangements under which the ownership function was dispersed among different line ministries were common. Since the early 2000s, there has been a strong trend toward greater consolidation and centralization of the SOE ownership function. OECD countries have

<sup>11</sup> The Ministry of Finance is the sole shareholder of Druk Holding and Investments (DHI).

concentrated on enhancing state ownership functions, transparency, and accountability, and SOE board functions (OECD 2011). Meanwhile, in Latin America, countries such as Brazil, Chile, and Paraguay are reforming their SOE ownership arrangements with a view to exercising more efficient oversight (WBG 2014b). The trend toward centralized SOE ownership is also observed in East Asian countries (Box 5).

#### BOX 5

### **Centralized Ownership Model of Four East Asian Countries**

**South Korea has a centralized ownership model led by the Ministry of Strategy and Finance (MOSF).** The Public Institution Policy Bureau within the MOSF is in charge of managing the SOE performance evaluation process and monitoring corporate governance practices in SOEs.

**In China, the State-Owned Assets Supervision and Administration Commission (SASAC) under the State Council manages and oversees nonfinancial SOEs owned by the central government.** The SASAC is responsible for investment decisions, as well as for the supervision and management of the state-owned assets of the 103 nonfinancial SOEs owned by the central government.

**The Malaysian government exercises ownership of its SOEs under a centralized model with a two-tier framework.** The top tier comprises seven government-linked investment companies (GLICs). The GLICs exercise the state's ownership function for all of Malaysia's government-linked companies (GLCs), which constitute the second tier. As owners, GLICs can influence the appointment of GLC board members and provide operational funds and/or capital guarantees to GLCs.

**In Singapore's centralized model, the ownership function is exercised by Temasek, a state-owned holding company.** Established to act as an investment company under the Ministry of Finance, Temasek owns, controls, and oversees all government-linked companies in Singapore.

## Performance Monitoring

**While arrangements for the regular monitoring of SOE performance are still evolving, several South Asian countries have made progress in this area.** Bhutan and India have established and applied performance monitoring arrangements over the last several years. Bangladesh, the Maldives, and Sri Lanka have recently initiated or revived SOE performance monitoring mechanisms, which are currently at an early stage of development.

### BOX 6

#### SOE Performance Monitoring in South Asia

Country	Performance Monitoring	Status	Duration
Bangladesh	Annual Performance Agreements (APA)	Early stage	Annual
Bhutan	Annual Compact Agreements (ACA)	Established	Annual
India	Memoranda of Understanding (MoU)	Established	Annual
Maldives	Results Agreement (RA)	Early stage	Annual
Sri Lanka	Statements of Corporate Intent (SCI)	Early stage	Three years

**In Bhutan and India, performance contracts have been used broadly and regularly as the main tool for monitoring SOE performance.** In Bhutan, Annual Compact Agreements (ACAs) for SOEs are negotiated annually between the SOE holding company Druk Holding and Investments (DHI) and the Ministry of Finance (MOF), and then with the SOEs. The system links key performance indicators to financial goals and corporate governance incentives. It has developed a performance-based incentive system based on the achievement of targets. In India, in 2015, over 200 SOEs signed annual Memoranda of Understanding (MoUs) with their respective ministries. The Department of Public Enterprises reviews the MoUs, evaluates progress against MoU indicators each year, and provides a final score on a five-point scale, which determines performance-related pay for managers of successful enterprises.

**The governments of Bangladesh, the Maldives, and Sri Lanka have recently taken specific actions to improve the measurement and monitoring of SOE performance.** In Bangladesh, the MOF has introduced Annual Performance Agreements (APAs) signed between the Cabinet, line ministries, and individual SOEs. In the Maldives, the Ministry of Finance and Treasury has initiated bilateral Results Agreements (RAs) to be signed between the ownership entity and individual SOEs. In Sri Lanka, the MOF, as part of a three-year extended arrangement with the International Monetary Fund (IMF), has signed performance agreements called Statements of Corporate Intent (SCIs) with five major SOEs.

**Performance agreements for SOEs are not available in Afghanistan, Nepal, and Pakistan.** Nepal has attempted to develop such agreements in the past, but their implementation has proven difficult. In Pakistan, monitoring mechanisms based on measurable indicators and targets are being applied to some SOEs, notably in the power sector. In Afghanistan, SOEs are not yet subject to a performance monitoring system.

#### *Experience from East Asia*

**South Korea provides an interesting example of an advanced and sophisticated SOE performance monitoring system.** South Korea has a long history of overseeing and managing large SOEs and has established a strong performance monitoring system based on objective indicators. The strengthened corporate governance measures have had a positive impact on the performance of Korean SOEs (Box 7).

#### **BOX 7**

#### **SOE Performance Monitoring in South Korea**

**South Korea has an effective management performance evaluation system for its SOEs.** The performance evaluation system is overseen by the Ministry of Strategy and Finance (MOSF). A Management Performance Evaluation Team consisting of independent experts develops performance indicators for SOEs. The MOSF publishes a Manual for the Management Performance Evaluation at the beginning of each year. The manual describes the relevant performance indicators, their relative weight, and how they will be measured, among other key information.

*(box continues on next page)*

**BOX 7** *continued*

**The MOSF and SOEs review and update these indicators and associated targets before each evaluation year begins.** Once an agreement has been reached on relevant indicators and targets for an SOE, the chief executive officer signs a performance contract with the relevant line minister. At the end of the year, the Management Performance Evaluation Team conducts the evaluation and provides results in the form of specific grades. Final grades from the performance evaluation are used to determine SOE incentive payments. High grades translate into higher incentive pay, whereas low grades can have serious consequences, including dismissal of the chief executive officer.

## **Boards of Directors**

**In South Asia, SOE boards are generally responsible for approving strategic decisions and company policies in key areas.** The boards are responsible for overseeing SOE management and operations, and for approving major investment, divestment, and borrowing decisions. Furthermore, the boards follow up on the company's financial performance. In Bhutan, India, and Pakistan, guidelines on board functions are explicitly formulated.

**SOE boards in most South Asian countries usually include direct participation of government officials.** The presence of professional boards of directors that meet regularly, provide strategic direction, and monitor SOE management is required by law. In many cases, however, SOE boards of directors are dominated by government officials, especially from line ministries. Some countries—including Bhutan, India, and Pakistan—have legislation requiring that the board composition include a combination of government and independent SOE members, including academics and senior executives from the private sector.

**Bhutan, India, the Maldives, and Pakistan have specific criteria or guidelines for the selection of SOE board members.** In Bhutan, the DHI has developed a list of potential directors from the private sector and the civil service, and candidates are selected from this list based on their skills, competencies, and knowledge. In India, guidelines put forward by the Department of Public Enterprises govern the appointment of board members. In the Maldives, the Privatization and Corporatization Board<sup>12</sup> verifies that nominated board members meet experience criteria for SOEs without

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12 The SOE ownership entity in the Maldives.



minority shareholders. In Pakistan, board nominees must meet “fit and proper” criteria set by the Rules of Corporate Governance for Public Sector Companies.

### *Experience from East Asia*

**Malaysia provides an interesting case regarding the professional development of SOE boards of directors.** This is particularly important for new SOE directors who need to acquire specialized knowledge to perform their duties. While the enterprises themselves may conduct some training, other training opportunities are provided by the SOE Board Academy (Box 8).

#### **BOX 8**

#### **The SOE Board Academy (MINDA) in Malaysia**

**The Malaysian Directors Academy (MINDA) was established in 2006 to train and support GLC board members.** MINDA programs include traditional training, national and regional case studies, and on-the-job learning and coaching. MINDA has also partnered with international institutions, such as Harvard University and the International Institute for Management Development. MINDA provides assessments to guide directors’ professional development. These include Board and Director Assessments, designed to assist boards in prioritizing their key strategic areas and implementation plans; Individual Director Evaluations, which provide feedback to directors on their performance as board members; and a Directors’ Gap Analysis, a tracking mechanism to evaluate the progress of individual directors over a given period.<sup>13</sup>

### **Transparency and Disclosure**

#### *SOE Financial Reporting*

**In all South Asian countries, annual reporting and disclosure of SOEs’ financial statements are required, but there is room for improvement in the publication and timeliness of the reports.** In most cases, SOEs are expected to periodically report their financial statements to their ownership entities, which typically include the MOF, and to publicly disclose their financial results, usually on the Internet. Compliance with reporting

<sup>13</sup> See <http://www.minda.com.my>.

requirements remains partial in several countries, however, and there are concerns regarding the quality and timeliness of financial information.

**Aggregated annual financial reporting is a growing practice in South Asia's SOE sector.** Bhutan, Nepal, India, and Sri Lanka regularly publish aggregated annual reports on the financial performance of SOEs. The MOF in Pakistan has published aggregated SOE reports for fiscal years 2013–2015 and is expected to continue doing so in subsequent years. The MOF in Bangladesh prepares an annual report covering only some statutory SOEs.

**Three out of eight South Asian countries use the International Financial Reporting Standards (IFRS) for SOE financial reporting.** Pakistan, the Maldives, and Sri Lanka employ IFRS accounting standards for SOE financial reporting. Afghanistan, Bhutan, India, and Nepal are using their respective national accounting standards, although efforts are under way to align national accounting frameworks more strongly with IFRS.

### *External Audit*

**While the annual external audit of SOE financial statements is legally required in all South Asian countries, there are important differences in the nature and coverage of audits.** In Bhutan and Sri Lanka, external audits of SOEs may be performed by private sector audit firms. In the Maldives and Pakistan, SOE audit mechanisms have been improving recently. In Pakistan, the Corporate Governance Rules for Public Sector Companies provide requirements for the selection of audit firms. In the Maldives, listed SOEs are audited by international audit firms, and nonlisted ones are subject to the auditor general's office. In Afghanistan, Bangladesh, and Nepal, SOEs are legally required to submit audits, but in many cases there are opportunities to improve compliance and the timeliness of submission.

### *Experience from East Asia*

**In South Korea, the All Public Information in One (ALIO) system is an interesting example of SOE transparency and disclosure.** The government has introduced an online information system as part of a set of reforms aimed at improving the transparency and disclosure of SOEs' performance information. The purpose of ALIO is to provide real-time public information on the Internet about the financial and nonfinancial performance of SOEs (Box 9). The system has gained public support during the launch phase, and in 2014, the average number of visitors surpassed 100,000 per month. The website discloses a vast amount of information on SOEs, which not only serves the information needs of the media and the general public, but also helps hold SOEs to a high standard of probity.

## BOX 9

### South Korea's ALIO System

**The All Public Information in One (ALIO) system is an Internet-based disclosure system in South Korea that allows public access to SOE management information.** Launched in 2006, it soon became the primary source of information on SOEs and generated a great deal of interest from the public. The ALIO system discloses a wide range of information on SOEs. It includes general profiles for all SOEs, as well as their operational status, human resources information, core business and performance indicators, and performance evaluation results. More recently, ALIO has begun to disclose SOE debt liabilities and operational statements of employee benefits.

**The MOSF monitors closely the quality and accuracy of the information provided on the ALIO website.** The MOSF provides SOEs with a set of guidelines regarding the type of information and form of disclosure, so that each SOE can regularly upload the data online. In cases of incomplete or inaccurate information, the MOSF imposes penalties on the SOEs concerned. Penalties take the form of points deductions, which affect the final institution's score on the annual performance evaluation.



PART 1

**SOUTH ASIA SOE CORPORATE  
GOVERNANCE STOCKTAKING**



## CHAPTER 1

# Afghanistan

## SOE Sector

### Evolution of the SOE Sector and Reforms

**From the 1950s to the 1970s, the Government of Afghanistan established many state-owned enterprises (SOEs) in several key industries through nationalization and the creation of new entities.** The political transition undergone by Afghanistan beginning in the 1950s led to a series of five-year development plans, through which many SOEs were established in diverse industries such as cement, textiles, sugar, and wheat products (Pateron and Blewett 2006). By the 1970s all major industries were state-owned, as were banks, energy companies, and mines (UNIDO 2002). The 1979 Soviet intervention further strengthened the role of the state as the primary driver of the economy through cooperative projects.

**Along with the country's economy, SOE operations were interrupted by internal conflict in the 1980s and after the collapse of the Soviet Union in the 1990s.** During the Mujahedeen and Taliban periods, many SOEs reduced or ceased their operations. Following the 1991 collapse of the Soviet Union, the privatization of several industries was initiated,

although not completed. Although many large SOEs retained significant assets, only a few were fully functional. Ongoing conflict and political upheaval resulted in unclear ownership rights, as well as lack of operational oversight and financial reporting.

**Following the 2002 political transition, the authorities reevaluated the viability of SOEs.** A 2005 Presidential Decree gave the Ministry of Finance (MOF) responsibility for assessing the portfolio of SOEs, with a mandate to privatize or liquidate unviable enterprises. The financial and operational systems of SOEs were assessed, assets and liabilities were accounted for, and the economic potential for production was considered. Following the assessment of 67 SOEs, the MOF recommended that eight enterprises be retained and 59 liquidated or privatized. As a result, 26 SOEs were liquidated, three were changed to state-owned corporations (SOCs), two were changed to budget units, and 36 of the enterprises remain active as SOEs.<sup>14</sup> An SOE department was established at the MOF to manage this process and to oversee ownership of the remaining SOEs.

## **Economic Significance**

**By 2016, Afghanistan had 36 nonfinancial state-owned enterprises, 16 state-owned corporations, and three state-owned commercial banks (SOCBs).**<sup>15</sup> In Afghanistan, SOEs are 100 percent government-owned companies, while government shareholding in SOCs varies. For 11 of the 16 SOCs, the government holds more than 50 percent of shares. At present, SOEs are relevant in energy and mining, security, construction, industrial, manufacturing, transport, and tourism sectors, whereas SOCs play a role in insurance, telecommunications, energy, water, and trade markets (Figure 2). SOCBs include the Bank-e-Millie Afghan and the Pashtany Bank, which were reissued licenses under new financial laws in 2004. Also, following the 2011 collapse of Kabul Bank, the MOF assumed ownership of the New Kabul Bank.

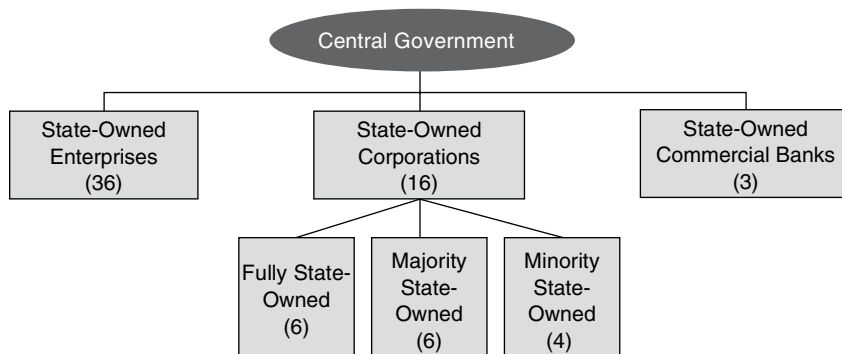
**In 2016, SOE and SOC revenues accounted for only 4.66 percent of gross domestic product (GDP) in Afghanistan, but these enterprises operated in strategic sectors.** Following two decades of divestment and facing significant operational challenges, gross revenues from SOEs and SOCs do not arise as a significant component of the country's GDP. However,

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<sup>14</sup> Data provided by the government.

<sup>15</sup> Data presented in this section include information provided by the government as part of the regional stocktaking (for SOEs and SOCs) and public reports published by the central bank (for SOCBs).

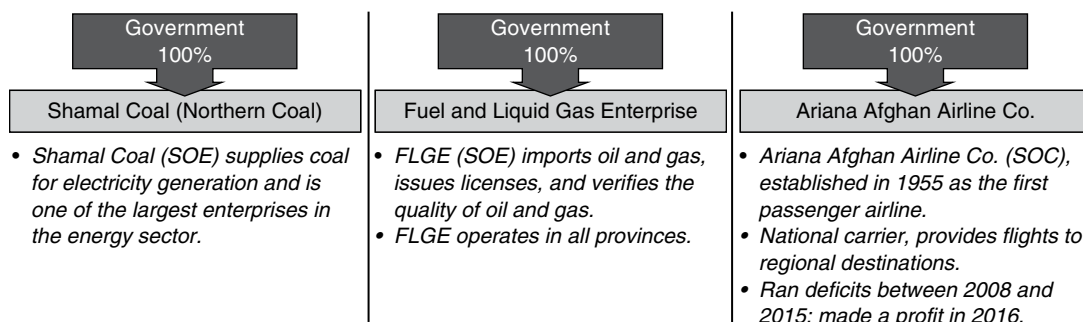
**FIGURE 2: Universe of the SOE Sector in Afghanistan**



Source: World Bank staff compilation.

SOEs and SOCs operate in strategic sectors of the Afghan economy, such as energy and mining, telecommunications, security, and airlines. The energy and mining sector (comprising FLGE, Northern Coal, and Afghan Gas) accounted for 30.78 percent of total SOE revenues in 2016, and the Afghanistan Public Protection Force accounted for 41.95 percent of total SOE revenues as it took over security responsibility from private companies.<sup>16</sup> As for SOCs, energy and water, telecommunications, and airlines were the most significant sectors in 2016, representing 52.25 percent, 39.23 percent, and 6.38 percent of total revenues, respectively (Figures 3 and 4).

**FIGURE 3: Selected SOEs and SOCs in Afghanistan, 2016**

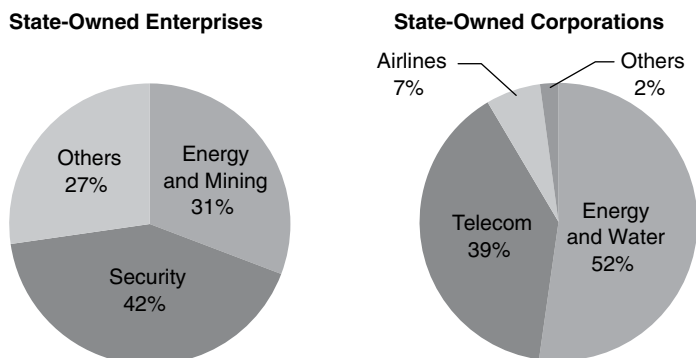


Source: World Bank staff compilation.

<sup>16</sup> Afghanistan Public Protection Force website (<http://www.appf.gov.af/index1.htm>) and press articles.



**FIGURE 4: SOE and SOC Sector Distribution (by revenues, 2016)**



Source: Directorate General of State Owned Enterprises and Corporations, MOF.

**SOEs and SOCs together employed around 25,070 people in 2016.**

Overall, the SOE/SOC sector remained relatively small in 2016, employing only 0.2 percent of the total labor force of 10.2 million,<sup>17</sup> as compared to civil service employment of 399,574 (Islamic Republic of Afghanistan 2016). The energy and telecommunications sector represented more than half of total SOE/SOC employment: Mazar Fertilizers & Electricity (1,775 employees), DABS (7,500 employees), Telecom (3,480 employees), and FLGE (1,767 employees).

**SOCBs represent a significant share of bank intermediation in the country.** The latest available data indicate that Bank-e-Millie Afghan, the Pashtany Bank, and New Kabul Bank—all operating under the country’s banking law and under the supervision of a board of shareholders, executive board, and supervisory board—accounted for 27 percent of the banking sector’s total assets in 2013–14.

**Macro-Fiscal and Service Delivery Implications**

**In 2016, the combined SOE/SOC profit of AFN 5.35 billion (USD 79.3 million) was attributable primarily to the energy and mining, telecommunications, and security sectors.** Among SOEs, the energy and mining and security sectors were the most profitable in 2016. The SOC sector was led by Afghan Telecom, which generated AFN 1.9 billion (USD 29 million) in profits.

<sup>17</sup> World Bank, World Development Indicators, Total Labor Force in Afghanistan in 2016.

**BOX 10****SOE and SOC Taxes Contribution, 2016**

	<b>Tax and Dividend (AFN)</b>	<b>Share of Government Revenue (%)</b>	<b>Share of GDP (%)</b>
<b>SOEs</b>	3.08 billion	4.39	0.23
<b>SOCs</b>	3.40 billion	4.86	0.25
<b>Total</b>	6.48 billion	9.25	0.48

Source: Directorate General of State-Owned Enterprises and Corporations, MOF.

**Total tax and dividend payments by SOEs and SOC accounted for 9.25 percent of total government revenues in 2016.** SOE/SOC tax and dividend contributions totaled about AFN 6.48 billion (USD 96 million) in 2016, which amounted to just under 10 percent of government revenues and around 0.5 percent of GDP.<sup>18</sup>

**The latest available data indicate that SOCB's profitability was volatile over the past years.** According to Afghanistan's central bank,<sup>19</sup> the sector recorded losses of AFN 408 million (USD 6.2 million) in fiscal year 2012–13, followed by a profit of AFN 514 million (USD 7.8 million) in 2013–14. In 2014–15, the sector again generated a loss of AFN 67 million (USD 1 million), prior to reporting significant growth with a profit of AFN 4,232 million (USD 64.1 million) in 2015–16 and a profit of AFN 459 million (USD 7 million) in the first half of 2016–17.

**Overall, limited financial oversight, data availability, and capacity constraints arise as significant challenges and represent a potential source of fiscal risks.** Due to limited capacity, SOEs are not always able to report and analyze their financial positions adequately. As a result, financial oversight of SOC remains limited (IMF 2015a). Furthermore, World Bank interviews with relevant government officials revealed that the government does regularly provide support to SOEs and SOC in the form of loan guarantees, concessions, tax expenditures, subsidies, and recapitalizations, but more specific information is not available. The available information, therefore, does not allow for fiscal risk monitoring or management.

<sup>18</sup> Data from the government.

<sup>19</sup> Da Afghanistan Bank 2014–2017. See bibliography for additional details.

## BOX 11

### Corporate Governance Laws and Regulations in Afghanistan

- State-Owned Enterprises Law, 1990
- SOEs' Charters 1975–1999
- Procurement Law, 2008
- Corporations Law and Limited Liability Companies Law, n.d.
- Banking Law No. 1394, 2014
- Corporate Governance Regulations, 2016
- Labor Law, 2007

Source: World Bank staff compilation.

## Corporate Governance

### Legal Framework

**Afghanistan distinguishes among three types of state enterprises—SOEs, SOCs, and SOCBs—each of which is governed by a distinct legal framework.** In addition, entities established through specific statutes may have separate legal provisions.

**SOEs are legal entities with an independent budget and owned entirely by the state.** SOEs in Afghanistan are governed by the 1990 State-Owned Enterprises Law, which aims to strengthen and promote the public sector economy and to regulate the activities of such enterprises.<sup>20</sup> The law is composed of 83 articles covering the legal, institutional, and financial aspects of SOEs. It endows the MOF with the authority to create enterprises, as well as to assess the economic viability of SOEs and determine their outlook for corporatization or privatization.

**SOCs may have varying degrees of state ownership, with shares held by line ministries (IMF 2015a).** As in the case of private-sector companies, SOCs are governed by both the Corporations and Limited Liability Companies Law and the Commercial Code.<sup>21</sup> The Corporations Law has 15 chapters and 114 articles covering procedures for establishing a corporation and its board of directors.

20 <http://www.aisa.org.af/Content/Media/Documents/743StateOwnedEnterprises13705112014184515140553325325.pdf> (accessed February 16, 2018).

21 <http://www.asianlii.org/af/legis/laws/clcoa1955uotcloa713/> (accessed February 16, 2018).

**SOCBs are licensed financial institutions with full or majority state ownership.** There are currently three SOCBs in Afghanistan: Bank Millie, Bank Pashtany, and New Kabul Bank. These banks are registered as companies, with a charter and license granted by the central bank. State-owned banks in Afghanistan operate under new licenses, reissued in 2004 after the adoption of a new legal framework governing the sector (Pavlović and Charap 2009).

**SOCBs are subject to central bank laws and regulations, such as the Law of Banking and the Corporate Governance Regulation.** The Banking Law regulates banking affairs and includes provisions on the establishment and licensing of banks; qualifying holdings; bank subsidiaries, associated enterprises, branches, and representative offices; bank corporate governance; activities and operational requirements; accounting and audits; reporting; and supervision. The Corporate Governance Regulation from 2016 outlines, among others, the general administrative and governance structure of banks; the composition and appointment procedures for boards;<sup>22</sup> board responsibilities; internal audit functions; and requirements and responsibilities related to disclosure and transparency.

**The Labor Law regulates general labor relations for SOE, SOCs, and SOCB employees, and the Civil Servants Law applies to SOEs.** The Labor Law applies to all employees working for the Government of Afghanistan. Most employees of state enterprises in Afghanistan are public servants, supported by contract workers and other employees. The Labor Law regulates the general labor relations of all categories of employees, whether Afghan or foreign, with their respective administration. The provisions of the Civil Servants Law also apply to SOEs.

**The Procurement Law (2008) governs SOE procurement.** This includes goods, services, and coordination of works for administrations, institutions, and mixed companies. Financial arrangements are governed by the Law on State-Owned Enterprises.

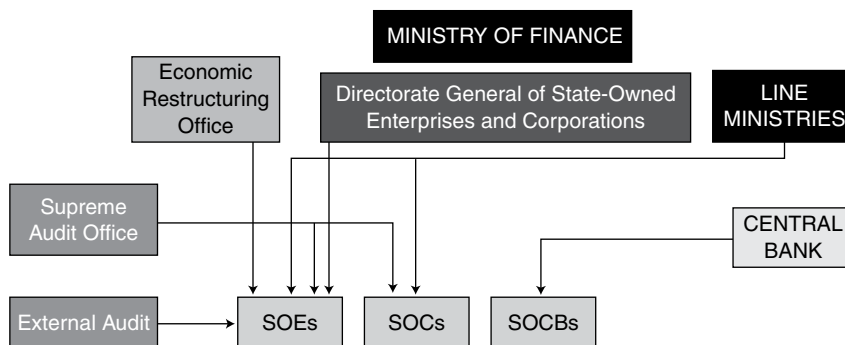
## Ownership Arrangements

**SOEs operate under a “dual model” of ownership.** Ownership oversight functions are performed by corresponding line ministries, in parallel with the Directorate General of State-Owned Enterprises and Corporations (SOEC) within the MOF. SOEs are legally owned by the MOF, but their

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<sup>22</sup> Both Boards of Directors (“Board of Supervisors”) and Boards of Management. The latter conducts the bank’s activities in line with the business strategy, risk, and other policies approved by the Board.

**FIGURE 5: The Ownership and Oversight Function in Afghanistan**



Source: World Bank staff compilation.

operational functions are supervised through their respective line ministries (Paterson and Blewett 2006), which also preside over SOE boards, denominated “Supreme Councils.” The Directorate General of SOEC analyzes, monitors, and approves major financial operations of SOEs. It also has the responsibility for auditing, reviewing capital investments, and monitoring SOE debt. The Directorate General of SOEC is divided into 7 subdepartments, covering different sectors within which SOEs operate: (i) SOE financial supervision; (ii) SOE assets supervision; (iii) Change in Legal Personality; (iv) SOC financial monitoring; (v) SOC assets monitoring; (vi) public-private partnerships; and (vii) the research and development division.<sup>23</sup>

**SOCs operate under a “decentralized model,” with ownership responsibilities distributed among several line ministries and other public bodies.** SOC report to their respective line ministry, as well as to other stakeholders. The government holds a majority stake in 11 SOCs, half of which report to the Ministry of Commerce and Industries. The extent and quality of reporting arrangements to line ministries are not publicly known, however. Although SOCs are mandated to report regularly to the MOF on their financial and operational affairs, the MOF exercises less financial oversight of SOCs.

**Finally, SOCBs are governed by central bank rules and regulations.** Central bank approval is required for SOCBs to secure a banking charter and license. The SOCBs must also report to the central bank, which is responsible for authorizing the board nominations that emerge from general shareholders meetings. The central bank consolidates information on the banking sector, including state-owned and private banks, and discloses an annual bulletin providing an update of the sector’s composition and performance.

23 Information provided by the government.

## Performance Monitoring

**Afghanistan’s central government public enterprises (SOEs, SOCs, and SOCBs) are not yet subject to a performance monitoring system.** There is no such thing as “performance agreements” or similar tools to monitor the performance of these enterprises. Moreover, in the case of SOEs, financial oversight—a responsibility of the MOF’s SOE department—is hampered by limited accounting capacity within SOEs, which do not report on their financial operations and position adequately or in a timely manner. The SOE department also lacks sufficient analytical capacity to monitor SOEs’ reports effectively (WBG 2013).

## Boards of Directors

**The legal frameworks governing SOEs, SOCs, and SOCBs specify their respective board arrangements.** The boards of directors of SOEs are known as “Supreme Councils,” those of SOCs as “Boards of Directors,” and those of SOCBs as “Boards of Supervisors.” The establishment, mandates, structure, and composition of these boards are presented in Box 12.

### BOX 12

#### Board Features in Afghanistan

**Name of the board: SOEs:** Supreme Council. **SOCs:** Board of Directors. **SOCBs:** Board of Supervisors.

**Nomination of board members: SOC:** By shareholders at annual general meeting (AGM); **SOCBs:** By nomination committee, approved by shareholders and Da Afghanistan Bank.

**Nomination of board chair: SOC:** Annually by board from among board members. **SOCBs:** By nomination committee, approved by shareholders and Da Afghanistan Bank.

**Nomination of Chief Executive Officer (CEO): SOCBs:** By nomination committee, approved by shareholders and Da Afghanistan Bank.

**Mandate of the board: SOEs:** Includes determination of policy and approval of the annual work plan; approval of the SOE’s financial plan and organization; presentation of proposals to the Council of Ministers

*(box continues on next page)*

**BOX 12** *continued*

regarding appointment/removal of members of the Board of Management; partial or total reviews of the Board of Management; and approval of the annual balance sheet.

**SOCs:** The board represents the SOC and has the power to execute any legal document, subject to limitations set forth in the Articles of Incorporation.

**SOCBs:** Includes organization of the General Assembly; approval of the bank's organizational structure; decisions regarding the establishment and dissolution of subsidiaries, branch offices, and representative offices; appointment, dismissal, and determination of the bank's management board; approval of the bank's business strategy; and supervision of the management board.

**Separation between board chair and CEO:** **SOCBs:** Separate by law.

**Composition of the board:** **SOEs:** 5–7 members; **SOCs:** Depends on articles of incorporation or bylaws; **SOCBs:** 3–9 members.

**Structure/profile of board members:** **SOEs:** The minister or chief of the agency supervising the SOE (chair); a representative of the MOF (serving as vice chair); other members as defined in the enterprise's charter. **SOCBs:** At least two-thirds of the members, including the chair, must be independent.

**Board committees:** **SOCs:** Formed as needed. **SOCBs:** Audit, nomination, risk management, remuneration, other.

**Remuneration of CEO and board members:** **SOCs:** Set by board, approved by shareholders. **SOCBs:** Determined at the General Meeting of Shareholders.

*Source:* World Bank staff compilation based on interviews and regulations.

### *State-Owned Enterprises*

**SOE boards in Afghanistan are known as Supreme Councils and are typically composed of between five and seven members.** The Supreme Council is deemed to be the highest authority in the enterprise. Each council is headed by a chairman, a position that is filled by the minister exercising ownership functions. The council also includes a representative from the MOF, who serves as the vice chairman. The remaining members are selected based on the charter of each individual SOE. The SOE Law does not provide information on nominations.

**The Supreme Council is responsible for SOEs' overall policy and supervision.** Under the guidelines of the SOE Law, the Supreme Council is assigned the responsibility to determine the policies of the enterprise; approve its annual work plan, financial framework, and balance sheet; conduct performance reviews of the executive body;<sup>24</sup> and make decisions to enhance the performance of the SOE. Information on committees, nominations, remuneration, and training is currently unavailable.

### *State-Owned Corporations*

**The size of SOC boards is determined by the articles of incorporation or bylaws of the company.** According to the Corporations and Limited Liability Companies Law, the minimum and maximum number of SOC board members is determined by the articles of incorporation or the bylaws of an individual SOC.<sup>25</sup> Board members serve for a term not exceeding three years, with the exact term limit set by the shareholders of the company. The chairman of the board serves a one-year term and is elected annually by the members.

**Board members are elected by shareholders at the Annual General Meeting (AGM).** Although there are no explicit selection criteria for board members, the Corporations and Limited Liability Companies Law states that candidates must be older than 18 and have no criminal record. Once elected, members may be removed from the board in the case of poor performance.

**SOC boards represent the company in legal transactions and appoint company officers.** Members are generally given authority to execute and sign legal documents. The board has discretion to appoint officers to the company and set their grades, terms, duties, and responsibilities. Boards may also create committees working under their authority.

**Remuneration of board members is typically determined by the board itself, subject to shareholders' approval.** In some cases, however, board remuneration may instead be set by the articles of incorporation or bylaws of the SOC.

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24 Known as “Boards of Management” and consisting of a director and a deputy director.

25 Information for individual SOCs could not be obtained, as the articles of incorporation and bylaw documents are not publicly available.



## *State-Owned Commercial Banks*

**SOCBs are governed by a so-called Board of Supervisors.** As outlined in the Banking Law<sup>26</sup> and the Corporate Governance Regulation,<sup>27</sup> these Boards of Supervisors are given the mandate to supervise the overall administration and financial and nonfinancial performance of the bank; approve the bank's strategic plans and annual budgets; and work with senior management to find a resolution in case the bank is in violation of any applicable laws or regulations.

**SOCBs' boards are composed by three to nine individuals.** Per the Banking Law and Corporate Governance Regulation, SOCB boards may not have less than three or more than nine members, and they must be composed of an uneven number of members at all times. Board members are appointed to the board by shareholders at the AGM and serve for a renewable term of no more than four years. The board chair is also appointed by the shareholders at the AGM, and all appointments—including for the chair position—must receive written authorization from the central bank prior to confirmation.

**Candidates for board and other senior management positions are selected by a nomination committee.** The committee comprises three members, including the chair, an independent member, and a dependent member of the Board of Supervisors. The committee is responsible for determining the selection criteria, reviewing candidates nominated by its members on the basis of these established criteria, and identifying appropriate candidates for eventual appointment by the shareholders. This includes all board positions; senior management posts such as chief executive officer, deputy chief executive officer, and others; and all committee positions. Per the Corporate Governance Regulation, the criteria to be applied in identifying candidates and reviewing nominations must include whether the individual is “fit and proper” for the office and whether he or she is qualified to hold the office based on relevant skills and previous experience.

**Boards of Supervisors can establish specialized committees as needed.** Specific committees noted in the Corporate Governance Regulation include audit committees, nomination committees, risk management committees, and compensation and remuneration committees. These or any other specialized committees must have a charter that sets out their

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26 [http://dab.gov.af/Content/Media/Documents/BankingLawofAfghanistanEnglish Translation6122015122139846553325325.pdf](http://dab.gov.af/Content/Media/Documents/BankingLawofAfghanistanEnglishTranslation6122015122139846553325325.pdf) (accessed February 16, 2018).

27 [http://dab.gov.af/Content/Media/Documents/CorporateGovernanceRegulationFinal\(July2016\)final312017114439717553325325.pdf](http://dab.gov.af/Content/Media/Documents/CorporateGovernanceRegulationFinal(July2016)final312017114439717553325325.pdf) (accessed February 16, 2018).

mandate, scope, and working procedures. The charter must also specify reporting hierarchies, the duties and responsibilities of committee members, and the term limits for serving on a committee.

## Transparency and Disclosure

**According to the State-Owned Enterprises Law, SOEs are to comply with the standard accounting plan and accounting forms approved by the MOF.** A report on financial activities and a balance sheet must be shared with the MOF, relevant line ministries, the statistics authority, and the bank that maintains transactions with the enterprise. In case of noncompliance, the Board of Management and the accounting staff can be sanctioned.<sup>28</sup>

**Compliance and timeliness of information, however, can be improved.** While the MOF is responsible for evaluating and assessing SOEs' financial and economic operations, the availability of aggregated information on SOE finances is limited. Moreover, the quality of information is limited, and reporting and auditing are not systematically carried out or enforced (WBG 2013).

**Consequently, only a few SOEs' and SOCs' financial reports are available online.** Financial information for SOEs and SOCs is recorded in the quarterly statistic reports published by the Central Statistics Organization of Afghanistan. Not all quarterly reports are available online, however, and distinctions between SOEs and SOCs are not always clear. There is also significant room to improve the timeliness of information. The most recent information available in mid-2017 referred to fiscal year 2014.

**The Supreme Audit Office is legally required to audit SOEs, but audits are carried out on an ad hoc rather than systematic basis.** According to the SOE department, about one-third of SOEs were audited by the Supreme Audit Office between 2008 and 2013. Furthermore, the Law on State-Owned Enterprises requires annual external audits of SOE financial statements, but capacity constraints have prevented these audits from being conducted regularly (IMF 2015a).

**In the case of SOCs, the Corporation and Limited Liability Companies Law mandates the issuance of annual financial reports, but there is room to improve compliance and quality of information.** Corporations must deliver financial statements for the previous fiscal year to all shareholders not less than 15 days prior to the Annual Meeting of the Shareholders. This report must include the balance sheet and profit-and-loss statement

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28 State-Owned Enterprise Law. *Chapter Three*.

for operations. Accounting standards are set by the International Accounting Standards Board, but reporting compliance is only partial and the timeliness and availability of information could be improved. Moreover, the fiscal relationship between SOCs and the Government of Afghanistan has been unclear in terms of subsidies, payment arrears, and payment of taxes (WBG 2013).

## CHAPTER 2

# Bangladesh

## SOE Sector

### Evolution of the SOE Sector and Reforms

**State-owned enterprises (SOEs) in Bangladesh emerged in the early 1970s following the country's independence and the pursuit of a state-driven industrial policy.** Upon independence in 1971, the Government of Bangladesh took over enterprises that were active in a wide range of economic sectors, including banking, commerce, and manufacturing (Akram 1999). In addition, the Industrial Enterprises Nationalization Order of 1972 restricted private sector ownership in the industrial sector to enterprises valued below BDT 1.5 million (USD 187,500).<sup>29</sup> As a result, by 1975 the state came to control hundreds of enterprises and around 90 percent of the country's total industrial capacity (Ahmed 2000).

**The switch to a market-oriented economic policy resulted in extensive divestments in the SOE sector.** This trend continued into the 1990s, when the government established a Privatization Board with the rationale of reducing the state's liabilities, as many SOEs at that time were loss-making

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29 At that time, the exchange rate ranged between BDT 7.5 and BDT 8 to the US dollar.

and relied on budgetary support and soft loans from state-owned banks. In 2001, the government complemented its privatization policy with a voluntary redundancy program, which provided more than 57,000 SOE staff with severance packages to cushion the social and political impact of privatization.

**The economic impact of the privatization process fell short of expectations, however.** In many cases, the new owners of privatized enterprises sold their most valuable assets, most notably land, almost immediately upon gaining control of the enterprise. The privatization process also attracted criticism on the grounds that some viable SOEs were reportedly sold below their estimated value. In addition, some privatization initiatives had an adverse impact on public finances—for example, the abortive attempt to privatize Rupali Bank.<sup>30</sup>

**The mixed results of privatization prompted a reconsideration of government policy and a shift in focus toward improving the performance and oversight of existing SOEs.** Since 2009, successive governments have put further privatizations on hold and attempted to reduce SOEs' dependence on budgetary support and contingent liabilities. To this end, the government established an SOE Monitoring Cell and strengthened SOE corporate governance practices in key areas such as financial reporting, audit requirements, board procedures, and the introduction of annual performance agreements with some SOEs.

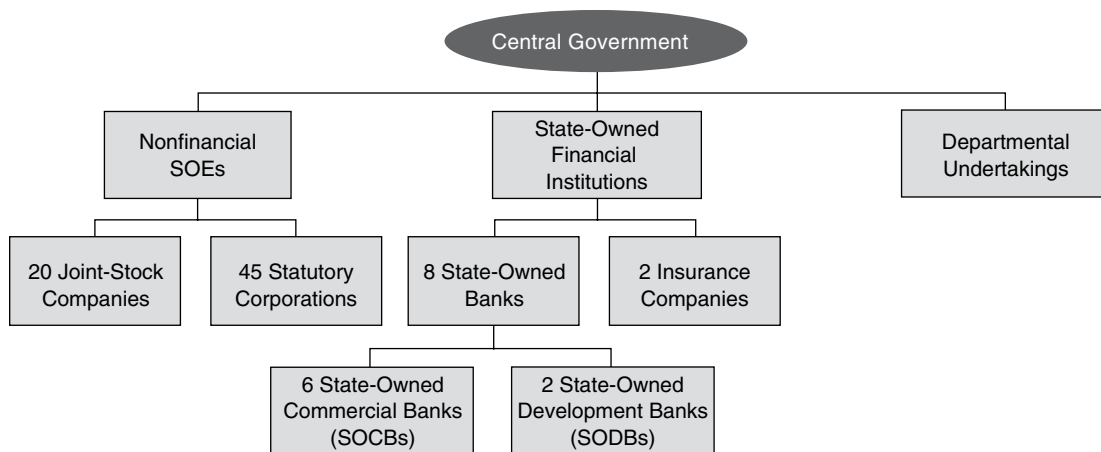
## **Economic Significance**

**As of 2017, Bangladesh has 65 key nonfinancial enterprises showing consolidated revenues of over 7 percent of gross domestic product (GDP).** Of these, 45 are “statutory corporations” and 20 are “joint-stock companies.” The statutory companies are 100 percent government-owned, while joint-stock companies are owned by multiple shareholders, with the majority of shares being held by the government in the case of SOEs. The parastatal sector also comprises a class of government entities known as “departmental undertakings,” which are not legally considered SOEs. They provide public services in monopoly sectors and collect revenues that are remitted directly into the government budget. In 2017, the largest departmental undertakings in the country were the railways, the postal service, and the state telecommunications company. Figure 6 provides an overview of the 65 SOEs.

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<sup>30</sup> Rupali Bank is the country's fourth largest commercial bank. The negotiating process for its privatization—which began in 2005, lasted three years, and ultimately failed—damaged the bank's financial position and increased the fiscal burden.

**FIGURE 6: Universe of the SOE Sector in Bangladesh**



Source: World Bank staff compilation based on Ministry of Finance (MOF) data.

**SOEs are active in most major sectors of the Bangladeshi economy, including public services such as energy, transport, telecommunications, and water and sanitation.** Despite several rounds of privatization, the state owns several SOEs that operate in commercial sectors. In 2015–16, statutory corporations and joint-stock companies generated BDT 1,366 billion<sup>31</sup> and BDT 186 billion in revenues, respectively. Nearly half of the revenues generated by statutory corporations were attributable to a few companies in the power and telecommunications sectors. In the same year, the joint-stock companies were dominated by the utility sector,<sup>32</sup> with revenues representing 88 percent of the total revenues of all joint-stock companies in Bangladesh. Figure 7 provides an overview of selected statutory corporations.

**SOEs are significant in the financial sector.** The state owns two development banks,<sup>33</sup> six commercial banks,<sup>34</sup> and two insurance companies. In 2014, state-owned banks (in particular commercial banks) accounted for almost one-third of the financial system’s total assets (Bangladesh Bank, 2015; IMF 2015). In 2015–16, the total deposits and total loans of the six

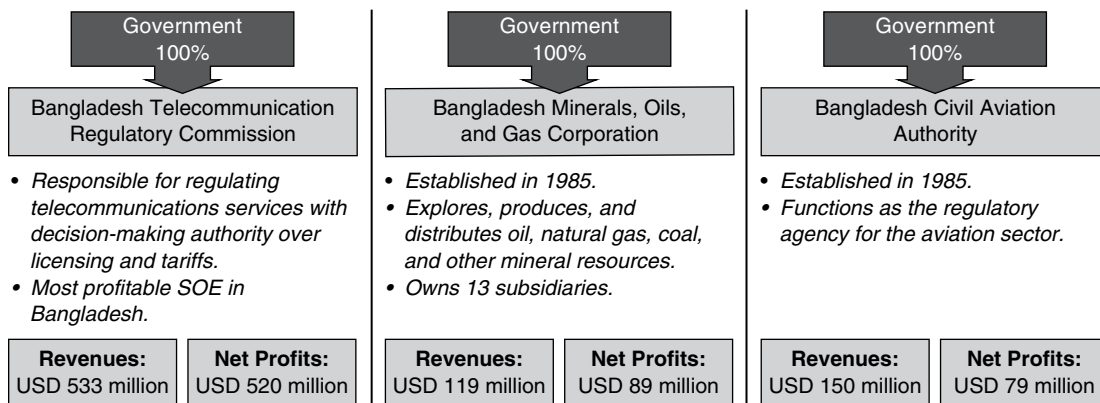
31 This figure includes the revenues of subsidiaries of statutory corporations. The 45 major corporations have 252 units and mills, for a combined total of close to 300 entities.

32 Utility includes power, gas, and water.

33 Bangladesh Krishi Bank and Rajshahi Krishi Unnayan Bank.

34 Sonali Bank Limited, Rupali Bank Limited, Agrani Bank Limited, Janata Bank Limited (JBL), BASIC Bank Limited, and Bangladesh Development Bank Limited.

**FIGURE 7: Selected Statutory Corporations in Bangladesh, 2015–16**



Source: World Bank staff compilation based on SOE websites and MOF report.

commercial banks amounted to BDT 2,137 billion (USD 27 billion) and BDT 1,362 billion (USD 17 billion), respectively.

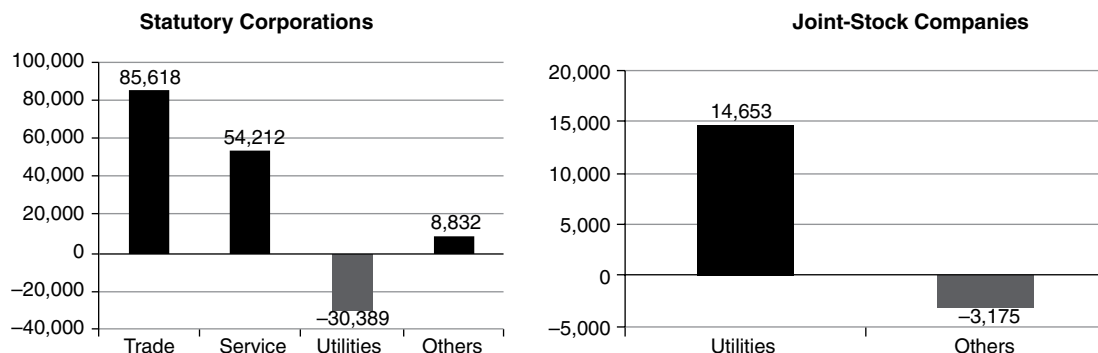
**Eighteen SOEs are currently listed on the Dhaka Stock Exchange, and many operate as subsidiaries of larger SOEs.** Listed SOEs include both financial and nonfinancial SOEs, all of which are required to comply with the rules and regulations put forward by the Bangladesh Securities and Exchange Commission (SEC). Several listed SOEs are subsidiaries of larger state enterprises. For example, Eastern Lubricants, Meghna Petroleum Limited, Padma Oil Company Limited, and Jamuna Oil Company Limited are all subsidiaries of Bangladesh Petroleum Corporation.

### Macro-Fiscal and Service Delivery Implications

**In FY2015–16, the combined profits of statutory corporations and joint-stock companies amounted to 6 percent of government revenues.** In FY2015–16, the SOE sector reported an overall profit of nearly BDT 130 billion (around USD 1.6 billion). Statutory corporations were particularly profitable, with profits growing by a factor of 1.6 from BDT 46 billion in 2014–15 to BDT 115 billion in 2015–16.<sup>35</sup> In the same year, the sector contributed BDT 63 billion (around USD 800 million) in dividends to the budget. Most of these dividends (BDT 60 billion) were attributable to the statutory corporations. The performance of SOEs in the utility sector was mixed; while the

35 These figures include subsidiaries.

**FIGURE 8: SOE Sector Profitability by Type of Company (BDT millions), 2015–16**



Source: World Bank staff compilation based on People’s Republic of Bangladesh, MOF (2017); People’s Republic of Bangladesh, MOF (2017) (for statutory corporations); and audited financial statements (for joint-stock companies).

Note: Utilities include power, gas, and water.

seven utilities organized as joint-stock companies were highly profitable, the five that were organized as statutory corporations generated losses.<sup>36</sup>

**Statutory corporations remain dependent on financial support from the government.** SOEs that are active in the water sector are the largest beneficiaries of government support. In FY2015–16, subsidies to 11 SOEs amounted to BDT 17 billion (around USD 208 million). Three water resource management companies—namely the Bangladesh Water Development Board, the Bangladesh Agricultural Development Corporation, and the Bangladesh Inland Water Transport Authority—absorbed most of the subsidies allocated to the SOE sector, as illustrated in Box 13.

**In addition to direct subsidies, the government has issued sovereign debt and debt guarantees to support statutory corporations financially.** On the one hand, the stock of debt-service liabilities issued to finance statutory corporations reached BDT 2,197 billion in 2015–16. On the other, government debt guarantees stood at 3.9 percent of GDP in FY2014–15. Energy-sector SOEs have been the main beneficiaries of government guarantees, followed by SOEs in industrial activities such as chemicals, manufacturing, textiles, and agri-processing.

**State-owned banks play a critical role in providing access to banking services for the population, but they represent a source of contingent liabilities for the government.** The eight state-owned banks in Bangladesh

<sup>36</sup> While the utility sector used to be predominated by statutory corporations, the sector was opened to private participation starting in 1996 to meet growing demand. Today, the utility sector includes seven joint-stock corporations that are highly profitable, with profits of BDT 15 billion, or USD 185 million in 2015–16 (Figure 8).



**BOX 13****Subsidies to Statutory Corporations**

Name	Amount (BDT millions)
Bangladesh Water Development Board	8,916
Bangladesh Agriculture Development Corporation	3,123
Bangladesh Inland Water Transport Authority	2,744
Bangladesh Small and Cottage Industries Corporation	1,157
Others	1,128
<b>TOTAL</b>	<b>17,066</b>

Source: World Bank staff compilation based on MOF (2017).

have large branch networks, especially in rural areas (where over 70 percent of their branches can be found), and they account for approximately 30 percent of total deposits from the banking sector (Sohel 2016). At the same time, state-owned banks have much higher levels of nonperforming loans than private banks, a negative return on assets, and inadequate capitalization (IMF 2015). In 2013, the government injected BDT 41 billion (around 0.4 percent of GDP) for the recapitalization of four state-owned commercial banks (IMF 2014).

**SOEs are key contributors in the delivery of critical services in Bangladesh, and they play an important role in shaping the country's economic development.** SOEs implement government policies and deliver essential services in core sectors of the economy, such as providing utilities to residential and commercial customers and ensuring national fuel security. Selected SOEs are at the center of economic development efforts, such as ramping up electricity generation and improving water resource development to increase agricultural productivity and promote greater food production.

**As is the case in other developing countries, however, SOEs in Bangladesh face service delivery challenges.** For example, despite extensive efforts by SOEs to promote development, 20 percent of the population in Bangladesh lacked access to electricity in 2016 (BPDB 2017). High production costs, reduced external competitiveness, and constrained investment are among the main factors behind low energy consumption in Bangladesh.

Frequent and serious electricity disruptions can cause significant productivity reductions in both industrial and agricultural production.

## Corporate Governance

### Legal Framework

**In Bangladesh, SOEs are defined as entities formed under specific legal proceedings<sup>37</sup> that are owned wholly or partially by the government.**

SOEs are involved in the production of marketable goods and services, have an explicit or extractable budget, and are supposed to finance their own operating costs. They can be governed by the corporate legal code and regulatory agencies, and usually adopt one of three organizational structures: statutory corporation, joint-stock company, or departmental undertaking.<sup>38</sup>

**Statutory corporations are enterprises that engage in economic or manufacturing activities and are set up under a specific act of Parliament.** These corporations are legal entities, separate from the government. Bangladesh Bank, the state-owned insurance companies, and Biman Bangladesh Airlines are examples of statutory corporations. Shares of such corporations are issued in the name of the state of Bangladesh and thus owned and controlled by the government. Statutory corporations enjoy extensive legal autonomy, and their rules, objectives, functions, and duties are defined and specified in their respective acts.

**Joint-stock companies are set up under the provisions of the Companies Act, and are typically linked to commercial objectives.** These SOEs are independent from day-to-day control by their parent ministry, and enjoy a high level of budgetary autonomy. Joint-stock companies are overseen by their respective boards of directors, and are subject to audit and other provisions of the Companies Act. The distinctive feature of a government-controlled joint-stock company is that the government usually finances their capital in full. Such companies are therefore wholly autonomous and make their own rules and decisions with respect to investments,

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<sup>37</sup> SOEs in Bangladesh are governed either by the Companies Act or by specific constituent acts. Currently, 46 enterprises have been set up through specific statutes, while 21 have been corporatized under the Companies Act of 1994.

<sup>38</sup> Departmental undertakings are set up by the executive actions of government bodies, without an independent budget, and charged with the duty of carrying out specially defined functions. As such, they are not considered SOEs in a strict sense and are not included in the present analysis.

finances, personnel, and commercial audits. Bangladesh Shilpa Bank, Bangladesh Shilpa Rin Sangstha, Bangladesh Krishi Bank, and nationalized commercial banks are examples of SOEs in the form of joint-stock companies in Bangladesh.

**The Dhaka Stock Exchange regulates listed companies, including listed SOEs, while the Securities and Exchange Commission issues several important regulations to which these companies must adhere.**

Companies that are listed on the exchange include both financial and nonfinancial SOEs, all of which are required to comply with SEC notifications comprising a set of clear rules and conditions related to the size of SOE boards, the independence and qualifications of directors, and the establishment of an audit committee. The SEC is also responsible for issuing key regulations, including the 2012 Guidelines on Corporate Governance. These guidelines cover topics such as the functioning of the board, and internal and external controls. However, they do not encompass other aspects of corporate governance, including shareholder rights, and compliance is only partial.

**The Bank Company Act of 1991, last amended in 2017, provides the legal framework for state-owned commercial banks (SOCB).** The central bank, Bangladesh Bank, regulates the financial sector under the 1991 Bank Company Act and the 1993 Financial Institution Act, and issued Prudential Regulations on Corporate Governance for Banks in 2003. The revised Bank Company Act<sup>39</sup> enhanced Bangladesh Bank's authority over SOCBs and clarified the bank's legal responsibilities. SOCBs are now under partial regulatory and supervisory control of the bank, which still lacks full authority over SOCBs.

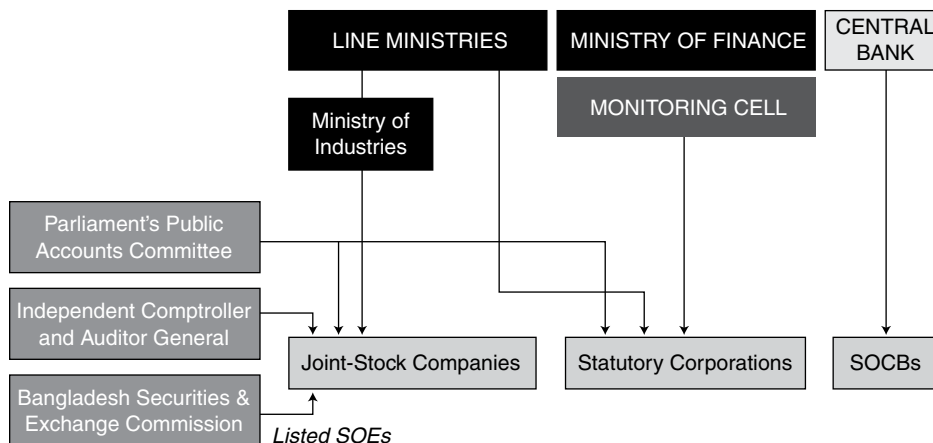
## **Ownership Arrangements**

**The government's SOE ownership function is largely decentralized across ministries.** Bangladesh follows a decentralized ownership model for SOEs, with many line ministries exercising ownership functions, such as performance monitoring and oversight and the nomination of boards of directors. According to Article 13 of the Constitution, state ownership is to be exercised "on behalf of the people through the creation of efficient and dynamic enterprises in key sectors of the economy" (OECD 2008). In several

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<sup>39</sup> The Bank Company Act 1991 was recently amended with effect from 28 January 2018 to allow four members of a family to be directors and for a director to be appointed for a tenure of nine years (three consecutive terms for three years).

**FIGURE 9: The Ownership and Oversight Function in Bangladesh**



Source: World Bank staff compilation.

cases, the ownership function remains intertwined with policy making and regulatory functions.

**The Ministry of Finance (MOF) exerts financial oversight over 45 SOEs through its SOE “Monitoring Cell” in the Finance Division.** The SOE Monitoring Cell focuses on compliance with the legislative framework and financial management, including reviewing and controlling SOE budgets and providing financial oversight for statutory SOEs, but not for SOEs established under the Companies Act. The SOE Wing operates as the administrative arm of the Monitoring Cell. While budgets are reviewed by the Monitoring Cell, financial reporting to the Cell is not analyzed systematically for discrepancies against the approved SOE budget. Other units of the MOF, such as the Debt Wing and the National Board of Revenue, are also involved.

**The Ministry of Industries is responsible for overseeing 10 key SOEs.** The Ministry of Industries has historically played a crucial role in the oversight of industrial companies in Bangladesh. Despite the privatization of many SOEs, the ministry remains critically important, with ownership responsibilities regarding 10 large-scale and strategic SOEs, including Bangladesh Sugar and Food Industries Corporation, Bangladesh Steel and Engineering Corporation, and Bangladesh Chemical Industries Corporation.

**Other line ministries take broad responsibility for government ownership, including financial oversight and policy direction.** Statutory SOEs often function as extensions of the portfolio ministry that provides policy (and in many cases regulatory) oversight. The ministry involved in the economic sector where the SOE operates provides policy supervision, as

well as regulatory oversight in sectors where a regulator has not yet been established (WBG 2016). Four line ministries—Textiles and Jute; Power, Energy, and Mineral Resources; Civil Aviation and Tourism; and Shipping—play a major role in terms of the number and relevance of SOEs under their oversight. Other ministries also exercise important responsibilities with a direct impact on SOEs. For example, the Ministry of Public Administration controls, at least partially, the appointment of chief executive officers and directors; the Ministry of Labor and Employment controls the Wage Commission;<sup>40</sup> and the Ministry of Commerce oversees company law and insurance (Bangladesh Enterprise Institute 2010).<sup>41</sup>

## Performance Monitoring

**The government developed a performance monitoring system decades ago, but implementation remains a challenge.** Performance monitoring tools have been used rarely since their introduction in 1985. Performance agreements signed by both SOE management and the relevant sector

### BOX 14

#### Performance Monitoring in Bangladesh

<b>Tools</b>	Performance contracts (Annual Performance Agreements)
<b>Scope</b>	Not publicly available
<b>Timespan</b>	Annually
<b>Indicators</b>	<ul style="list-style-type: none"> <li>• Strategic objectives (department-related, based on the SOE's core operational area)</li> <li>• Mandatory strategic objectives (consistent across all SOEs):             <ol style="list-style-type: none"> <li>1. Improvement of financial management</li> <li>2. Improvement of service delivery</li> <li>3. Improvement in governance</li> </ol> </li> </ul>

Source: World Bank staff compilation based on interviews.

40 The Wage Commission is responsible for the wages and salaries of officers employed in SOEs.

41 Other agencies involved include the Procurement Office, the Ministry of Public Administration, the Bangladesh Telecommunication Regulatory Commission, the Bangladesh Energy Regulatory Commission, and legislative bodies (such as the Public Accounts Committee and Public Undertaking Committee).

ministry, which involved an analysis of the enterprise’s objectives and the negotiation of targets with the concerned ministries and committees, were established to facilitate follow-up on performance. In practice, however, only SOEs that have generated “exceptionally good revenue” were included in the category of contract-signing enterprises, and implementation was below expectations.

**In 2015, the government introduced the use of Annual Performance Agreements (APAs).** Since then, 42 SOEs have signed APAs with the government. These APAs are based on a transfer of knowledge from India’s Memoranda of Understanding (bilateral performance agreements) and are expected to increase SOE accountability and improve performance. Under this scheme, individual SOEs sign an APA with their respective line ministries on specific targets and objectives. The line ministries in turn sign an agreement with the Cabinet that includes among its objectives the performance of SOEs under that particular ministry. The focus is on achieving financial objectives to alleviate the SOE sector’s continued dependence on the central government and on financing from state-owned banks. The APAs scheme is in its early stages, and progress in monitoring and reviewing APAs is difficult to assess, given that information on their implementation is not available publicly. If successful, however, it is expected to improve SOE performance.

## **Board of Directors**

**SOE boards comprise seven to thirteen members, on average.** For non-listed SOEs, board processes are not well defined, although the Companies Act and Bangladesh Bank’s regulations generally provide a framework without specific instructions on nomination of directors. Statutes spell out the powers of the board but are sometimes influenced by the respective ministry. For listed companies, the SEC has formulated guidelines on board composition. The guidelines refer to the size of the board (five to 20 members), recommend the appointment of independent directors—who are intended to comprise at least one-fifth of the total number and to be knowledgeable in a specific field, suggest that board chair and CEO positions be filled by different individuals, and note that directors should report to shareholders (Box 15).

**There are no specific rules or policy guidelines for nominating the directors of SOE boards, and line ministries are usually involved in the nomination.** Although the government has sought to increase its emphasis on appointing independent directors to SOEs to improve the governance

## BOX 15

### Board Features in Bangladesh

**Nomination of board members:** No specific rules or policy guidelines for nomination; nomination and appointments are political.

**Nomination of SOE board chair:** No specific rules or policy guidelines for nomination at this time; nomination and appointments are political.

**Nomination of Chief Executive Officer (CEO):** No specific rules or policy guidelines for nomination at this time; nomination and appointments are political.

**Mandate of the board:** The primary mandate of the SOE boards is to turn around the performance of poorly performing SOEs, and to provide general direction to and administration of the corporation's officers and business.

**Separation between board chair and CEO:** Roles of board chair and CEO to be held by different individuals is recommended.

**Composition of the board:** The existing recommendation regarding the ideal size of the board is 5–20 members, with independent directors comprising at least one-fifth of the total number. This recommendation is imposed on a “compliance basis.” In practice, SOE boards comprise 7–13 members. The revised Bank Company Act allows for longer tenure and four members of a family to be directors.

**Structure of the board:** Single unitary body.

**Profile of board members:** Civil service and private sector.

**Board committees:** Most SOEs have at least an audit committee, staff promotion committee, and a procurement committee.

**Remuneration of CEO and board members:** With few exceptions, most members of the board of directors receive remuneration on the basis of government pay scales. Nonexecutive directors receive only a fee for attending the board meeting.

*Source:* World Bank staff compilation based on interviews and regulations.

framework (PRB 2010), line ministries typically nominate board members. Most SOE board members are senior public officials, ministers, and other high-level authorities, and directors are sometimes appointed directly by the prime minister. CEO and board chair positions are filled mostly by civil servants selected by the Civil Service Commission.

**Frequent turnover among SOE board members affects board effectiveness.** Many board members serve *ex officio*, or by virtue of holding another position in the public sector. When these board members are transferred or give up their main position, they also give up their role on the SOE board, and proper board functioning is disrupted. Only a few SOE boards have one to two directors from the private sector with industry experience, and the lack of expertise in key business areas presents a challenge.

**In the financial sector, the Bangladesh Bank issued guidelines in 2010 to further reform the boards of SOCBs, including guidelines on board nomination.** The guidelines include “Fit and Proper Test Criteria” for the nomination of directors, detailing their responsibilities, powers, and suitability for the position. The criteria are somewhat lenient, however, and have yet to be implemented fully. While these standards could be improved to apply to all board members, rather than only to selected candidates, they have been followed strictly in the selection of CEOs and Managing Directors of SOCBs. Furthermore, the MOF’s Financial Institutions Division decided to nominate retired civil servants to chair SOCB boards to reduce political influence (WBG 2015b).

## Transparency and Disclosure

**The SOE Monitoring Cell delivers an aggregated annual financial report that includes some statutory SOEs.** Year-end financial reports are submitted by some statutory SOEs to the MOF, which then prepares an aggregate report analyzing profit-and-loss statements, contribution to government revenue, government grants and subsidies, bank loans, debt service liabilities, and SOE sector financial performance (OECD 2008). This aggregated report is generally attached as a supplementary document to the National Budget and analyzed in the Bangladesh Economic Review. However, information provided by the Monitoring Cell is not used effectively in government decision making relevant to SOEs, including in budget deliberations (Box 16).

**Although six regulators play a role in monitoring and enforcing financial reporting, noncompliance is common (WBG 2015b).** While SOEs’ annual audited financial statements must be published, in many cases



## BOX 16

### Transparency and Disclosure Practices in Bangladesh

**Accounting standards:** Bangladesh Accounting Standards (specifically BAS 30)

**Transmission of financial and activity reports by SOEs:** Reports are submitted by the SOEs to MOF.

**Aggregated reports:** MOF prepares an aggregated report covering statutory SOEs, which is generally attached as a supplementary document to the National Budget.

**Disclosure:** Larger SOEs publish financial statements on their websites.<sup>42</sup> Smaller SOEs do not seem to publish financial statements publicly, and their disclosure could be more timely, comprehensive, and frequent.

**External audit:** Comptroller and Auditor General of Bangladesh.

*Source:* World Bank staff compilation based on interviews.

they are behind schedule and compliance is only partial. Furthermore, there are no statutory requirements for SOEs to comply with International Financial Reporting Standards or International Public Sector Auditing Standards.<sup>43</sup> The information system and the templates used by the Monitoring Cell for income statements, balance sheets, and cash flow statements (System for Autonomous Bodies Reporting and Evaluation) to collect SOE financial information do not conform to the Bangladesh Financial Reporting Standards. As a result, there is a wide variation in SOE financial reporting practices. Regulatory authorities are concerned primarily with reviewing the entities' budgets and receiving periodic nonfinancial reports to assess performance. Overall, there is a need for improvement in the quality of

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42 Some large-scale SOEs provide comprehensive online information through their respective websites, including financial statements, audit reports, and, in some cases, nonfinancial reporting. See <http://www.caab.gov.bd/> in the case of the Civil Aviation Authority of Bangladesh and <http://www.petrobangla.org.bd/> in the case of the Bangladesh Oil, Gas, and Mineral Corporation.

43 In addition, there are government business enterprises that do not receive government financial support for day-to-day operations, but may require interim support such as a working capital loan. Their financial systems are outside the government's accounting system and not subject to any reporting standards.

financial reporting to ensure accountability in the use of public resources. While companies are required by the Companies Act of 1994 to file audited financial statements, noncompliance is common (WBG 2015b).

**SOE external audits are carried out, in most cases, by the auditor general and are frequently affected by capacity constraints.** SOEs are audited annually by the Office of the Comptroller and Auditor General.<sup>44</sup> External audits for listed SOEs tend to be relatively thorough, as the Bangladesh SEC has full authority to monitor and enforce financial reporting in these cases. For nonlisted SOEs, though, audit procedures are less strict. While the auditor general assigns an auditor to these SOEs, the audit process is usually hampered by insufficient information, late submission of financial statements, and other limiting factors. Some SOEs are also audited by private sector firms, but based on national accounting standards. In addition, internal audit processes for SOEs represent another challenge, as well-trained and skilled auditors frequently choose to work in the private sector where remuneration tends to be higher.

**Reporting and disclosure practices for financial SOEs (SOCBs) are incomplete.** Many SOCBs have limited business processes, inadequate accounting and auditing practices, limited compliance procedures, and low levels of financial and nonfinancial disclosure. Compliance with financial statement reporting formats and disclosures, found in the Bank Companies Act and Bangladesh Accounting Standards (specifically BAS 30), varies by bank (WBG 2015b).

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<sup>44</sup> SOE auditing arrangements are mandated under different statutes. In general, external audits are conducted by two sets of auditors: the Office of the Comptroller and Auditor General and a Chartered Accountants firm appointed by SOE management.



## CHAPTER 3

# Bhutan

## SOE Sector

### Evolution of SOE Sector and Reforms

**The Royal Government of Bhutan (RGOB) established state-owned enterprises (SOEs) in the 1960s to provide infrastructure and public services (WBG 2007).** As Bhutan opened its economy, the government took a leading role in the provision of basic goods and social services. With a small population and mountainous geography, infrastructure was costly and economies of scale in service provision were difficult to achieve. In this context, the private sector was not able to deliver critical services, and the state therefore took on a central role in economic development.

**From the outset, the RGOB's development strategy balanced material wealth with cultural traditions and the environment.** The Bank of Bhutan was the first SOE in the country, operating as both commercial bank and central bank until the establishment of the Royal Monetary Authority in 1982.<sup>45</sup> By the 1970s, SOEs had taken on a prominent role in economic development with the establishment of the Food Corporation of Bhutan and

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45 See Bank of Bhutan, <http://www.bob.bt/about-us/> (accessed February 16, 2018).

Penden Cement Authority. In the 1980s, the RGOB used foreign financing to establish resource-based SOEs in industries such as hydropower, forestry, and mining.

**The RGOB began promoting private sector development during the 1990s.** In the early 1990s, economic growth slowed and policy shifted to partial privatization of state-owned businesses to stimulate growth. The government divested from its equity holdings, corporatized a number of enterprises, and encouraged private sector development. In fact, some of the largest private companies currently operating in Bhutan started as public entities, including Bhutan Carbide and Chemicals Limited. Despite these initiatives, Bhutan's private sector has remained relatively small as compared to regional and international standards.

**The government modified its ownership policy by establishing Druk Holding and Investments (DHI) in 2007.** Acting as the commercial arm of the RGOB, DHI's mandate is "to hold and manage the existing and future investments of the Royal Government for the long-term benefit of the people of Bhutan."<sup>46</sup> The objectives of state ownership are to accelerate socioeconomic development; achieve the goals of "gross national happiness;"<sup>47</sup> safeguard and enhance national wealth; and build a strong economy, enhance international economic partnerships, and prevent corruption (DHI 2008).

## **Economic Significance**

**There were 33 SOEs in Bhutan in 2016.**<sup>48</sup> These SOEs can be grouped into two broad categories: commercially oriented SOEs and socially oriented SOEs. Commercially oriented SOEs are held indirectly by the government through DHI, whereas socially oriented SOEs are held directly by the Ministry of Finance.<sup>49</sup> Autonomous bodies and agencies such as the Gross National Happiness Commission and the Dzongkha Development Commission fall under the central government. There are no SOEs linked to subnational levels of government in Bhutan.

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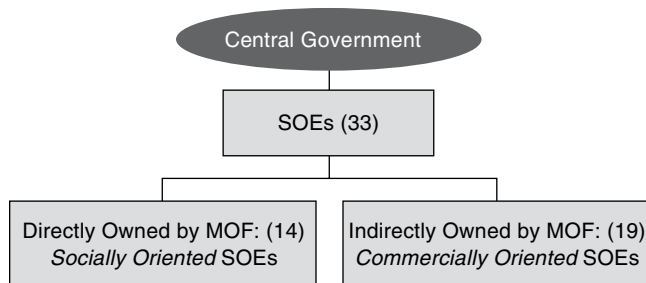
<sup>46</sup> See DHI, <http://www.dhi.bt/company-profile> (accessed February 16, 2018).

<sup>47</sup> According to the Gross National Happiness Centre of Bhutan, gross national happiness is defined as "a holistic and sustainable approach to development, which balances material and nonmaterial values with the conviction that humans want to search for happiness." The objective is to achieve balanced development.

<sup>48</sup> Two new SOEs were established in 2017: the Bhutan Livestock Development Corporation and Menjong Sorig Pharmaceutical Corporation Ltd. Financial information for these entities is not available and therefore not included in the stocktaking.

<sup>49</sup> See the section on the legal framework for more details.

**FIGURE 10: Universe of the SOE Sector in Bhutan**

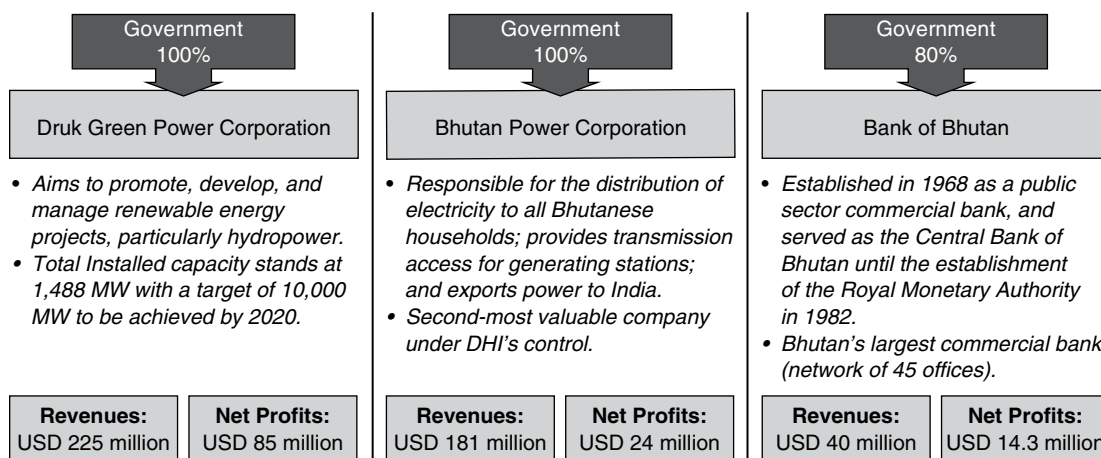


Source: World Bank staff compilation.

**Bhutan’s economy is significantly driven by SOEs.** The consolidated gross revenues of SOEs accounted for BTN 60.67 billion (USD 932 million, or 43 percent of gross domestic product, or GDP) and total profits before tax reached BTN 15.16 billion (USD 233 million, or 10.7 percent of GDP) in 2016. Total SOE assets exceeded BTN 240 billion (USD 3.69 billion) in the same year. Figure 11 presents key statistics and summarizes the primary activities of the three largest SOEs in Bhutan, as measured by their annual revenues in 2016.

**Bhutan’s SOEs are concentrated in energy and financial services.** SOEs operate in key strategic areas, including energy, banking, manufacturing, and telecommunications. The financial services and energy sectors are particularly significant for Bhutan’s economy, with assets representing

**FIGURE 11: Selected Large-Scale SOEs in Bhutan, 2016**



Source: World Bank staff compilation based on DHI and SOEs’ websites. Exchange rate: 1 USD = 65.11 Bhutanese ngultrum.

almost 50 percent (financial services) and 34 percent (hydropower) of total SOE assets, respectively (MOF 2017).

**Socially oriented SOEs with nonfinancial objectives are held directly by the Ministry of Finance.** The government directly holds shares in 14 SOEs whose main objective is the delivery of basic public goods and services. They operate under broad social mandates and primarily fulfill non-commercial social objectives. For example, the Bhutan Postal Corporation provides services to rural areas that are not covered by the private sector; and the Bhutan Development Bank was established with the social responsibility objective of providing low-interest loans to the rural population.

**Commercially oriented SOEs are held through DHI, a state-owned holding company.** Commercially oriented SOEs seek to maximize profits and represent more than 90 percent of the value of the government's SOE holdings. Five SOEs represent the majority of assets: Druk Green Power Corporation, Bhutan Power Corporation, Bank of Bhutan, Bhutan National Bank, and Bhutan Development Bank. In Bhutan, hydropower is a key strategic resource; while the country imports energy from India during the winter, it exports energy during the remaining seven to eight months of the year. The government has emphasized hydropower since the establishment of the Druk Green Power Corporation in 2008 (Box 17).

#### BOX 17

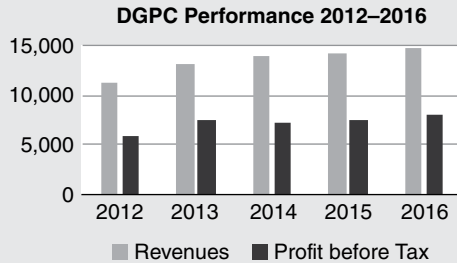
### **Hydropower Sector in Bhutan—Druk Green Power Corporation**

- The Druk Green Power Corporation (DGPC), established in 2008, is the only hydropower enterprise in Bhutan.
- Installed capacity: 1,480 MW in 2015, growing from 460 MW in 2008.
- Four hydropower plants operating under the corporation generated 7,573.8 million units of electricity in 2016.
- Net worth: BTN 44.4 billion (USD 682 million), representing 23 percent of all SOE assets.
- Expansion projects: PPP Project Dagachhu Hydroelectric Project in southwest Bhutan, and joint ventures/construction projects.

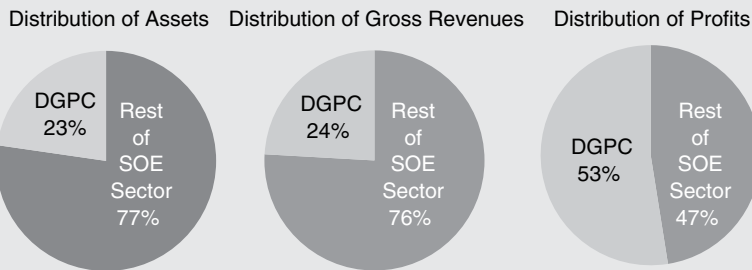
#### **Performance Highlights (2016):**

- Revenues account for 10 percent of GDP.
- Profits accounted for 19.79 percent of general government revenues, and 3.9 percent of GDP.

- Net energy exports to India: 5,373 million units in 2016 (90 percent of generation).
- Revenues have grown by 30 percent since 2011.



**DGPC within the SOE Sector in 2016**



Source: World Bank staff compilation based on MOF (2017); DGPC's website: <http://www.drukgreen.bt/>; and IMF (2017).

**SOEs in Bhutan are large employers, representing over 20 percent of total public sector employment.** Employment generation has been defined as a central policy objective of the RGOB, and SOEs have been used as a vehicle to create jobs.<sup>50</sup> In 2016, approximately 11,481 people were employed by SOEs, representing over 20 percent of total public sector employment—second only to the civil service—and 3 percent of overall employment in Bhutan (MOF 2017).

**In 2016, eight of the 21 companies listed on the Royal Securities Exchange of Bhutan were owned by the state.** Furthermore, the government's direct holdings in these companies represented almost 70 percent of the total market capitalization of the exchange (USD 345 billion) this year

<sup>50</sup> For example, the Thimphu Tech Park was developed not only to enhance information technology services throughout the country, but also to meet the challenge of youth unemployment. The Tech Park currently employs 700 Bhutanese, consisting primarily of young workers.



(Royal Securities Exchange of Bhutan 2016). Government ownership levels vary across listings, but the public sector holds a majority stake in Dungsam Polymers Ltd., the State Trading Corporation of Bhutan, and Kuensel Corporation.

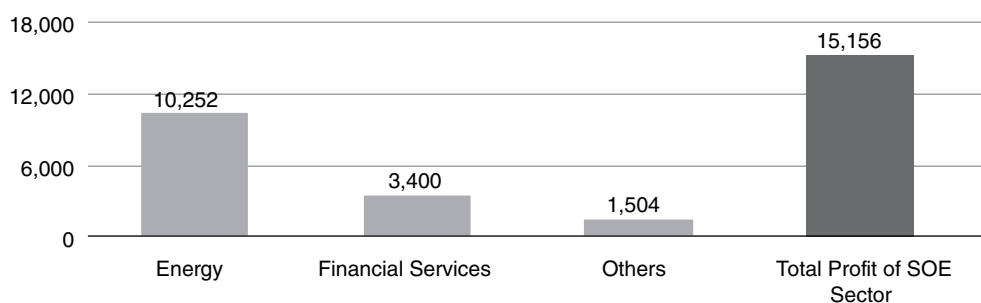
## Macro-Fiscal and Service Delivery Implications

**Most SOEs are profitable in Bhutan, showing strong financial performance.** SOEs reported an average growth in gross revenues of 12.85 percent in 2016, reaching total gross revenues of up to BTN 60.67 billion (USD 932 million). Pretax profits rose 13.3 percent from BTN 13.38 billion (USD 205 million) in 2015 to BTN 15.16 billion (USD 233 million) in 2016. A majority of SOEs were profitable in 2016, particularly in the energy and banking sectors (Figure 12).

**SOE profitability is driven significantly by SOEs operating in the energy and financial services sectors.** Approximately 43.5 percent of combined SOE gross revenues in 2016 came from only two companies: Druk Green Power Corporation and Bhutan Power Corporation Limited.<sup>51</sup> These two large-scale SOEs also recorded the highest profits during the year, followed by the Bank of Bhutan and Bhutan Telecom. In contrast, there were some loss-making SOEs during the same period—for example, Dungsam Cement Corporation, Construction Development Corporation, and Bhutan Broadcasting Limited.

**SOEs were expected to receive direct subsidies estimated at BTN 568 million in 2016, as well as indirect financial support.** Total subsidies

**FIGURE 12: SOE Sector—Pretax Profits, 2016 (BTN millions)**



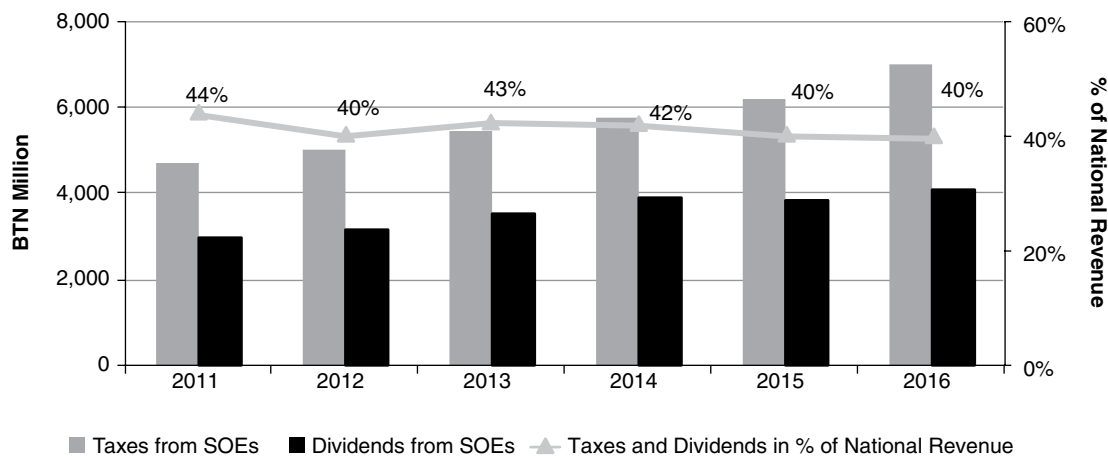
Source: World Bank staff compilation based on MOF (2017).

51 Nu. 14,624 million and Nu. 11,757 million, respectively.

allocated to SOEs in 2016–17 were estimated at BTN 568 million (USD 8.7 million), with BTN 230 million (USD 3.5 million) directed toward SOE interest subsidy expenses.<sup>52</sup> For some socially oriented SOEs, financial support is also given through exemptions and guarantees. Namely, Bhutan Broadcasting Service Corporation, Bhutan Development Bank, and the Thimphu Tech Park received a tax holiday in 2014 amounting to BTN 296 million (USD 4.5 million) (MOF DRC 2015). During the same period, government guarantees were given to Bhutan Development Bank and Bhutan Development Finance Corporation for rural credits and loans allocated to small and medium enterprises, totaling BTN 431.43 million (USD 6.6 million) (MOF DPA 2015).

**SOE taxes and dividends averaged 41 percent of total national revenues during 2011–2016.** In 2016, SOEs accounted for BTN 11.09 billion (USD 170 million) in taxes and dividends, or 40 percent of total domestic revenue (Figure 13). Druk Green Power Corporation was the largest contributor, accounting for 26 percent of total domestic revenue.

**FIGURE 13: Evolution of Tax and Dividend Payments from SOEs, 2011–2016**



Source: MOF (2017).

52 Subsidy payments during FY 2016–17 include: Bhutan Broadcasting Service Corporation (Nu. 191.65 million), Bhutan Postal Corporation Limited (Nu. 27.94 million), DrukAir Corporation (Nu. 165.679 million), Food Corporation of Bhutan (Nu. 5.25 million), National Housing Development Corporation (Nu. 63.8 million), Bhutan Telecom (Nu. 6.5 million), Thimphu Tech Park (Nu. 6.5 million), Royal Bhutan Lottery (Nu. 50 million), and Farm Machinery Corporation Ltd. (Nu. 50 million).

**SOE debt constituted around 18 percent of total public debt in 2016.**

Overall, total borrowing of SOEs and linked companies has declined by 4.36 percent from BTN 29,703 million (USD 456 million) in 2015 to BTN 28,407 million (USD 436 million) in 2016, which is mainly attributed to the reduction in Druk Green Power Corporation’s long-term borrowings. Meanwhile, Bhutan has several new hydropower projects under construction where the debt is estimated to be at least BTN 108.44 billion (USD 1.67 billion). The bulk of the debt pertains to ongoing hydropower projects which are under project authority and does not fall under the purview of the SOE.

**SOE service delivery has improved significantly over the past several years.** In the energy sector, Druk Green Power Corporation increased exports by 4.35 percent in 2016, while Bhutan Power Corporation achieved 99.5 percent electricity coverage in the country. In information technology and communication, Bhutan Telecom increased penetration of its services to reach 73 percent of Bhutan’s population.

## **Corporate Governance**

### **Legal Framework**

**In 2000, all SOEs were corporatized and classified as separate legal entities under the Companies Act.** Bhutan’s SOEs were each governed by their specific charters until the introduction of the Companies Act. This Act, introduced in 1989 and revised in 2000, governs all enterprises in Bhutan, including SOEs, both fully and partially state owned.<sup>53</sup>

**The Companies Act governs corporatization and corporate governance aspects for both private companies and SOEs.** It sets forth incorporation requirements, rules governing company share capital, disclosure standards, content of financial statements and audit reports, and shareholder rights and obligations. The Ministry of Trade and Industry is responsible for the enforcement of the Act and is empowered to give approval, sanction, consent, confirmation, direction, or exemption to companies. The Companies Act also includes specific clauses for SOEs. Article 134 gives the RGOB power to selectively apply the Act, stating that “the Government may, by general or special order, direct that any of the provisions of this Act shall not apply to a Government company or with such modification as deemed fit.”

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<sup>53</sup> According to this legislation, a company is “limited by shares incorporated and registered under the Companies Act of Bhutan, 2000.”

Additionally, Article 96 of the act allows the RGOB to merge two or more state-owned companies.

**The 2007 Public Finance Act specifies requirements for creating an SOE.** According to this legislation, the government may establish an SOE to undertake commercial activities under certain conditions: (i) if the activity is not catered for by the private sector; (ii) if the business should be undertaken for reasons of social policy or security; or (iii) if the activity could be categorized as a natural monopoly. The Act requires the Ministry of Finance (MOF) to report to Parliament on the performance of SOEs and their investments, including DHI and its subsidiaries. The Act, which was revised and updated in 2012, specifies procedures for divesting or privatizing SOEs, and empowers the MOF to regulate the prices of goods and services produced by SOEs operating as monopolies.

**SOEs owned by DHI are also governed under the Royal Charter of 2007, which outlines DHI’s ownership policy and establishes the legal framework for the relationship between DHI and the government.** According to the Charter, DHI’s mandate is “to promote the competitiveness of Bhutan’s economy by transforming companies with government shareholding into efficient and productive companies that strive for excellence.” DHI is required to complement the growth of a dynamic private sector by strengthening corporate governance, enhancing performance, and raising funds for investment. The Charter also outlines the governance structure of DHI, along with guidelines for the nomination, appointment, and removal of board members (DHI 2008).

**The Public Finance Act of 2007 and the Royal Charter of 2007 set reporting standards for SOEs.** In conjunction with the provisions of the Companies Act, Article 93 of the Public Finance Act requires that all state enterprises “shall prepare an annual report including audited financial statements.” Both laws require DHI to submit periodic reports on the performance of its portfolio to the MOF, while the Public Finance Act requires the MOF to report to Parliament on the entire SOE sector. The MOF is required to report on the performance of its investments, including any information on material losses, unauthorized or wasteful expenditures, and any disciplinary actions issued.

**The Corporate Governance Code provides a set of corporate governance guidelines for DHI-owned companies.** The Code, introduced in 2010 and updated in 2013, is one of DHI’s key initiatives for setting high corporate governance standards among its SOEs. The Code aligns with the OECD’s Principles of Corporate Governance, and therefore provides governance principles that encompass several categories, including the legal and regulatory framework, transparency and disclosure, and board responsibilities. The Corporate

Governance Code includes a board charter, an audit committee charter, and a code of conduct for directors and senior managers. SOEs under direct ownership of MOF are not subject to the Corporate Governance Code.

**Guidelines for SOE boards of directors were issued by the Ministry of Finance in 2004 (WBG 2007).** These guidelines apply to fully owned and majority-owned SOEs under direct ownership of the MOF—that is, socially oriented SOEs. They set procedures for the appointment and removal of SOE board members, list audit requirements, and establish standards for disclosure and transparency procedures. Additionally, provisions from the supplementary “Good Governance Plus” document stipulate that “the government should strictly implement Guidelines for the Boards of Government Corporations, and that the recruitment for government corporate boards shall be through open competition.” Implementation is not mandatory, however.

**Companies listed on the Royal Exchange of Bhutan must adhere to the Corporate Governance Regulations issued in 2011 by the Royal Monetary Authority of Bhutan (RMA).** The regulations were issued pursuant to Section 202 of the Financial Services Act of Bhutan of 2011 and the Companies Act of 2000 (RGOB RMA 2011). These Corporate Governance Regulations apply to all financial institutions licensed by the RMA, companies listed on the exchange (including SOEs), and any other licensee issued by the RMA. State banks, which are also regulated by the RMA, must abide by its Prudential Regulations, which include a provision stating explicitly that these banks are not allowed to provide preferential terms or subsidized loans to SOEs.

## Ownership Arrangements

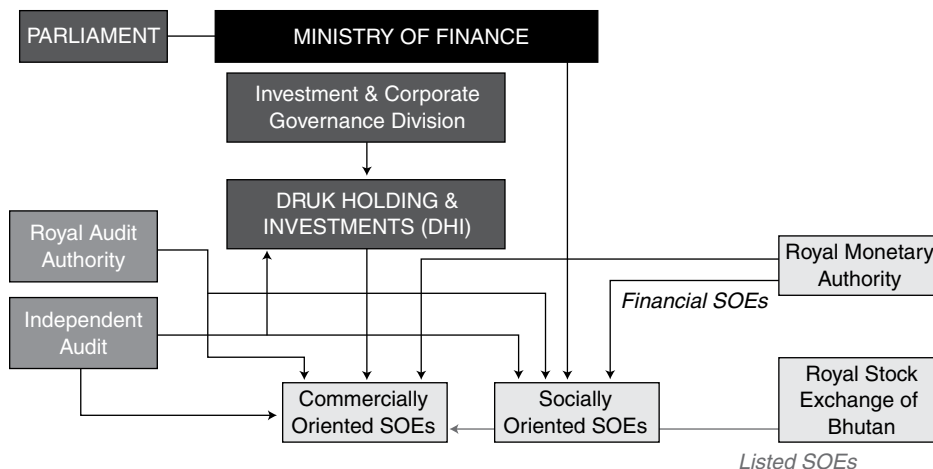
**Bhutan has a centralized model of SOE ownership.** MOF is the sole shareholder of DHI, the holding company that holds centralized ownership over its portfolio of SOEs. For SOEs not held under DHI, the MOF retains all ownership rights by holding share certificates on behalf of the state, attending shareholder meetings, and voting on RGOB shares. Figure 14 illustrates the ownership and oversight structure of the sector.

**The Investment and Corporate Governance Division (ICGD) of MOF, formerly known as the Public Enterprise Division, is responsible for the oversight of SOEs not held by DHI.** The ICGD, created in 2006, provides oversight management and ensures that SOEs adhere to the purpose of their establishment. The division, which is staffed by only three people,<sup>54</sup> is responsible for reviewing and reporting on SOE performance,

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54 Information collected during interviews, 2016 (SOE questionnaire).

**FIGURE 14: The Ownership and Oversight Function in Bhutan**



Source: World Bank staff compilation.

issuing corporate assessment guidelines with line ministries, and certifying that SOEs are managed efficiently (WBG 2007). ICGD responsibilities include developing recommendations related to the capital structure of SOEs, divestment and privatization, capital expenditures, and foreign equity participation in state-owned companies.

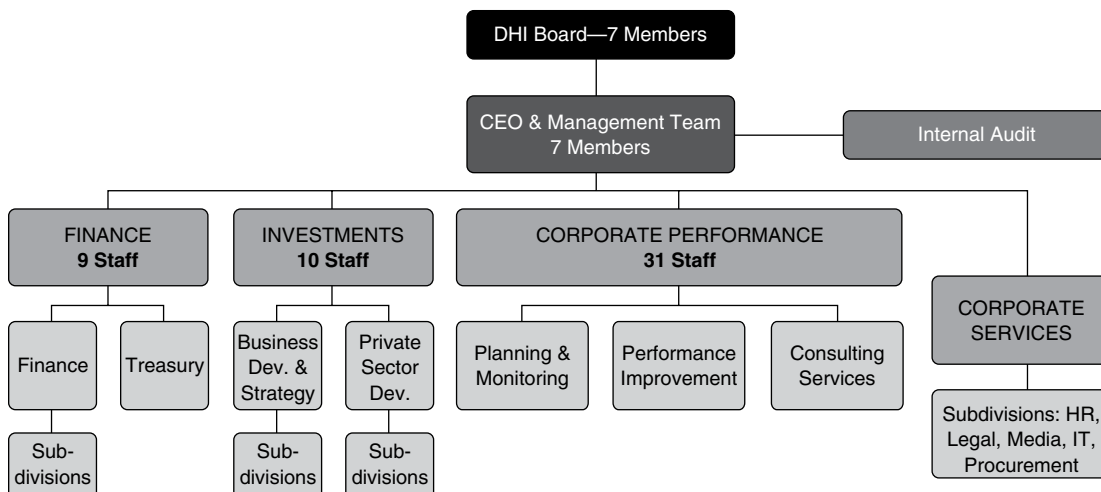
**DHI acts as a centralized ownership entity governed by a board of directors.** DHI was established as a government-owned holding company in 2007 with the mandate to maximize returns to its shareholder, the people of Bhutan, represented by the MOF. The holding company consists of three main divisions: finance, investments, and corporate performance. It currently has a staff of 60 employees in total (Figure 15). The corporate performance division is staffed by 31 employees, as DHI has placed an emphasis on improving the corporate governance of SOEs, which in turn has increased overall portfolio performance. The Chair of DHI is appointed by His Majesty the King, and other DHI board directors are selected by the Blue Ribbon Panel.<sup>55</sup> The chief executive officer (CEO) is appointed by the Board of DHI and is automatically designated as a board member.<sup>56</sup>

**DHI's Ownership Policy provides the framework for the governance and administration of companies under the holding's portfolio.** The

55 The Blue Ribbon Panel consists of the Chairperson, the Chairperson of the Royal Civil Service Commission, the Secretary of the MOF, the Secretary of the Ministry of Economic Affairs, and the Governor of the RMA.

56 The Chairman and CEO shall not be the same person.

**FIGURE 15: DHI Organizational Structure**



Source: DHI website, <http://www.dhi.bt/>.

Ownership Policy was first introduced in 2010 to fulfill the mandates laid out in the Royal Charter of 2007, and revised in 2012 to refine the ownership administration framework and incorporate new policy requirements. The policy articulates DHI’s expectations, policies, and functional relationships with regard to its companies, and defines DHI’s ownership function as it relates to its portfolio companies, which are commonly classified as follows: DHI-Owned Companies (DOCs), fully owned by DHI; DHI-Controlled Companies (DCCs), which are at least 50 percent DHI-owned; and DHI-Linked Companies (DLCs), which are less than 50 percent DHI-owned. In particular, DHI expects all DOCs and DCCs to fully apply and abide by provisions related to corporate governance, human resources administration and development, remuneration and employee benefits, selection and appointment of CEOs and board directors, and other policy requirements (DHI 2013a, c).

### **Performance Monitoring**

**DHI introduced a performance management system in 2008.**<sup>57</sup> The system was introduced through the signing of Annual Compact Agreements (ACAs), which are agreed between DHI, its portfolio companies, and the MOF. The system sets annual targets, reviews and evaluates performance,

<sup>57</sup> The system covers only commercially oriented SOEs, those that are owned by DHI.

**BOX 18**

**Performance Monitoring in Bhutan**

	<b>SOEs under DHI</b>	<b>SOEs under MOF</b>
<b>Tools</b>	Performance contracts denominated as Annual Compact Agreements (ACAs).	Except with DHI, no performance agreement with SOEs. Performance compact between SOE board and management is executed.
<b>Scope</b>	Number of SOEs covered: 21.	Only DHI.
<b>Timespan</b>	Annually.	Annually.
<b>Indicators</b>	<ul style="list-style-type: none"> <li>• Policy-directed key performance indicators (KPIs).</li> <li>• Performance measurement KPIs:               <ul style="list-style-type: none"> <li>– financial indicators (revenue, profit after tax, return on equity)</li> <li>– nonfinancial indicators (completion of project, customer care initiatives).</li> </ul> </li> <li>• Organizational management KPIs:               <ul style="list-style-type: none"> <li>– risk management</li> <li>– internal audit</li> <li>– information technology management</li> <li>– human resource management.</li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>• Policy-directed KPIs.</li> <li>• Financial indicators (revenue, profit after tax, return on equity).</li> <li>• Nonfinancial indicators (socioeconomic benefits and achievement of social mandates).</li> <li>• Risk management; statutory audit, internal audit; human resource management.</li> </ul>
<b>Reporting</b>	Quarterly reports.	Financial indicators quarterly.

*Source: World Bank staff compilation based on interviews.*

and links performance indicators to corporate governance incentives for DHI-owned companies. These agreements allow performance monitoring by developing clearly measurable targets to be accomplished during the year (Box 18).

**In developing an ACA, the MOF and DHI first negotiate performance benchmarks.** These benchmarks are negotiated based on past trends of each SOE’s performance and on expectations of changes in economic



conditions. After the MOF consults with relevant line ministries, it submits financial and nonfinancial targets to the RGOB for consideration. At this stage, other important negotiations are finalized, including an agreement on annual dividend payments from DHI to the MOF (DHI 2012a).

**DHI portfolio companies then sign ACAs with DHI, based on key performance indicators (KPIs).** ACAs are discussed at the SOE management and board levels prior to submission to the DHI secretariat. They are then signed by the DHI and SOE boards and are aligned closely with their three- to five-year strategic plans. KPIs measure performance in four areas: financial, customer service, corporate governance, and RGOB policy (OECD 2015). They are grouped into three categories: policy-directed indicators, performance measurement indicators, and organizational management indicators. Policy-directed indicators are imposed, either implicitly or explicitly, by the government through DHI and are essentially “social obligations.” Performance measurement indicators include financial and nonfinancial indicators, although the primary focus is on measuring financial performance. Finally, organizational management indicators are standardized across all DHI-owned SOEs on the basis of predefined key organizational management areas, and as such they do not require annual negotiation of specific targets.

**The weight assigned to each of the three KPI categories can be negotiated, although the emphasis is placed on financial indicators.** In principle, the greatest weight (between 50 and 70 percent) is assigned to financial indicators, as they are considered to be the most important to DHI’s overall objectives and are easier to measure and verify. A weight of around 10 percent is given, in most cases, to organizational management indicators, which serve as a way of alerting SOEs of their managerial deficiencies. The remaining weight (between 20 and 40 percent) is distributed between nonfinancial and policy-directed indicators.

**DHI has developed a performance-based incentive system to link bonus payments to the achievement of targets.** Corporate-level compacts, once signed with the DHI, cascade down to the departmental/division/unit and individual levels to monitor the company’s performance at each level. CEOs from DHI-owned SOEs receive a performance-based variable allowance (PBVA) based on a performance rating carried out by the board (20 percent) and based on the company’s achievement (80 percent) against its ACA. If 95 percent or more of the targets are met, the full PBVA is rewarded.<sup>58</sup> If 75 to 95 percent of targets are achieved, a partial bonus is dis-

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58 Employees receive a 15% PBVA bonus, and CEOs a 25% bonus, or as specified in their contract agreements.

tributed at a prorated amount. If fewer than 75 percent of targets are met, no PBVA bonus is paid.

## **Board of Directors and Management**

### *DHI's Board of Directors*

**The DHI Board comprises seven directors, four of whom are independent nonexecutives.** The DHI Board is composed of both private sector and civil service members. The size of the board, its composition, and the number of independent directors are determined through the Board Charter<sup>59</sup> and the Corporate Governance Code.<sup>60</sup> Included in the board are secretaries from the MOF, the Ministry of Trade and Industry, the Ministry of Agriculture and Forests, and the Land Commission. The board is composed of four independent nonexecutives, two nonindependent executives (Chair and CEO), and one nonindependent nonexecutive (Secretary, MOF).<sup>61</sup> The maximum tenure for the CEO is three years and can be renewed (by one more term, after which he/she could apply again but would compete for the position in the market). The DHI Board met seven times in 2014.

**DHI's Corporate Governance Code and Ownership Policy set the responsibilities of the board based on the OECD's Principles of Corporate Governance.** The Corporate Governance Code establishes the role and duties of the board, provides a framework for the board's composition, and describes the roles of board committees and the Chair. The DHI Board is entrusted with managing the strategic direction of the company, appointing directors (including the CEO), and ensuring proper planning at the executive management level. The board of directors has full authority to make decisions regarding investments, divestments, and issuances of securities.

**The DHI Board has established four committees to enhance its effectiveness.** The specific powers and responsibilities of each committee are outlined in the Committee Charter. The various committees make recommendations to support the decision making of the DHI Board. The Board Nominations Committee is primarily responsible for recommending potential board directors. The Board Committee for Performance Management negotiates and monitors ACAs with DHI-owned companies. The

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59 See section on Ownership Arrangements.

60 See section on Performance Monitoring.

61 There are cases of DHI Board members acting also as board members of SOEs within the holding. For example, the current Chairman of DHI is also the Chairman of Druk Green Power Corporation and DrukAir Corporation, while the CEO of DHI is the Chairman of Dungsam Cement Corporation.

Investment and Finance Committee assesses and evaluates all projects and investments proposed by DHI Management. Finally, the Nomination and Governance Committee for the Selection of CEOs<sup>62</sup> carries out the selection of CEOs for DHI-owned companies.<sup>63</sup>

### *SOE Boards*

**The Companies Act includes general provisions regarding SOE board directors, complemented by additional regulations.** These provisions concern, among others, the number of directors, appointment requirements, removal of directors, rules for board meetings, the general powers and restrictions of the board, and the appointment of the CEO. In addition, certain provisions of the Corporate Governance Code, such as board composition, structure, and member profiles apply to SOEs under the MOF.

**SOE board members represent investor interests and serve as the company’s ultimate decision-making body.** The SOE board sets the company’s strategic plan, which outlines goals and targets over the medium term

#### **BOX 19**

### **SOE Board Features in Bhutan**

	<b>SOEs under DHI</b>	<b>SOEs under MOF</b>
<b>Nomination of board members</b>	<p>Selection process:</p> <ul style="list-style-type: none"> <li>• DOCs: DHI Board</li> <li>• DCCs and DLCs: DHI Board shareholders.</li> </ul> <p>Final Decision: DHI for all subsidiaries. MOF if civil servants are nominated for appointment.</p>	<p>Selection process: Investment and Corporate Governance Division in consultation with line ministries and DHI.</p> <p>Final Decision: Government (Cabinet).</p>
<b>Nomination of SOE board chair</b>	<p>Under DHI Ownership Policy, DHI Board approves appointment of CEOs once the subsidiary boards recommend it, whereas individual boards select subsidiary board chairs.</p>	<p>MOF, in consultation with sector ministries, nominates the Chair, and the Cabinet approves the appointment.</p>

<sup>62</sup> Membership of this committee is composed of the DHI Board and subsidiary board.

<sup>63</sup> The latter is a special board committee with representatives from both the SOE Board and the DHI Board.

	<b>SOEs under DHI</b>	<b>SOEs under MOF</b>
<b>Nomination of CEO</b>	DHI Board.	The SOE Board selects the CEO through a competitive process and recommends to the government for appointment.
<b>Mandate of the board</b>	Hold and manage the existing and future investments of the RGOB.	As per articles of incorporation.
<b>Separation between Chair and CEO</b>	Yes.	Yes.
<b>Composition of the board</b>	5–9 members (including CEO). Nonindependent executives, nonindependent nonexecutives, and independent nonexecutives may be represented.	5–7 members (including CEO). Majority of nonexecutive members, at least one of which is an independent director.
<b>Structure of the board</b>	Single unitary body.	Single unitary body.
<b>Profile of board members</b>	<ul style="list-style-type: none"> <li>• Civil service.</li> <li>• Corporate and private sector.</li> </ul>	<ul style="list-style-type: none"> <li>• Civil service.</li> <li>• Private sector.</li> </ul>
<b>Board committees</b>	<ul style="list-style-type: none"> <li>• Mandatory: Audit Committee; Nomination and Governance Committee.</li> <li>• Facultative: Risk Committee; Procurement Committee; Human Resources Committee.</li> </ul>	<ul style="list-style-type: none"> <li>• Mandatory: Audit Committee; Nomination &amp; Governance Committee.</li> <li>• Facultative: Risk Committee; Procurement Committee; Human Resources Committee.</li> </ul>
<b>Remuneration of CEO and board members</b>	<ul style="list-style-type: none"> <li>• Sitting fee.</li> <li>• Additional compensation for additional activity.</li> </ul>	<ul style="list-style-type: none"> <li>• Salary and allowances for CEOs.</li> <li>• Members of board are paid sitting fees only and no other compensation.</li> </ul>
<b>Evaluation of the board</b>	<ul style="list-style-type: none"> <li>• Annual board of directors performance evaluation.</li> <li>• Annual individual board committee performance evaluation.</li> <li>• Annual self-assessment of individual directors.</li> <li>• Annual assessment of CEO's performance.</li> </ul>	<ul style="list-style-type: none"> <li>• Annual performance evaluation of the board and CEO.</li> <li>• Annual assessment of CEO performance by the board based on the compact.</li> </ul>

Source: World Bank staff compilation based on interviews and regulation.

(three to five years). In the case of DHI, the Board Charter sets out the role, duties, and powers of the board of directors for its portfolio of SOEs. The DHI Board oversees activities to fulfill its mandate to maximize profits. In the cases of socially oriented SOEs, boards aim to provide the maximum social benefit to the shareholder—the people of Bhutan. In all cases, SOE boards set the company policy, adopt bylaws, name committee members, and evaluate management performance.

**The DHI Board appoints DOC directors and works with other shareholders in the appointment process for DCCs and DLCs (DHI 2013a, c).** DHI's Ownership Policy includes selection and appointment guidelines for CEOs of DOCs and DCCs. DHI's Corporate Governance Department has developed a list of potential directors from the private sector and the civil service, and potential candidates are selected from this list based on their skills, competencies, and knowledge. The Corporate Governance Department recommends candidates from the list to the DHI Board, including a nominee director from among the DHI's senior employees. Directors of SOE boards must be independent; if DHI proposes the appointment of a civil servant, the MOF must be consulted to determine whether there might be a conflict of interest, and the appointee must be approved by the Cabinet. While the selection of board members comes from the DHI Board, the final selection—particularly for civil servants—is confirmed by the MOF after assessing potential conflicts of interest.

**Boards of socially oriented SOEs (owned directly by the MOF) are appointed by the Cabinet.** MOF plays a lead role in the selection and appointment of board members for SOEs under MOF. In consultation with sector ministries, MOF's ICGD develops a list of potential directors for a specific SOE, assessing their knowledge and skills. The ICGD selects the three best candidates from the list and submits their names for the consideration of the Cabinet, which makes the final decision. The size of the board for these SOEs is required to be between five and seven members.<sup>64</sup>

**An Audit Committee and a Nomination and Governance Board Committee are mandatory for all SOEs.** Audit committees must be comprised

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64 Board composition, structure, and member profiles are similar in all SOEs. The number of board members should be between five and nine, including at least one independent director, with ideally one-third of directors being independent. Additionally, a clear distinction should be made between the board and the executives in charge of managing the company. Board members should have the necessary skills, competencies, knowledge, and experience to support decision making.

only of nonexecutive directors who monitor and assure the operation of the internal control system, internal audit activities, financial reporting, external audit, accounting, and legal compliance. The nomination and governance committee must ensure that shareholder corporate governance concerns are addressed properly; that board membership reflects an appropriate balance of skills, qualities, and characteristics; and that each board member is equipped with the proper tools and motivation to carry out her/his responsibilities. Apart from mandatory committees, the board may establish other committees, depending on specific requirements.

**Newly appointed directors must complete an induction program within three months of appointment.** Directors are expected to undertake necessary professional development to enable them to execute their duties effectively. Board evaluation processes are used in some cases to determine directors' training and development needs. Most board directors appointed at DHI companies are trained in basic corporate governance procedures and financial skills.

**In commercially oriented SOEs, self and peer assessment are used to evaluate directors.** Four key result areas are included: dedication, preparedness and participation, teamwork, and contribution. The board chair is responsible for coordinating the evaluation and ensuring that it is carried out prior to the end of the financial year.

## **Transparency and Disclosure**

**DHI publishes both aggregated and stand-alone SOE reports.** As many SOEs conduct business with each other, stand-alone statements are required to reflect the audited financial performance, including all disclosures, of individual companies. This information may not be captured adequately in consolidated statements if they do not affect the overall financial state of the holding company.

**In addition, the government publishes consolidated information on SOE sector trends in the national budget report.** The budget report presents the latest developments in the sector (including newly created SOEs, transfers to DHI, and so on) and describes overall performance of the sector. Financial performance assessments are based on indicators such as assets, net worth, investments, revenue growth, profitability (including revenues, profits, and return on equity), and SOE contributions to government revenues (taxes and dividends). The budget report also presents financial and operational highlights of DHI.

## BOX 20

### Transparency and Disclosure Practices in Bhutan

**Accounting standards:** Bhutan Accounting Standards, adapted from International Financial Report Standards (IFRS).

**Transmission of financial and activity reports by SOEs:** DHI-owned companies report to DHI; companies under MOF report to MOF.

**Aggregated reports:** Yes, annually: DHI and MOF through the budget.

**Disclosure:** Financial statements of all DHI companies are made public, and most are available on companies' websites.

**Internal audit:** Internal audit committee.

**External audit:** Royal Audit Authority, Independent Statutory Auditors, Revenue Audit, and Internal Audit.

*Source:* World Bank staff compilation based on interviews and regulations.

#### *SOE Financial and Nonfinancial Reporting*

**DHI has spearheaded efforts to implement International Financial Reporting Standards.** Currently in Bhutan, reporting of financial statements for SOEs must comply with the Bhutan Accounting Standards, which are adapted from IFRS standards. DHI has begun the transition toward complete compliance with IFRS guidelines for its portfolio of SOEs. DHI companies will comply fully with IFRS standards by 2018, and IFRS compliance across Bhutan's public sector is planned to be complete by 2021.

**Timely disclosure is required by the Corporate Governance Code for all financial, operational, and governance matters.** The Code establishes that DHI-owned SOEs and their subsidiaries must deliver comprehensive, accurate, and timely disclosures on all relevant matters affecting the SOE, including its financial position, operations, ownership, and governance. According to the Code, SOEs shall make timely and balanced disclosures routinely and disclose extraordinary matters as they arise in order to ensure a fair representation of their affairs.

**SOE annual reports offer a comprehensive and objective view of the company and its activities, thus allowing all stakeholders to have a full and fair picture of its performance and prospects.** According to the Corporate Governance Code, the Annual Report must include financial

statements, share performance, dividend payments, actual transactions with related parties, discussion of factors affecting operations and financial performance, and corporate social responsibility activities.

**A Corporate Governance Report is included in the Annual Report of DHI-owned SOEs.** This report includes a statement of compliance with the Corporate Governance Code; the names and profiles of independent non-executive and executive directors; a record of board meetings, attendance, and remuneration; a statement on risk management and internal controls; and board evaluation policies.

**Annual external audits of SOEs' financial statements must be conducted by an independent, competent, and qualified external auditor.** It aims to assure the board and shareholders that financial statements fairly represent the SOE's financial position. The quality and suitability of the external auditor is examined by the audit committee as per the rules set out by the Royal Audit Authority, Bhutan's supreme audit institution—on the appointment of external auditors.

**In accordance to the Corporate Governance Code, SOEs are also required to establish an internal audit committee.** This committee is comprised of nonexecutive and mostly independent directors and undertakes its activities in accordance with a board-approved audit committee charter. The audit committee monitors the operation of the SOE's internal control system and internal audit activities, as well as financial reporting, external audit, accounting, and legal compliance. The board is mandated to establish an effective, independent internal audit function that reports directly to the board or to the audit committee.

**Internal audit committees play a lead role in relations with external auditors.** Within the requirements of the Companies Act and the Royal Audit Authority, the audit committee charter provides for interactions with relevant persons and shareholders on the appointment and removal of external auditors, as well as for meeting with the external auditor to receive audit findings and recommendations for management. The charter provides a mandate to monitor non-audit services provided to the SOE by the external auditors to ensure that these additional services do not compromise the quality or independence of the external audit.





## CHAPTER 4

# India

### SOE Sector

**State-owned enterprises (SOEs) have been central to economic policy in India since 1947.** In the 1940s, India was largely an agricultural economy with a limited industrial base and limited infrastructure. At the time of independence, India faced important socioeconomic challenges, including income inequality, high unemployment, and regional economic disparities. In this context, Central Public Sector Enterprises (CPSEs) were created to drive industrialization and economic growth. CPSEs were expected to limit the concentration of economic power, reduce regional inequality, and promote inclusive development.

**The first CPSEs can be traced back to the Five-Year Plan of 1956–61 and the Industrial Policy Resolution of 1956.** The Industrial Policy Resolution identified 17 strategic industries that would primarily be the responsibility of the state. These so-called “Schedule A” industries included irrigation, fertilizers and chemicals, communication infrastructure, heavy industries, and natural resources. A second tier of “Schedule B” enterprises consisted of firms with mixed public and private ownership, including manufacturing of raw materials and production of essential drugs. Later on, this group

included consumer goods, consultancy services, contracting, and transportation services.

**The number of CPSEs grew progressively until the 1990s.** A large number of CPSEs were established in new industries under successive five-year plans, especially during the 1970s and 1980s. Meanwhile, existing private firms became CPSEs owing either to insolvency or to nationalization, including foreign-owned manufacturers. This trend continued with the nationalization of 20 of India's largest private banks. Driven by the limited financial performance and the inefficiency of some CPSEs, the New Industrial Policy encouraged disinvestment, starting in the early 1990s, and focused on reducing government participation in nonstrategic industries.

**In 1996, a Public Sector Disinvestment Commission was established to guide and monitor disinvestment.**<sup>65</sup> While 57 firms were targeted for disinvestment, progress was limited by unfavorable market conditions, unclear disinvestment policies, and resistance from employee and trade unions. A Department of Disinvestment was created under the Ministry of Finance (MOF) in 1999, and became a full-fledged ministry in 2001. Disinvestments were made through strategic sales to investors or to the public. In some cases, management and control were transferred to private entities; in other cases, the government retained management functions while selling equity to the public. Although these sales generated significant revenues, they did not meet the intended sales targets.

**The government adopted a more cautious approach to privatization in 2004, when the National Common Minimum Program was established.** A shift in policy sought to preserve profitable CPSEs while encouraging private capital participation. The program called for the delegation of managerial and financial autonomy to profit-making SOEs in competitive sectors.<sup>66</sup> The Disinvestment Commission was dissolved, and the Ministry of Disinvestment was converted back to a department under the MOF. It was recently renamed the Department of Investment and Public Asset Management to reflect its role in managing CPSEs.

**Over the past decade, policy has shifted from divestiture to improving corporate governance through a system of performance agreements.** Although some CPSE disinvestments have continued, corporate governance reforms have also been targeted to improve performance and

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65 The Public Sector Disinvestment Commission was initially constituted for a period of three years. The Commission was reconstituted in 2001 for a period of two years, and subsequently its term was extended until 2004. After 2004, the Board for Reconstruction of Public Sector Enterprises became responsible for studying loss-making SOEs.

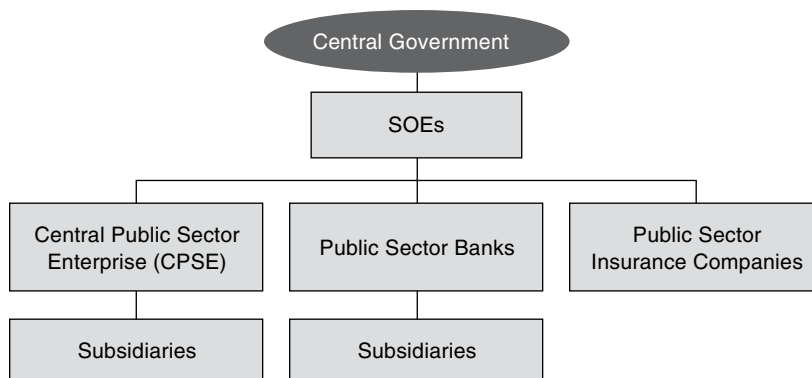
66 The details of the categorizations are provided in the next section.

competitiveness.<sup>67</sup> The introduction of a performance monitoring system for CPSEs added pressure to public enterprises. By 2016, about 215 CPSEs had signed bilateral performance agreements, or Memoranda of Understanding (MoUs).<sup>68</sup> For public enterprises listed on a stock exchange, board procedures and transparency mechanisms have matched private firm requirements. Corporate governance guidelines issued in 2007 extended these practices to nonlisted CPSEs.

## Economic Significance

**There are currently 244 functional CPSEs in India (GOI, DPE 2016),<sup>69</sup> 27 public sector banks,<sup>70</sup> and seven public sector insurance companies.<sup>71</sup>** Although a total of 320 CPSEs are reported by the Department of Public Enterprises (DPE),<sup>72</sup> 76 of them are not currently operational, resulting in 244 operational CPSEs. India's public sector banks are monitored and regulated by the Reserve Bank of India, while the public sector insurance companies fall under the purview of the MOF's Department of Financial Services.

**FIGURE 16: Universe of the Central Government SOE Sector in India**



Source: World Bank staff compilation.

67 However, the government has set an ambitious disinvestment target of INR 565 billion (USD 8.69 billion) for FY2016.

68 Please see Performance Management section for details.

69 Please see GOI, DPE Public Enterprise Survey Reports in bibliography for additional details.

70 See <http://financialservices.gov.in> (accessed February 16, 2018).

71 See <http://financialservices.gov.in> (accessed February 16, 2018).

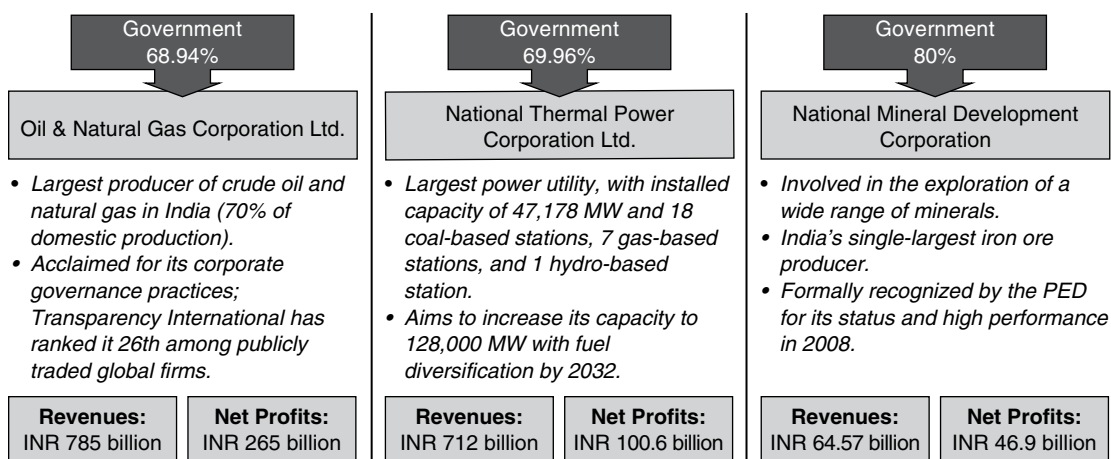
72 The DPE depends on the Ministry of Heavy Industries and Public Enterprises (MHI&PE).

India also has a large number of State-Level Public Enterprises, which are not covered by this stocktaking.

**In 2016, the total revenue generated by operational CPSEs was reported to be INR 18.55 trillion, equivalent to 13.66 percent of gross domestic product (GDP).** The asset base of all CPSEs stands at INR 31.81 trillion, equivalent to 23.43 percent of GDP. CPSEs operate in five core sectors: agriculture, mining, manufacturing, electricity, and services. Figure 17 summarizes the primary activities of the largest CPSEs in India.

**Several Indian CPSEs have become leading multinationals.** The government has identified several CPSEs with the potential to be international leaders. In these cases, CPSEs have been given special guidelines to restructure boards and financial autonomy to support their foreign expansion strategies. Indian Oil, for example, is an integrated energy company with a significant presence in almost all streams of oil, gas, petrochemical, and alternative energy sources. It has subsidiaries in Sri Lanka, Mauritius, and the Middle East. By 2017, it ranked seventh in size on the Platts global energy company rankings. Oil and Natural Gas Corporation Ltd. has grown into a major multinational oil and gas producer. Incorporated in 1993, it has been involved in exploration and production of oil and natural gas across Asia and Africa. By 2017, it ranked 11th on the Platts global rankings, with USD 42.43 billion in assets.<sup>73</sup>

**FIGURE 17: Selected CPSEs in India, 2016**



Source: World Bank staff compilation based on CPSE websites and GOI, DPE (2017).

73 See S&P Global Platts Top 250 Global Energy Company Rankings, <https://top250.platts.com/>.

**CPSEs account for 11.68 percent of the Bombay Stock Exchange, but performance has lagged behind the index.** As of 2016, 46 CPSEs traded on the Bombay Stock Exchange, accounting for 11.68 percent of total market capitalization (GOI, DPE 2017). While listed CPSE market capitalization declined by 16.62 percent in 2015–16, performance trailed the overall index, which declined by 9.36 percent. As a percentage of Bombay Stock Exchange capitalization, CPSEs decreased from 13.08 percent in 2014–15 to 11.68 percent in 2015–16.

**CPSEs are also major employers in India, with 1.23 million employees in 2015–16.** CPSE employment has fallen by 4.41 percent from 2014–15 due to retirement and attrition. Wage expenditure increased by 4.14 percent from INR 1.27 trillion in 2014–15 to INR 1.28 trillion in 2015–16. While wages rose, per-employee turnover decreased from INR 15.5 million in 2014–15 to INR 15.02 million in 2015–16.

## Macro-Fiscal and Service Delivery Implications

**CPSE profits reached INR 1.16 trillion (USD 17.84 billion) in 2015–16.** Mining, electricity, and manufacturing were the most profitable sectors (Figure 18). Aggregate profits rose by 12.54 percent from INR 1.02 trillion in 2014–15. In 2015–16, 165 CPSEs were profitable, with 10 CPSEs accounting for almost 63.46 percent of total profits, while 78 other enterprises were loss-making.

**Profitable CPSEs are required to pay a minimum dividend of 30 percent of profits after tax or 30 percent of central government equity, whichever is higher.** To address budget constraints, the Fourteenth Finance Commission<sup>74</sup> directed that the transfer to reserves and payment of dividends be set by policy.<sup>75</sup> In practice, while some CPSEs exceed these minimums, others have been required to borrow to replace government equity. In 2015–16, total CPSE contributions to the Central Exchequer<sup>76</sup> were INR 2.78 trillion (USD 42.74 billion). Out of this, INR 437 billion (USD 6.72 billion), or about 1.4 percent of total government revenue, was collected as dividends. Figure 19 illustrates the trend in dividends collected and dividends as a ratio of government revenue between 2012 and 2016 (ENS Economic Bureau 2016).

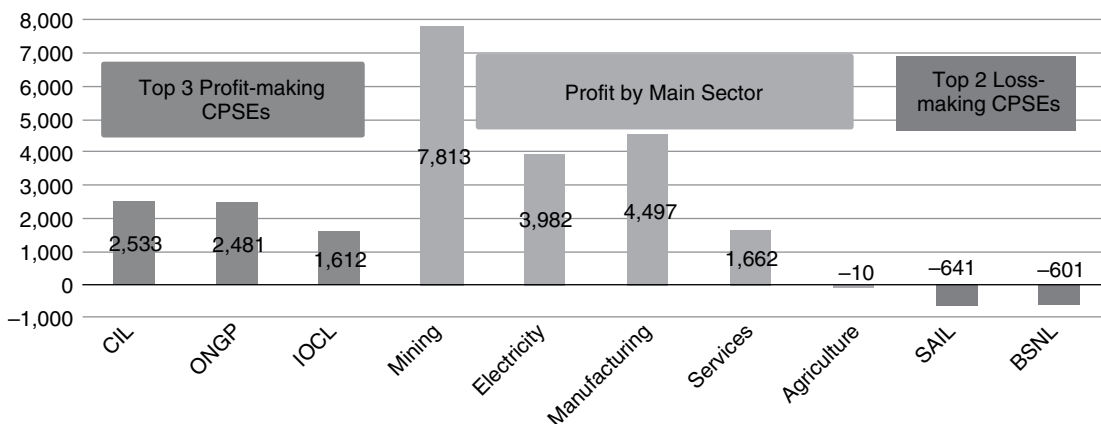
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74 The Finance Commission is a constitutional body established every five years. The Fourteenth Finance Commission submitted its report in 2015.

75 See <http://finmin.nic.in> (accessed February 16, 2018).

76 Including dividends, interest on government loans, and remittance of taxes and duties.

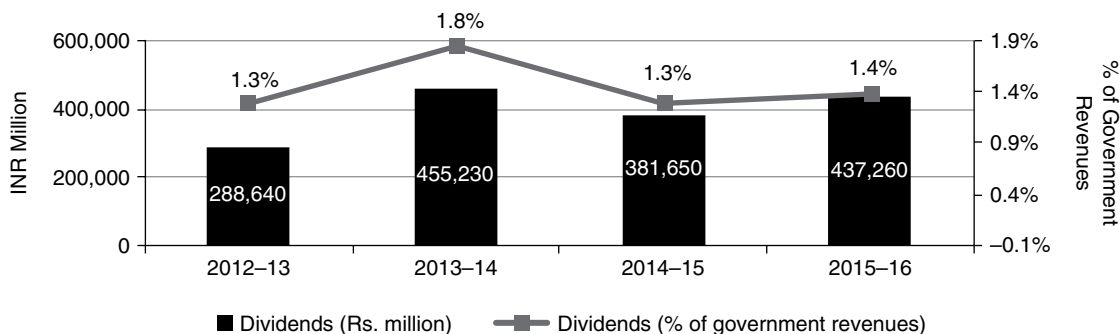
**FIGURE 18: CPSEs' Net Profits, 2015–16 (USD millions)**



Note: CIL = Coal India Ltd.; ONGP = Oil & Natural Gas Corporation Ltd.; IOCL = Indian Oil Corporation Ltd.; SAIL = Steel Authority of India Ltd.; and BSNL = Bharat Sanchar Nigam Ltd.

Source: World Bank staff compilation based on GOI, DPE (2017).

**FIGURE 19: CPSE Dividends, 2012–16**



Source: World Bank staff compilation based on GOI, DPE (2017) and IMF (2017).

**While service delivery by public enterprises in India is concentrated primarily at the state level, CPSEs play an important role in the provision of strategic public goods.** Water and electricity services in India are largely under the purview of state-level public enterprises. Meanwhile, CPSEs play a significant role in gas production and distribution (GAIL India), the production and sale of electricity to state-level public enterprises (National Thermal Power Corporation), the provision of airline services (Air India), power plant equipment (Bharat Heavy Electricals Limited), and exploration and production of oil (India Oil Corporation).

# Corporate Governance

## Legal Framework

**CPSEs are defined as entities in which the Government of India holds 51 percent or more of share capital.**<sup>77</sup> While this term includes a wide range of firms at the state level, the scope of this chapter is limited to CPSEs. At present, the central government directly holds 51 percent or more of shares in 320 CPSEs in India, of which 244 are functional.<sup>78</sup>

**There are three types of CPSEs: Departmental Enterprises, Statutory Corporations, and Government Limited Companies.** Departmental Enterprises are CPSEs that function as a part of a government department. Their finances are provided by the government, and the minister of the department is in charge of the enterprise. Railways, post, defense, and nuclear power fall into this category. Statutory Corporations are established under a special act of Parliament, which defines their powers, functions, rules, and corresponding regulations. Examples include the Airport Authority of India and National Highway Authority of India. Finally, Government Limited Companies are registered under the Companies Act. Examples include large-scale CPSEs such as Coal India Ltd. and the Steel Authority of India.

**In 2010, the Department of Public Enterprises (DPE) introduced an additional categorization of profit-making CPSEs to delegate managerial and financial autonomy based on performance.**<sup>79</sup> The purpose of this system is to introduce objective, transparent criteria to incentivize performance. The highest category is known as *Maharatna*, which translates literally to “magnificent jewel.” The remaining three categories of profit-making CPSEs, in decreasing order, are: *Navratna*, *Miniratna I*, and *Miniratna II*, respectively. All *Maharatnas* must be listed on Indian stock exchanges, show average annual (after tax) profits beyond INR 50 billion over the past three years, and have “notable global presence” or international operations. Coal India and the National Thermal Power Corporation are both CPSEs currently categorized as *Maharatnas*. Overall, enterprises with higher status according to this categorization enjoy greater board and management independence, as described further in the section on boards below.

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77 Section 2 (45) of the Companies Act, 2013. Ownership of paid-up share capital, either directly or indirectly.

78 See <http://www.bsepsu.com/list-cpse.asp> (accessed February 16, 2018).

79 See <http://www.bsepsu.com/maharatnas.asp> (accessed February 16, 2018) for further details.



**Most CPSEs are governed by the Companies Act, but some differences exist in how CPSEs and private enterprises are treated.**<sup>80</sup> For example, CPSEs carrying out sovereign functions are exempt from the Competition Act, and CPSE auditors are appointed by the Comptroller and Auditor General (CAG), rather than by shareholders. Also, in the case of mergers, the power of the High Court is exercised by the government. The Companies Act also governs insolvency and liquidation, in which CPSEs and private companies follow the same procedures. The Ministry of Corporate Affairs oversees CPSE compliance with the Companies Act.

**Other CPSEs follow separate legal frameworks, including public corporations, banks, and insurance companies.** Public corporations are formed under specific acts of Parliament, and legislation must be approved by Parliament to modify their legal frameworks. For example, statutory corporations cannot be dissolved without an act of Parliament. The banking and insurance sectors follow specific legal frameworks. Public sector financial institutions are subject to separate legislation, including the Banking Companies (Acquisitions) Act of 1970 and the Banking Companies Act of 1949.<sup>81</sup> The insurance sector is governed by the Insurance Regulatory and Development Authority Act (1999).

**Listed CPSEs also follow listing requirements issued by the Securities and Exchange Board of India (SEBI).** Mandatory provisions include rules for board procedures, audit procedures, reporting framework, and disclosure policies. Moreover, the 2014 SEBI Guidelines on Corporate Governance reinforced shareholder protection and introduced mandatory whistle-blower protection for employees and directors of listed companies.

**In 2010, the DPE issued Guidelines on Corporate Governance for State-Owned Enterprises.** These guidelines were initially issued in 2007 on an experimental and voluntary basis for a period of one year. Based on the responses received, the guidelines were modified and made mandatory for all CPSEs from 2010–11 on. The main focus of the guidelines is on the board of directors, audit committees, disclosure, and subsidiary companies. CPSEs are expected to submit annual compliance reports and are graded on their level of compliance.

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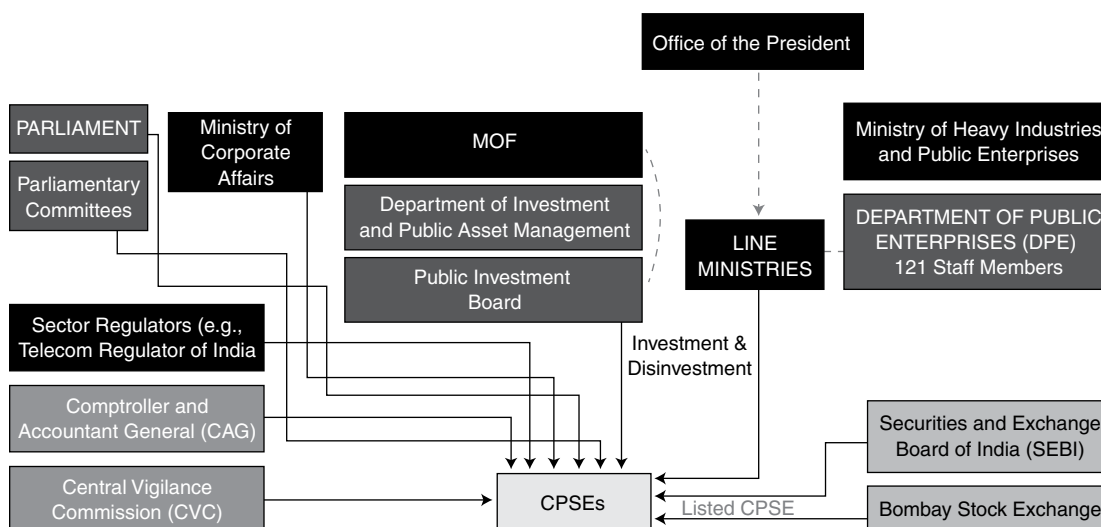
80 Note that subnational public enterprises fall outside the purview of this stocktaking.

81 <https://rbidocs.rbi.org.in/rdocs/Publications/PDFs/BANKI15122014.pdf> (accessed February 16, 2018).

## Ownership Arrangements

**India has an advisory CPSE ownership model, in which line ministries are highly relevant and the DPE plays an advisory role.** Line ministries are responsible for key ownership functions for CPSEs, including the appointment of board members, based on the recommendation of the Public Enterprises Selection Board (PESB),<sup>82</sup> and the signing of bilateral performance agreements, or MoUs.<sup>83</sup> Line ministries also oversee CPSE policies and verify if government objectives are being implemented. They confer (or rescind) *Miniratna* status to CPSEs, a practice that is emerging as a powerful performance incentive. At the same time, the DPE, which depends on the Ministry of Heavy Industry and Public Enterprises (MHI&PE), serves as a nodal agency for monitoring and evaluating CPSEs.

**FIGURE 20: Ownership and Oversight Arrangements for CPSEs in India**



Source: World Bank staff compilation.

82 Established in 1987, the main function of the PESB is to advise the government on matters relating to appointments, and select top managers for CPSEs. In addition, the PESB advises the government regarding training and development programs for management personnel, the structure of CPSE boards, performance appraisal systems, the formulation of a code of conduct for management personnel in CPSEs; and also has a function of data centralization. See <http://pesb.gov.in/> (accessed February 16, 2018).

83 See section on Performance Monitoring below.

**The DPE is responsible for common guidelines and oversight of all CPSEs.** It assists in the formulation of policies on performance improvement and evaluation, financial accounting, and personnel management. DPE collects, evaluates, and maintains information across all CPSEs, coordinating with other ministries and organizations. In addition, DPE facilitates the Interministerial Apex Committee for granting of high-level *Ratna* status. Recently, the DPE has taken steps to improve the performance of CPSEs by facilitating capacity building initiatives. The DPE is headed by a Secretary, with 121 staff reporting to the Cabinet Minister and the Minister of State. The Secretary is divided into five divisions covering financial policy, management policy, MoUs, administration and coordination, and arbitration.

**In the case of large investments, the MOF is also involved in the financial oversight of CPSEs.** Along with the Public Investment Board, the MOF reviews CPSE finances and investment decisions beyond INR 1 billion. The Department of Investment and Public Assets Management, under the MOF, is responsible for all matters relating to the management of government investments in equity, including disinvestment decisions of CPSEs.

## **Performance Monitoring**

**Performance Agreements called MoUs are used broadly in India as a principal tool for monitoring CPSE performance.** MoUs are mutually negotiated agreements between Government of India/Holding Company and CPSE management. Since 2007, all CPSEs have been required to sign MoUs with few exceptions; as a result, over 200 CPSEs signed their respective MoUs in 2016.

**MoUs include both financial and nonfinancial indicators.** These two categories of indicators are assigned equal weighting of 50 percent. The financial parameters generally relate to revenues from operations, operating profit and return on investment ratio, and the profit after tax/net worth ratio. For nonfinancial parameters, a menu of possible indicators has been suggested for selection depending on the sector in which the CPSE is operating.

**MoU negotiation is completed in three phases.** First, draft MoUs are prepared by CPSEs on the basis of DPE Guidelines<sup>84</sup> for review by CPSE boards and line ministries, and then submitted to the DPE. Second, draft MoUs are reviewed by DPE in detail, and actual negotiations are held between the DPE, relevant line ministries, and the CPSE. Finally, MoUs are

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84 These guidelines indicate the broad structure and the aspects to be covered in the draft MoU, including the weights to be assigned to the financial parameters.

signed by the chief executive of the CPSE and the secretary of the corresponding ministry.

**The High Power Committee on MoUs (HPC) is the uppermost body overseeing the MoU process.** The HPC on MoUs is a Committee of Secretaries set up by the government to assess the performance of MoU-signing CPSEs with reference to the commitments they made in the MoU. The HPC is headed by the Cabinet Secretary and comprises the Finance Secretary; Secretary (Expenditure); Secretary (Planning Commission); Secretary (Statistics and Program Implementation); Chair, Public Enterprises Selection Board; Chief Economic Advisor, Department of Economic Affairs; Chair, Tariff Commission; and Secretary (Performance Management). The HPC gives guidance and direction with respect to determining the principles and parameters for evaluating the performance of CPSEs.

**CPSE performance is evaluated against MoU indicators.** In the evaluation, CPSEs submit a self-evaluation to the administrative ministry for review and approval. The DPE then reviews the evaluation and assigns a final score on a five-point scale ranging from excellent to poor. In 2014–15, 30 percent of CPSEs were rated excellent, 30 percent very good, 15 percent good, 12 percent fair, and 13 percent poor (GOI, DPE 2016).

**Performance-related pay (PRP) is determined based on a composite score.** PRP<sup>85</sup> is payable at 100 percent for an excellent rating, and 80 percent, 60 percent, and 40 percent, respectively, for lower scores. If a CPSE's MoU performance is rated “poor,” it is not eligible for PRP. In addition, twelve MoU Excellence Awards are announced annually as nonmonetary recognition of good CPSE performance.

## **Board of Directors and Management**

**All CPSEs are mandated to have boards of directors to lead and oversee their management and operations.** Boards operate within the applicable legal and regulatory frameworks and under the guidelines outlined by the DPE. The main features of the board of directors in India are outlined in Box 21.

**There are three main categories of CPSE board members: functional, government, and independent directors.** Functional directors are responsible for day-to-day functioning of the enterprise on a full-time basis. Government directors (or nominees) are civil servants who represent the interest of the administrative ministry and serve as part-time members.

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85 As per the 2007 revised pay for CPSEs, PRP ranges from 40 percent to 200 percent of base pay. For any given CPSE, total PRP may not exceed 5 percent of after-tax profits.

**BOX 21**

**CPSE Board Features in India**

**Nomination of board members:** Administrative ministries and PESB.

**Nomination of board chair:** PESB.

**Nomination of CEO:** PESB.

**Mandate of the board:** Providing vision for the management of the company's resources and funds to secure and promote the interests of all stakeholders.

**Separation between Chair and CEO:** No.

**Composition of the board:** Typical size of the board ranges from 7 to 14 members, including: Chair (Chief Managing Directors/CEO); Functional Directors (cannot exceed 50 percent of the strength of the board); Government Directors (not more than one-sixth of the board, up to a maximum of two); and Independent/Non-Official Directors (should be at least half the size of the board).

**Structure of the board:** Single unitary body.

**Profile of board members:** Private sector, academics, civil servants.

**Board committees:** Audit Committee; Remuneration Committee; Human Resource Committee.

**Remuneration of CEO and board members:** Follows pay grades established by schedule of the enterprise.

*Source:* World Bank staff compilation based on interviews and regulations.

Independent directors (or nonofficial directors) are experts drawn from the CPSE's industry and serve as consultants. SEBI Corporate Governance Guidelines (in the case of listed CPSEs) and DPE Guidelines govern the appointment of board members.

**The PESB and the Appointment Committee of Cabinet are responsible for the selection and placement of CPSEs' board members and senior-level management posts.** The PESB, composed by a chairperson and three members,<sup>86</sup> is responsible for selection for the posts of

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86 They shall have a career in management of public or private corporations or public administration and have a proven record of achievements, preferably in the field of personnel, finance, production, or marketing. The three members include: a present or former chief executive of a public sector or private sector or joint sector enterprise; a person with experience in selection

Chair, Managing Director or Chair-cum-Managing Director (Level-I), and Functional Director (Level-II) in CPSEs. It maintains a short list of qualified functional director candidates and participates on the interview panel to select persons for these posts. The Appointment Committee of Cabinet, on the other hand, comprises the Prime Minister and the Minister of Home Affairs and is responsible for final approval of functional directors of Schedule A and Schedule B CPSEs, as well as all independent directors.

**Functional directors are responsible for the functioning of the enterprise on a full-time basis.** According to DPE guidelines, the posts of finance director and personnel functional director should be present in all Schedule A and Schedule B enterprises, and on a selective basis in Schedule C companies. Other functional directors may cover production, marketing, and project planning. Overall, the number of functional directors should not exceed 50 percent of the total number of board members.

**Independent directors are drawn from an external pool of experts and are expected to contribute to board professionalism.** They may include experienced technocrats, retired government officials, management experts and consultants, and professional managers in industry and trade.<sup>87</sup> According to DPE guidelines, the number of independent directors (non-official) should be at least one-third of the total number of board members if there is no Executive Chair. If the board has an Executive Chair, the ratio of independent directors should not be less than 50 percent. The role of independent directors becomes more critical for the autonomous *Ratna* companies (selected profit-making CPSEs). In that case, the guidelines stipulate a minimum of four independent directors for high-performing *Maharatnas* and *Navratnas* companies, and three independent directors for *Miniratnas* companies. In practice, however, the number of independent directors on CPSE boards tends to fall short of the targets specified in DPE and SEBI guidelines.

**Government directors represent the interest of the administrative ministry on the board.** There are usually two government directors on the board: (i) the Joint Secretary or Additional Secretary of the administrative

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of top management personnel; and a present or former civil servant with experience in the management of public sector enterprises or in the areas of finance, industry, or economic affairs. See [http://persmin.gov.in/DOPT/Publication/EODivison\\_Guidelines\\_BoardLevelAppt\\_InCPSU/GUIDELINES/scanned%20docs/scanned%20docs/03.03.1987.pdf](http://persmin.gov.in/DOPT/Publication/EODivison_Guidelines_BoardLevelAppt_InCPSU/GUIDELINES/scanned%20docs/scanned%20docs/03.03.1987.pdf) (accessed February 16, 2018).

<sup>87</sup> Furthermore, apart from receiving a director's remuneration, an independent director does not have any material pecuniary relationship or transaction with the company, its directors, its senior management, or its holding company, subsidiaries, or associates.

ministry that deals with the particular CPSE; and (ii) the Financial Adviser of the administrative ministry.

**Ministers, members of parliament, and members of legislative assemblies are not allowed to serve on the boards of CPSEs.** These candidates could have privileged information by virtue of their office. Their membership may also restrict open, equal, and free speech, since other members may not want to contradict or overrule a political leader and may not be able to present an unbiased picture of the CPSE to the Parliament.

**All new CPSE board members are required to complete board training programs.** The content of the training covers the business model of the company (including the risk profile of the business), the responsibilities of the respective directors, and the manner in which such responsibilities are to be discharged. The DPE has also organized several training workshops on corporate governance, in collaboration with the Chartered Accountants of India and the International Management Institute.

## **Transparency and Disclosure**

**CPSEs are accountable to a number of independent bodies set up under the National Constitution.** The Parliament is the primary oversight body, with committees that routinely review CPSE performance. The Comptroller and Auditor General (CAG) is the supreme auditing authority of CPSEs and is responsible for: (i) appointing statutory auditors and overseeing and supplementing their work; (ii) conducting regular transaction audits of CPSEs; (iii) conducting performance audits of CPSEs that focus on particular topics and sectors; and (iv) reporting findings to Parliament. The Central Vigilance Commission is mandated to deter corruption and malpractice in CPSEs through observance of procurement matters and clearance for all board positions.

**Regarding the disclosure of CPSE information, a Consolidated Annual Report on CPSEs performance is published annually by the DPE.**<sup>88</sup> This aggregated report provides financial and nonfinancial data for all CPSEs and presents new developments and initiatives in the sector. Annual reports are submitted to the Parliament within nine months of the close of the corresponding fiscal year.

**The DPE also publishes an annual Public Enterprises Survey.** This report covers financial and nonfinancial performance of CPSEs using data

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<sup>88</sup> See <http://dpe.gov.in/publication/pe-survey/pe-survey-report> (accessed February 16, 2018).

from MoUs. It is submitted by the DPE to the Parliament each year, and is subsequently posted on DPE's website.

**Complementarily, administrative ministries publish their own annual reports, including the financial accounts of CPSEs under their responsibility.** CPSEs submit their annual audited accounts to their respective line ministries. The administrative ministry then includes these financial statements in its annual report, which is submitted to the Parliament within nine months of the end of the corresponding fiscal year.

**SEBI regulations mandate that listed CPSEs issue half-yearly and quarterly financial reports.** These reports, in addition to their annual reports, are submitted to SEBI, the Ministry of Corporate Affairs, the Registrar of Companies, and Indian stock exchanges. Key elements of the reports are posted on the companies' websites. Listing requirements mandate the disclosure of related-party transactions, including transactions with directors and remuneration of directors. These requirements also mandate the inclusion of directors' reports and management discussions on relevant issues such as foreseeable risks, risk management policies, internal controls, and corporate social responsibility.

#### BOX 22

### Transparency and Disclosure Practices in India

**Accounting standards:** Institute of Chartered Accountants of India.

**Transmission of financial and activity reports by SOEs:** All CPSEs report to their respective administrative ministry, the DPE, the CAG, Parliament, and parliamentary committees.

**Aggregated reports:**

- DPE publishes a Consolidated Annual Report on CPSE performance.
- DPE publishes Public Enterprises Survey based on data from MoUs.
- Line ministries produce an Annual Report that includes the financial accounts of CPSEs under their responsibility.

**Disclosure:** DPE's Consolidated Annual Report and Public Enterprises Survey are both available online.

**Internal audit:** Audit committees.

**External audit:** CAG, statutory audits, and line ministries also empowered to conduct audits.

*Source:* World Bank staff compilation based on various reports.



**Overall, CPSE compliance with disclosure requirements is good.** In practice, most CPSEs meet basic filing requirements, and listed ones provide a high level of disclosure of both financial and nonfinancial information, consistent with securities regulation. Many nonlisted CPSEs also disclose information via their websites, but there is limited monitoring of compliance with disclosure requirements. Although no cases have been reported, the Ministry of Corporate Affairs may take action against CPSEs that fail to submit their financial statements, and SEBI may take disciplinary action against listed CPSEs that are not in compliance.

**CPSEs are subject to a three-tier audit system, including: (i) statutory audit; (ii) CAG audit; and (iii) internal audit.** The CAG appoints statutory auditors and directs how statutory audits will be carried out. In addition to the statutory audits and (potential) tax audits with which all companies must comply, CPSEs are audited by the CAG. Finally, CPSEs are mandated to carry out internal audits by establishing audit committees. In turn, the work of these committees is reviewed by statutory auditors.

**CPSE boards are required to establish an internal audit committee.** This committee is responsible for reviewing CPSEs' annual financial statements and audits and ensuring that they are in compliance with applicable laws, regulations, and company policies before submission to the board for approval. The committee is responsible for the oversight of CPSEs' financial reporting and for the disclosure of financial information. It is empowered to seek assistance from external experts when necessary.

**SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015, specifies the general composition and basic responsibilities of listed CPSEs' audit committees.** Audit committees should have a minimum of three directors, and two-thirds of the committee should be composed of independent directors (including the audit committee chair). At least one member must have accounting or financial management expertise. The committee is required to meet four times per year, and minimum quorum requires two independent members.

**CPSEs' audit reports are prepared using national accounting standards that converge with International Financial Reporting Standards (IFRS), as applicable to the CPSE.** The national standards include the Indian Generally Accepted Accounting Principles (Indian GAAP) or the new Indian Accounting Standards (Ind AS).

## CHAPTER 5

# The Maldives

## SOE Sector

### Evolution of SOE Sector and Reforms

**State-owned enterprises (SOEs) have been an important part of the economy of the Republic of Maldives<sup>89</sup> since the 1960s.** Originating with the State Trading Organization (STO) in 1964, which has imported essential fuel and food products since the country's independence, operations undertaken by SOEs have grown to cover a wide range of activities. Today, SOEs provide electricity and utilities, communications, financial, and tourism services; offer air and sea transport; and operate fisheries. While the government has sought to bolster the private sector in recent years, SOEs are still prominent and play a major role in the implementation of public investments as part of the country's growth strategy.

**Considering the economic importance of SOEs, the government established the Public Enterprises Monitoring and Evaluation Board (PEMEB) in 1995 to monitor SOEs centrally.** The PEMEB was created as a division within the Ministry of Finance and Treasury (MOFT), both to

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89 The Republic of Maldives is subsequently referred to as the Maldives.

serve as a monitoring and evaluation unit and to provide recommendations on improving SOE performance and increasing the return on investments. Given the large size of the sector and the limited capacity of the PEMEB, however, complete supervision of SOEs proved challenging.

**In the early 2000s, SOEs faced performance challenges, and the Maldives engaged in several SOE reform efforts.** An initial reform plan, issued in 2006, identified three SOEs to be privatized and proposed that State Electric Company Limited (STELCO), the primary electricity provider, be restructured. However, a shifting political landscape between 2008 and 2012 limited the impact of the proposed policy recommendations.

**In 2013, the government relaunched the SOE reform agenda and created the Privatization and Corporatization Board (PCB) to strengthen the SOE oversight function.** The PCB replaced the PEMEB as a centralized SOE ownership unit within the MOFT. The PCB is responsible for key ownership functions, such as planning and implementing SOE privatization, corporatization, and performance monitoring. The focus of the PCB has been to re-establish standards for financial reporting and promoting better corporate governance to improve SOE financial performance, rather than on privatization.

**Today, the Government of the Maldives uses SOEs to deliver public services and to manage public infrastructure investments.** SOEs are the main providers of electricity and interisland transportation and import basic commodities and food staples. SOEs also play a central role in significant government investments that aim to expand tourism, including the operation of a national airport.

## **Economic Significance**

**While there are currently 97 SOEs in the Maldives, 21 large firms account for the majority of revenues.**<sup>90</sup> The Maldivian government currently holds 100 percent ownership in 17 SOEs and a majority stake in four other large enterprises. In addition, the state holds minority and joint venture positions in other firms. It also holds 10 nonoperating “paper companies,” and 24 SOEs identified for liquidation (Figure 21).<sup>91</sup>

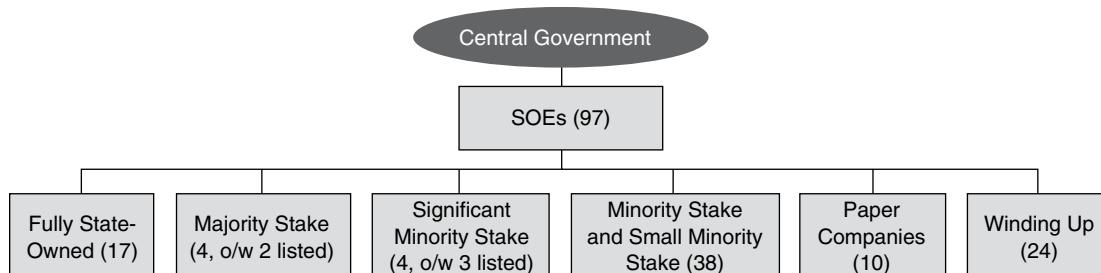
**SOEs are a significant component of the Maldives’ economy, with revenues representing over 50 percent of gross domestic product**

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90 The government considers an SOE to be any entity engaged in a commercial activity with state ownership above 5 percent.

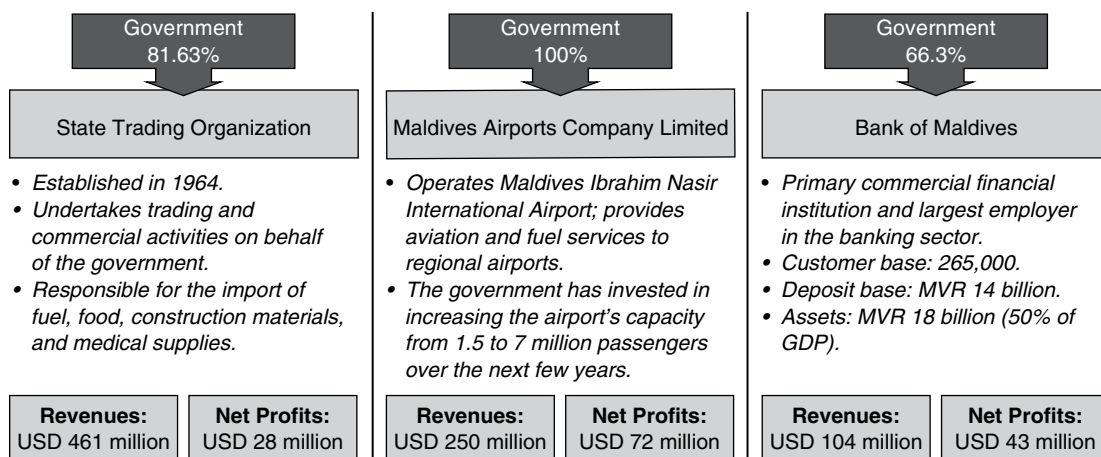
91 Eight companies have been assigned to a private contractor for liquidation; the rest are being announced for tender.

**FIGURE 21: Universe of the SOE and Parastatal Sector in the Maldives**



Source: World Bank staff compilation.

**FIGURE 22: Selected SOEs in the Maldives, 2015**



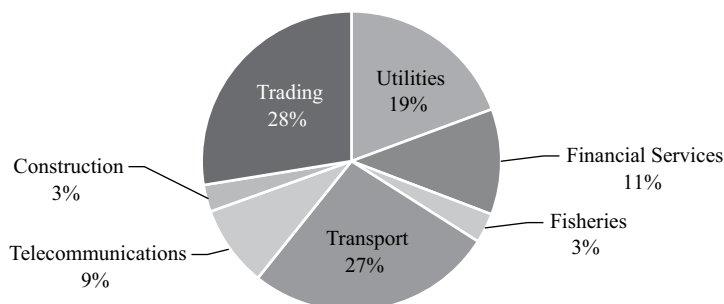
Source: World Bank staff compilation based on MOF, SOE websites, and interviews.

**(GDP).** In 2015, the combined gross revenues of the 25 main SOEs totaled over MVR 26 billion (USD 1.7 billion).<sup>92</sup> Figure 22 illustrates the activities of selected large-scale Maldivian SOEs.

**SOEs cover a broad spectrum of activities, including trading, transport, and utilities.** SOEs have played an outsized role in the delivery of basic services, when compared to other countries in South Asia. Given the challenges of delivering affordable services across many individual islands, SOEs

<sup>92</sup> Data collected from the Privatization and Corporatization Board, Ministry of Finance and Treasury. Combined gross revenues include available data for 22 SOEs out of 26 SOEs covered in the stocktaking.

**FIGURE 23: Distribution of Major SOEs by Revenues, 2015**



Source: World Bank staff compilation based on 16 largest SOEs, representing 99% of total SOE revenues in 2015.

have taken up a major role in transportation, utilities, trading, and financial services (Figure 23).

**SOEs also contributed significantly in employment.** SOE employment has risen recently, as SOEs have taken on the management of large public investments. Between 2015 and 2016, SOE-related employment rose from 16,238 to 19,582 employees (PCB 2016), representing an estimated 18.5 percent of the country's total workforce and 44 percent of employment within the public sector.<sup>93</sup>

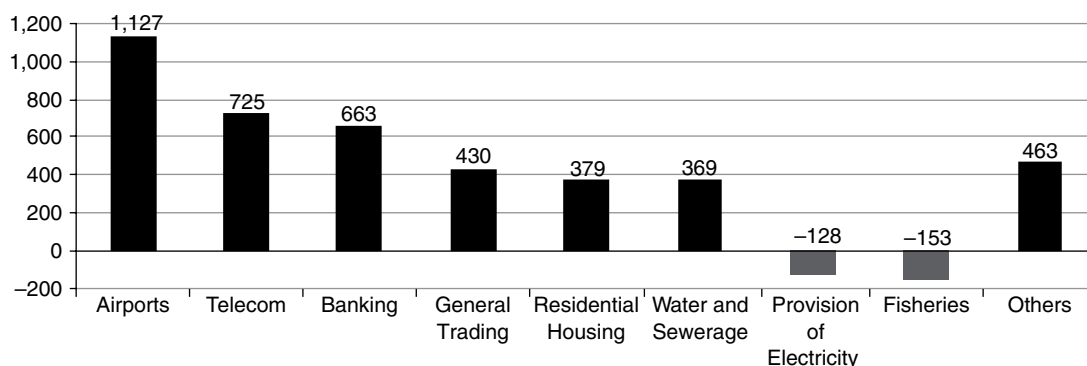
**Five of the Maldives' largest SOEs are listed on the Maldives Stock Exchange.** Bank of Maldives, STO, Maldives Transport and Contracting Company (MTCC), Maldives Tourism Development Company (MTDC), and Dhiraagu (telecommunications)—all partially government-owned companies—accounted for 98.5 percent of the stock exchange's total market capitalization in 2016 (CMDA 2016). The investment opportunities available to the public are narrow given the limited number of companies and outstanding shares. Trading volumes are constrained, as most investors primarily hold shares to receive dividend payments.

### **Macro-Fiscal and Service Delivery Implications**

**In 2015, the Maldives' largest SOEs realized net profits of over MVR 3.87 billion (USD 253 million), representing 8 percent of GDP.** Of the 25 largest SOEs, 18 reported net profits in 2015 (Figure 24). Maldives Airports Company Limited led the sector in net profits (MVR 1.12 billion/USD 73 million), followed by the telecommunications company, Dhiraagu

93 Total population estimated at 365,000.

**FIGURE 24: SOE Profits and Losses by Sector, 2015 (MVR millions)**



Source: World Bank staff compilation based on PCB. Profits include available data for 20 of the 25 SOEs covered in the stocktaking.

(MVR 724 million/USD 47 million). In contrast, the electricity company (STELCO) and the fish processor and exporter Maldives Industries Fisheries Company (MIFCO), were the two largest loss-making SOEs in 2015, losing MVR 128 million (USD 8.4 million) and MVR 112 million (USD 7.3 million), respectively. Overall, the sector accumulated a total net profit of MVR 3.87 billion.

**In some cases, SOE profitability is affected by costly service delivery obligations across the Maldives' scattered islands.**<sup>94</sup> Service delivery requirements have kept profits below potential, forcing some companies to borrow to finance operations. For example, STELCO is required to provide electricity to over 30 islands, but only generates a profit in the capital city of Malé. Similarly, MTCC, which provides ferry services to the public, operates at below-market prices.

**Indebtedness varies widely across individual SOEs.** As of the fourth quarter of 2015, STO displayed the highest absolute level of current liabilities at MVR 2.5 billion (USD 163 million), followed by the Bank of Maldives (MVR 1.5 billion/USD 98 million), MIFCO (MVR 684 million/USD 45 million), and STELCO (MVR 637 million/USD 42 million). At the same time, registered debt-to-equity ratios (gearing) were low for some SOEs (for example, 0 percent for Maldives Airports Company Limited and 5 percent for Dhiraagu) and high for others (for example, 93.3 percent for the Maldives Hajj Corporation and 83.5 percent for the MTDC).

94 In several countries, SOE profitability can also be influenced by factors such as monopoly status and related-party transactions that are not carried out at market prices (for example, SOEs that charge higher or lower prices to each other).

**SOEs contribute to revenues through dividend payments made by a few companies.** Historically, SOE dividends and profits have been important sources of nontax revenue in the Maldives. SOE dividends paid to the Treasury in 2015 amounted to MVR 464.4 million (USD 30 million), up from MVR 322.7 million (USD 21 million) in 2014. Overall, dividend transfers accounted for approximately 10.7 percent of nontax revenue (2.4 percent of total government revenue) in 2015, and came from a limited number of companies.<sup>95</sup> In fact, only seven SOEs currently declare dividends in the Maldives, but have not yet paid all outstanding amounts to the government.

**SOEs contribute to tax revenues, although not all SOEs pay taxes and some hold deferred tax liabilities.** While the Maldives Inland Revenue Authority has made substantial progress in updating its systems by tracking tax receipts for large SOEs—the Maldives’ primary tax contributors—and improving accountability, comprehensive data on tax collection are not yet available for the entire SOE portfolio. The revenue authority notes that a total of 15 SOEs paid taxes in 2015. During the same period, STELCO had accumulated MVR 64 million (USD 4.2 million) in deferred tax liabilities. In 2016, however, electricity subsidies were largely abolished.

**The Maldivian government provides financial support to SOEs through direct subsidies and transfers.** According to available data, the government transferred an estimated MVR 1.134 billion (USD 74 million) in subsidies to SOEs in 2015, which was approximately 7 percent of total central government spending (MMA 2015). Subsidies were directed primarily toward SOEs providing basic goods and services. For example, MTCC, the transportation SOE, received MVR 62 million (USD 4.1 million) in subsidies so that it would be able to charge below-cost ferry fares and therefore ensure connectivity between islands, and STO received transfers of MVR 332 million (USD 21.7 million) for food subsidies.<sup>96</sup> In 2016, however, electricity subsidies have largely been abolished.

**The government provides support through the issuance of loan guarantees.** Several SOEs lack the capacity to borrow based on the strength of their own businesses, and as a result, they request loan guarantees from the government in order to finance their activities. Central government loan guarantees given to STO and STELCO in 2015 amounted to MVR 3.7 billion (USD 242 million). Nonperforming loans are not included in the budget, making the total liability of SOE loans difficult to estimate. Central govern-

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95 Dhiraagu, Maldives Ports, and the Bank of Maldives were major contributors in 2015.

96 Lower global oil prices and increased scrutiny of company operational activities have prompted a cutback in transfers to the company. STELCO still received MVR 9 million (USD 0.6 million) through operational grants in 2015.

ment public debt rose from around 36 percent of GDP in 2004 to 74.6 percent of GDP in 2014.

**Inter-SOE transactions also render the assessment of the financial performance of individual SOEs and fiscal risks related to the SOE sector more complex.** SOEs dominate core economic sectors and often provide services to one another, resulting in a high level of interconnectedness in the form of cross-subsidies, cross-debts, and discounted sales. For example, STO, as the only importer of petroleum, provides discounted—or, at times, marked-up—petroleum prices to STELCO and FENAKA, a utility company. In addition, there are frequently “trade credits” between SOEs, through which some entities allow others to pay after the delivery of goods and services, and they sometimes accumulate into arrears. In fact, the stock of accumulated payment arrears between SOEs was estimated to be 6.2 percent of GDP in 2012 (WBG 2015).

**In terms of service delivery, SOEs in the Maldives are central to the provision of electricity and water.** STELCO and FENAKA are primarily responsible for generating and distributing electricity,<sup>97</sup> while Maldives Water and Sewerage Company and FENAKA provide waste management and sewerage services. The Maldives Water and Sewerage Company, in which the state holds an 80 percent ownership stake, produces and distributes drinking water.

**Transportation and construction services throughout the country are provided mainly through SOEs.** Air, land, and sea transport services are all provided by SOEs. Maldives Airports Company Limited operates Ibrahim Nasir International Airport and provides aviation services to the Maldives’ regional airports. MTCC, which is also involved in various construction projects, provides subsidized ferry services from Malé to neighboring islands.

## Corporate Governance

### Legal Framework

**In the Maldives, an SOE is defined as an entity in which the state holds at least 5 percent ownership.** Much of the legal and regulatory framework of SOEs in the Maldives has been adopted within the past decade (Box 23). The introduction of new legal instruments for SOEs, such as the

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97 STELCO serves the Malé region, while FENAKA provides services to the remaining islands.



**BOX 23****SOE-Related Legislation in the Maldives**

Law	Year of Last Amendment
Law No. 10/1996 "The Companies Act"	1996
Law No. 2/2006 "Maldives Securities Act"	2006
Law 4/2007 "Audit Act"	2007
Law No. 5/2007 "Civil Service Act"	2007
Constitution, 1932	2008
Employment Act and Civil Service Act	2008
Banking Act	2009
"Maldives Monetary Authority Act"	2010
Law No. 3/2013 "Privatization, Corporatization, Monitoring, and Evaluation of State Owned Enterprises Act"	2013
Corporate Governance Code (CGC)	2014

Source: World Bank staff compilation based on data from PCB, AGO, CMDA.

Privatization, Corporatization, Monitoring, and Evaluation of State Owned Enterprises Act (Law No. 3/2013), and the Corporate Governance Code (CGC), amended in 2014), have contributed to balancing trade-offs between the state's public interest and its commercial objectives.

**The Companies Act regulates the formation, registration, and management of all companies, including SOEs.** Article 95 of the Act provides that companies whose shares are held solely by the government or by a body of the government, have to be formed by a law or by a decree of the President of the Republic. The Act also provides a legal framework for the liquidation of companies. Under Articles 75 to 93 of the Act, in conjunction with Article 39 of Law 3/2013, a legal procedure has been established for the PCB to liquidate SOEs.

**The Audit Act (Law 4/2007) establishes the requirements for the audit of all government institutions, accounts, and entities, and outlines the duties and responsibilities of the Auditor General's Office (AGO).** The AGO was created in 2008 in an attempt to further strengthen accountability and governance in the public sector, including in SOEs. In line with the 2008 Constitution, the AGO audits all SOEs, with the exception of

those listed on the Maldives Stock Exchange, which are regulated by the Capital Market Development Authority (CMDA).

**The Banking Act, passed in 2009, provides regulations for financial institutions operating in the Maldives, including state-owned banks.**

Through the Banking Act, the Maldives Monetary Authority introduced in 2009 new regulations for banks, which span from capital adequacy to corporate governance requirements, and include related-party transactions. These regulations also apply to state-owned banks and to branches of foreign banks operating within the Maldivian territory.

**Law No. 3/2013 governs all SOE privatization and corporatization processes and provides for the establishment of the Privatization and Corporatization Board.** Law No. 3/2013 regulates: (i) the privatization, corporatization, and monitoring and evaluation of SOEs and their assets; and (ii) how shares of these enterprises are to be offered publicly, and the relevant legal procedures to follow in such instances. To this end, the law established the PCB, which is tasked with planning, implementing, administering, and monitoring the government's privatization and corporatization efforts.

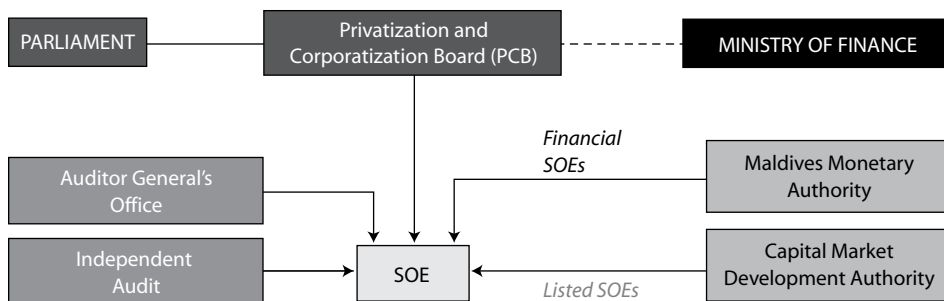
**The CMDA's Corporate Governance Code (CGC), updated and revised in 2014, applies to all listed companies.** CMDA issued the CGC for the first time in 2007. Since 2008, all listed companies, including SOEs, have been required to comply with the CGC, or to explain their areas of noncompliance. Other public companies and private companies that intend to list are encouraged to comply with the provisions of the CGC. The CGC focuses primarily on board procedures, but also contains important provisions on internal and external audit, disclosure and transparency, and shareholder rights.

## **Ownership Arrangements**

**Since 1995, through the creation of the Public Enterprises Monitoring and Evaluation Board (PEMEB), the Government of Maldives operated a centralized SOE ownership model based within the MOFT.** The PEMEB was established within the MOFT in 1995 to strengthen financial oversight over SOEs. The PEMEB sought to ensure that "all Public Enterprises operate in an efficient manner and in compliance with corporate governance requirements." Its mandate covered three main functions: strategic development and corporate governance, performance evaluation and monitoring, and privatization/support for public-private enterprises.

**In 2008, the government strengthened its centralized ownership model while launching a wave of corporatizations and privatizations.**

**FIGURE 25: The Ownership and Oversight Function in the Maldives**



Source: World Bank staff compilation.

The PEMEB began, for the first time, to collect regular quarterly and annual financial ratios from SOEs. This information supported the government’s decision-making process for a series of corporatizations and privatizations that began in 2008 in the sectors of radio and television, construction, aviation, telecommunications, and tourism.

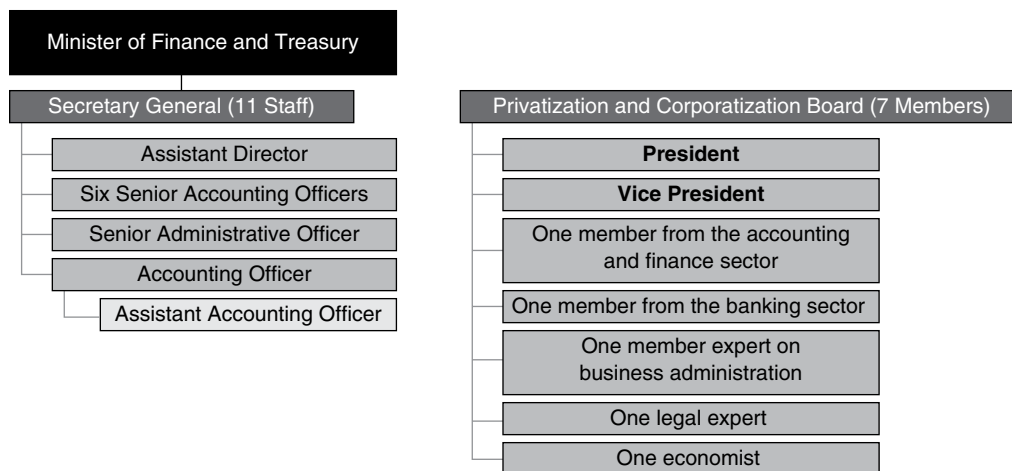
**In 2013, the government established the Privatization and Corporatization Board.** The PCB, which took over the PEMEB’s functions, was established with a mandate to support commercial growth and competitiveness, broaden ownership participation, and increase government revenues. The Privatization, Corporatization, Monitoring, and Evaluation of State Owned Enterprises Act (Law No. 3/2013) established the PCB Board and a supporting Secretariat, setting out clear procedures for the privatization and corporatization of loss-making SOEs and for the financial monitoring of SOEs, among others. Following a handover period to ensure continuity, PEMEB operations ended.

### *Structure of the Privatization and Corporatization Board*

**The PCB has a two-tier structure, reports to the president and parliament, and cooperates closely with MOFT.** The two-tier structure includes the PCB Board and its Secretariat. The PCB reports to the President of the Republic and the parliament (People’s Majlis) through an Annual Report on the SOE portfolio and ad hoc reports advises specific SOEs upon request. Given the financial importance of SOEs, the PCB also works closely with the MOFT and provides regular reports to the Minister of Finance.<sup>98</sup>

98 While the president and vice president of the PCB work out of MOFT offices, they are not civil servants and retain an independent status as members of the PCB Board.

**FIGURE 26: PCB Structure**



Source: World Bank staff compilation based on Law 3/2013; WBG (2016); and a *vnews* press article.

**The PCB Board consists of seven members appointed by the President of the Republic and approved by the parliament with four-year mandates.** The board is led by a president and vice president who serve on a full-time basis, while the remaining five board members serve on a part-time basis and are drawn from different sectors (Box 7). The PCB Board meets at least twice per month.

**The PCB Secretariat, located at the MOFT, operates as the PCB's administrative body.** It comprises MOFT civil servants, including a secretary general, an assistant director, and nine staff.<sup>99</sup> The secretariat serves as the administrative body of the PCB Board, carrying out the PCB's day-to-day functions. The PCB does not have an independent budget, and its secretariat is administratively mapped to the MOFT. Both the PCB Board and the PCB Secretariat currently use offices and facilities located inside the MOFT.

### *PCB Responsibilities on SOE Ownership*

**The PCB is responsible for state oversight of the SOE portfolio and has begun to undertake most of the ownership functions that are typically associated with a centralized ownership entity.** The PCB liaises regularly with the presidency, the parliament, the MOFT, and SOEs, systematically gathering information from SOEs to respond to requests for updates on investment projects and corporate performance.

<sup>99</sup> Two of these positions are currently vacant.

**The PCB is responsible for reviewing and appointing candidates for SOE board positions of nonlisted SOEs and has recently developed new criteria for board members.** While the ultimate authority for nominating board members to specific vacancies within SOE boards rests with the President of the Republic, the PCB reviews the candidates and provides a recommendation on their suitability. The PCB has recently strengthened its involvement in the board nomination process by developing specific criteria for SOE board membership.<sup>100</sup>

**Since its establishment in 2013, the PCB has made significant progress in strengthening its financial monitoring function and developed a basic electronic database with SOE information covering 22 of the 25 largest SOEs.** Maintained by the PCB Secretariat,<sup>101</sup> the database compiles key information for 22 large SOEs<sup>102</sup> on financial performance data and ratios; SOE boards of directors; audited financial reports; employment statistics; business plans; dividend payments; debt guarantees; and basic information on investment projects. In addition, the PCB maintains basic records of SOE loans guaranteed by the government, in coordination with the MOFT's Debt Management section. The PCB is also mandated to review fiscal policies and analyze SOEs' business plans and cash flows, although given the current availability of information from SOEs, this function is not yet systematically implemented.

**The PCB plays a role in winding up nonoperational, defunct, or loss-making entities and has identified 24 loss-making SOEs for liquidation.** This process is initiated through a court order, following the procedures outlined in the Companies Act. To support this process, private sector liquidators specializing in this task have been engaged to manage the process of winding down operations and liquidating the assets of these companies. To date, eight companies have been assigned to a private contractor for liquidation, while the rest are in the process of being announced for tender.

### *PCB Responsibilities on SOE Privatization and Corporatization*

**As indicated by its name, the PCB has a mandate for SOE privatization and corporatization.** Detailed privatization procedures are outlined in the 2013 law that establishes the PCB. While the PCB may draw up a list of

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100 Further details are provided in the section on boards of directors.

101 The database represents visible progress compared to the situation observed by a World Bank mission in June 2014, when financial information for most SOEs was incomplete, not updated, and in some cases paper-based.

102 The database includes information for 14 of the 17 active fully owned SOEs, plus the 8 large SOEs with majority state ownership or a significant minority stake on the part of the state.

proposed privatizations, a Divestiture Sequence Plan must be approved by the President of the Republic. The privatization must be publicized in local newspapers, and a valuation of the government business must be performed, with a report presented to the PCB. The government may keep a share in privatized companies to maintain special decision rights.

**The PCB has focused primarily on oversight and corporate governance of key SOEs, rather than on privatization and corporatization.**

Since its inception in 2013, the PCB has focused mainly on strengthening its monitoring function, processes, and systems, as well as on developing policies and guidance for further strengthening SOE corporate governance. As a result, SOE privatization has not been an important agenda item, and as of the time of report preparation, the PCB had not completed any privatizations or corporatizations.

#### BOX 24

### Performance Monitoring in the Maldives

	Quarterly Monitoring and Online Data Management	SOE Results Agreements (early stage)
<b>Description</b>	The PCB collects quarterly data on various financial indicators and ratios for each SOE, and compares it with the previous quarter and the same quarter from the previous year.	
<b>Scope</b>	97 SOEs are covered, although reporting reliability is variable.	The PCB is piloting the introduction of results agreements with 17 fully owned SOEs.
<b>Timespan</b>	Quarterly.	Annual.
<b>Indicators</b>	Profitability ratios; liquidity ratios; efficiency ratios; financial stability ratios.	Financial and nonfinancial SOE performance indicators.
<b>Reporting</b>	The PCB prepares a report annually on the financial performance of each SOE and submits it to the presidency and the parliament. These annual reports are not currently available publicly.	n/a

Source: World Bank staff compilation based on PCB information and interviews.

## Performance Monitoring

### *Financial Performance Monitoring*

**The Republic of Maldives is at an early stage in the development of an SOE performance monitoring framework.** Law No. 3/2013 requires the PCB to track the financial performance of each SOE. This includes information on profits made by the SOE and their distribution, budget analysis and its utilization, and other financial figures. In other words, the PCB is the central data management unit for all SOE-related information.

### *SOE Results Agreements*

**In 2015, the MOFT introduced bilateral performance agreements between the PCB and individual SOEs, called Results Agreements.** The proposed agreements aim to provide a summary of mutually agreed objectives that SOEs are expected to meet within a given financial year, together with indicators and targets for measuring progress. The agreements capture the understanding between the PCB, representing the government's priorities and vision, and the chief executive of individual SOEs, representing the SOE's mandate. The PCB is currently piloting the introduction of Results Agreements in all 17 fully owned SOEs with implementation expected to commence by 2018.

**Results Agreements are expected to provide an objective and unified measure of SOE performance in the Maldives.** At the end of the financial year, the PCB will be able to calculate a composite score for any individual SOE by summing the ratio between targeted versus actual achievement of each indicator, multiplied by the indicator's respective weight. The score will reflect performance and shift the ownership focus from process-oriented oversight to results-oriented management as a means to improve objectivity in evaluating SOE performance.

## Board of Directors and Management

**For listed SOEs, the mandate of board members is provided by the Companies Act and the CGC.** Under CGC provisions, the boards of listed SOEs have the main responsibility for setting the company's long-term goals and making all strategic decisions, as well as taking care of the appointment and supervision of management. In line with international practices, SOE boards are responsible for ensuring the establishment of efficient governance rules and must be accountable to shareholders for overall

## BOX 25

### Board Features in the Maldives

**Nomination of board members: Listed SOEs:** Shareholders' Annual General Meeting;

**Nonlisted SOEs:** President of the Republic.

**Nomination of board chair: Listed SOEs:** Selected through election at Annual General Meeting;

**Nonlisted SOEs:** The President of the Republic nominates board members to specific positions, including the Chair. The PCB verifies that nominated board members meet experience criteria (10 years in a relevant field, with 3–4 years of technical experience).

**Nomination of the Chief Executive Officer (CEO):** SOE boards are responsible for the selection, appointment, oversight, and removal of management.

**Mandate of the board:** Setting the company's long-term goals, making strategic decisions, and appointment and supervision of management.

**Separation between Chair and CEO:** Roles are separated. The Chair is a nonexecutive board member.

**Composition of the board:** Average board size: 5 members; Minimum size: 2 members.

**Structure of the board:** Unitary structure.

**Profile of board members:** Relevant academic and professional qualifications, with a concentration in management, finance, or accounting.

**Board committees:** Most common committees related to audit, remuneration, and corporate governance. SOEs may also establish committees for the nomination of board members.

**Remuneration of CEO and board members:** Monitored and approved by the PCB based on a four-grade scale set by the MOFT, depending on the size and responsibilities of the SOE.

*Source:* World Bank staff compilation based on interviews and existing regulations.



performance. In turn, no similar rules exist for the boards of nonlisted SOEs, thus creating a gap in governance provisions. To address this issue, the PCB has recently developed a Corporate Governance Policy that aims to apply CGC principles to all SOEs with respect to the roles and responsibilities of boards and management.<sup>103</sup>

**Boards generally follow a unitary structure, although their specific characteristics vary across SOEs.** The average SOE board has five members, and the minimum size is two. While SOE boards have some common minimum standards, board size, internal structure, and composition vary across SOEs. A review of the current profile of SOE boards indicates that board members hold a range of relevant academic and professional qualifications, with a concentration in management, finance, and accounting.<sup>104</sup> The duration of board appointments also varies across SOEs, and has not been legally defined. Cabinet ministers are not eligible for board membership, but board members of foreign nationality are permitted. Most SOE boards meet at least four times per year, although the frequency of board meetings varies.<sup>105</sup>

**SOEs may establish specialized board committees, which usually exist in larger, listed SOEs.** While there are no common rules and practices, the most common board committees relate to audit, remuneration, and corporate governance, with the Auditor General encouraging the establishment of an audit committee. SOEs may also establish committees for the nomination of board members. Overall, larger SOEs—in particular, those listed on the stock exchange—tend to have boards with stronger capacity, including specialized committees.

**Nomination of board members for listed companies is made at the shareholders' Annual General Meeting.** For listed companies, including SOEs, the nomination procedures are regulated by the CGC. A Nomination Committee composed of at least three directors, all of whom must be non-executive, makes recommendations to the shareholders' Annual General Meeting on the appointment and removal of board members. Nomination Committees must review the composition of the board annually to ensure compliance with existing regulations.

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103 As mentioned in the section on ownership arrangements, this policy has not yet been approved by the PCB Board.

104 The PCB maintains a comprehensive list of board positions (executive and nonexecutive), current members, and educational qualifications/professional designations.

105 In some cases, the frequency of SOE board meetings is determined in the SOE's articles of incorporation.

**The President of the Republic is the primary authority for the appointment and removal of board members of nonlisted SOEs.**<sup>106</sup>

Under this procedure, the presidency nominates individuals to the PCB for appointment to (or removal from) specific board positions. In some cases, ministers will submit nominee requests to the presidency, which will then inform the PCB. The PCB is tasked with screening nominees for appointment.

**The PCB has developed a framework for ensuring that SOE board nominees for fully owned SOEs are qualified for their respective positions.** Although the law does not outline specific criteria that are required for SOE board members, the PCB is given the authority to set criteria and determine an appointment procedure.<sup>107</sup> Accordingly, board candidates are subjected to a criminal background screening and evaluation of their educational background, work experience, and overall suitability for the position.<sup>108</sup> In cases where a candidate is deemed to be unsuitable for a position, the PCB provides an explanation and requests an alternative recommendation from the presidency. Thus far, the PCB has developed a record of enforcing criteria for board confirmation.

**SOE boards are responsible for the selection, appointment, oversight, and removal of management.** The PCB does not play an active role in the selection of SOE management, which remains the prerogative of SOE boards. In the event of financial irregularities, boards are responsible for taking action, flagging the issue to the PCB, and cooperating with Anti-Corruption Commission investigations.

**Board remuneration is tracked and approved by the PCB and is based on a four-grade scale set by the MOFT, depending on the size and responsibilities of the SOE.** The MOFT pay scale sets rates for board directors, board chairs, and management. Compensation varies across companies and includes basic pay as well as sitting fees and other allowances. Based on exchanges with counterparts, compensation of CEOs and SOE board members is generally considered to be attractive and competitive compared to other public sector salaries. Management salaries may not exceed the salaries of line ministers, however. Although in a few cases, listed SOEs have undertaken self-evaluations of board performance, there are currently no provisions for performance-based board payments.

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106 In some countries, the authority to nominate board members is allocated to the centralized SOE ownership entity.

107 The PCB maintains information on SOE-specific board size and membership criteria, as specific criteria are required by some articles of incorporation.

108 For example, the PCB requires that board chairs have at least ten years of leadership experience in a relevant field, with at least three years of technical experience.

## Transparency and Disclosure

### BOX 26

#### Transparency and Disclosure Practices in the Maldives

**Accounting standards:** All listed and nonlisted SOEs follow International Financial Reporting Standards (IFRS).

**Transmission of financial and activity reports by SOEs:** All SOEs are required to provide quarterly and annual financial reports.

**Aggregated reports:** The PCB provides a confidential annual aggregated report on SOEs, both to the parliament and the presidency.

**Disclosure: Listed SOEs:** Reports are disclosed as required by the Companies Act and the CGC.

**Nonlisted SOEs:** Reports are provided to the PCB and, in some cases, published online voluntarily by SOEs.

**Information system:** The PCB is working on the implementation of a new information system to track and manage reports, but this system is not yet operational.

**Internal audit:** All SOEs are supposed to have internal audit functions, but this function is more strongly developed in larger SOEs.

**External audit: Listed SOEs:** Independent external auditors selected from international accounting firms.

**Nonlisted SOEs:** Auditor General's Office.

*Source:* World Bank staff compilation based on interviews.

**The PCB submits an Annual Report to the president and to the parliament on the overall performance of SOEs.** The first of these reports was completed following the passage of Law No. 3/2013, which established the PCB. While these are not currently publicly available, the PCB is considering publishing them on its website in the near future. In addition to regular portfolio reports, the PCB prepares ad hoc reports on selected SOEs upon request from political authorities.

**Financial reporting standards in the Maldives vary for both non-listed and listed companies, with the latter subject to stricter requirements.** All companies are required to submit their reports to the PCB. Annual reports are required to be submitted before the end of January each

year, as the PCB subsequently reports on the sector to parliament in February. All incorporated SOEs are legally required to prepare annual reports. However, reporting practice varies between listed and nonlisted companies. Listed companies are required by the CGC to publish financial statements publicly on a quarterly basis. Listed SOEs tend to have higher quality financial reports in line with IFRS accounting standards for large companies.<sup>109</sup>

**The Auditor General's Office is responsible for the external audit of all nonlisted SOEs, while listed SOEs select independent external auditors from a group of international accounting firms.** Per its constitutional mandate, the AGO is required to audit all nonlisted SOEs. Although the entire SOE portfolio is not yet covered, the AGO has improved transparency and reporting in recent years through increased coverage and improved audit processes. Audits are conducted by external firms for larger companies, and in the case of listed SOEs, the selection of the private external audit firm is made during the SOE's general shareholder meeting.<sup>110</sup> All SOE audit reports are submitted to the MOFT, the PCB, the presidency, and parliament.

**Internal audit practices vary greatly among SOEs and are more common in larger enterprises.** The degree of internal control and the extent of internal audit practices across SOEs depend largely on the size of the enterprise. Although, in principle, all SOEs are supposed to have internal audit functions, this function is more strongly developed in larger SOEs. For example, Dhiraagu's Audit Committee approves, reviews, and prepares an Internal Audit Plan, from which the guidelines for internal audit are conducted. Internal auditors then deliver their report to the board, which reviews and scrutinizes the audit. Meanwhile, many smaller SOEs have not yet adopted internal audit practices.

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109 Overall, financial reporting is stronger for larger SOEs. IFRS reporting standards differ for small- and medium-sized enterprises.

110 There are currently three external audit firms in the Maldives—KPMG, PWC, and Ernst & Young—which conduct audits in line with international standards.



## CHAPTER 6

# Nepal

## SOE Sector

### Evolution of SOE Sector and Reforms

**Starting in the 1950s and for several decades, Nepal's state-owned enterprises—denominated Public Enterprises (PE)—played a strategic role in the government's social and economic development plans.** By the 1950s, Nepal was primarily an agrarian economy, with limited infrastructure and a small civil service. To drive growth over the next decades, the government adopted a series of five-year economic plans,<sup>111</sup> in which PEs were established as the principal drivers in building infrastructure, stabilizing prices, supplying essential goods, and creating jobs. Subsequently, during the 1970s and 1980s, the government established PEs in almost all sectors with the assistance of India, China, the former Soviet Union, and the United Kingdom.

**While PEs played an important role in Nepal's development, under-performance and limited efficiency led to a policy shift toward privatization in the 1990s.** By 1990, the number of PEs in Nepal had grown to 67,

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111 The first five-year plan was introduced in 1956.

and despite the critical services they provided, the performance of some PEs was becoming a challenge. The 1991 Privatization Policy Act and the 1994 Privatization Act initiated asset sales, equity sales, and liquidations of PEs. The privatization process covered the manufacturing, trading, banking, and services sectors. By the end of 2008, 30 PEs had been privatized by the government, including through full and partial privatizations.<sup>112</sup>

**As of 2016, the Government of Nepal was considering deepening the process of PE privatization, in conjunction with improving their corporate governance.** It established a Privatization Cell within the Ministry of Finance (MOF), which considers three policy options: sale of loss-making PEs that pose a fiscal burden on the government's budget; sale of profit-making PEs to strategic investors; and merger of PEs that perform similar functions to generate economies of scale.<sup>113</sup> The government recognizes, however, that these plans may face the same types of challenges encountered by previous privatization initiatives. In its 2016 Annual Performance Review of Public Enterprises (known as the Yellow Book, MOF 2016), the government emphasized that it is essential to strengthen the legal and institutional framework to improve the efficiency and performance of both PEs and privatized enterprises. Particularly for PEs, the government aims to improve the performance monitoring system to strengthen the role of PEs in the country's economic growth and development.

## Economic Significance

**The government reported 41 PEs at the central government level, with a combined operating income equivalent to 10.7 percent of gross domestic product (GDP) during FY2015/16.**<sup>114</sup> Between 2013/14 and 2015/16, the PE sector's operating income<sup>115</sup> decreased by 6.7 percent, from NPR 257.8 billion (USD 2.47 billion) to 240.5 billion (USD 2.31 billion). Net profits, which increased significantly between 2013/14 and 2015/16 from NPR 5.5 billion (USD 52.79 million) to NPR 35.0 billion (USD 335.57 million) contributed

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112 Among these 30 PEs, only 11 are operating, and 5 are in good financial health and generating profits. The remaining enterprises are either not operating or have since closed.

113 Based on interviews with MOF representatives.

114 Two new PEs, National Transmission Grid Company Ltd. and Bidhut Utpadan Company Ltd., were established in 2016, but as they are not yet fully operational, data on their performance are unavailable.

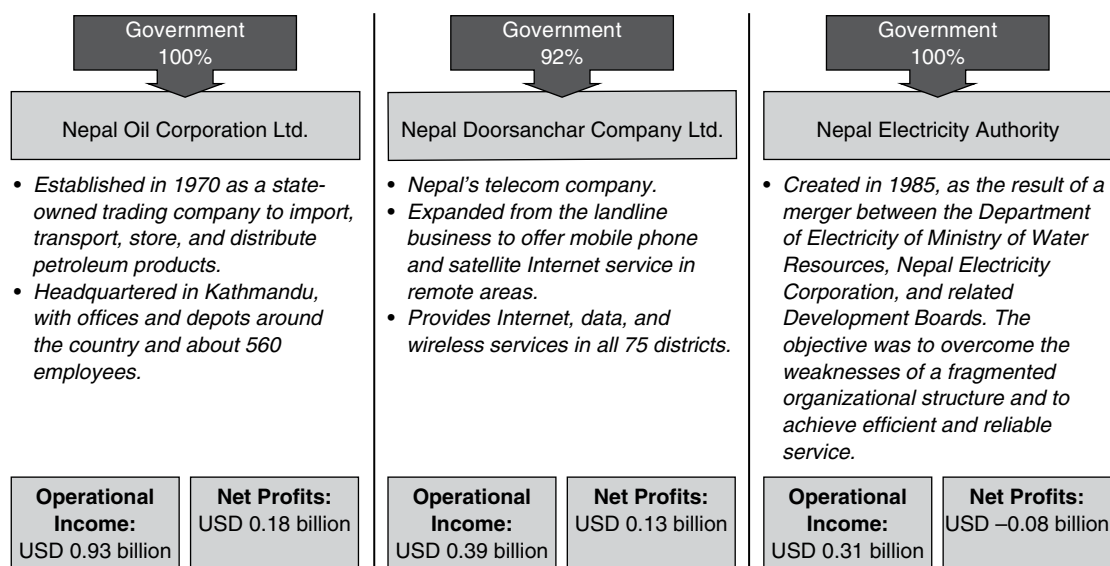
115 This figure refers to the sales revenues of PEs, including the operational subsidy from the government. It excludes income from other sources, such as interest on investment, profit on the sale of fixed assets, application fees, tender fees, and so on, which are casual and not related to the ordinary business of PEs (MOF 2016).

7.24 percent of total government revenues in 2015/16 (MOF 2017a). These officially reported PEs are the main focus of analysis in this report.

**The government holds minority shares in 24 other enterprises that are not considered to be PEs by the government (MOF 2017a).**<sup>116</sup> The government holds a 0.14 percent share in Morang Sugar Mill Ltd. and 35 percent in Nepal Tea Development Corporation. This list also includes three partially privatized PEs: Butwal Power Company Ltd., Nepal Bank Ltd., and Raghupati Jute Mills. As the government does not provide systematic information on these enterprises and does report them officially as PEs, they are not part of the present analysis.

**PEs operate in most key sectors of the economy, and are prominent in the financial and utilities sectors.** PEs operate in the industrial, trading, services, social, public utilities, and financial sectors. Eleven of the 41 PEs in Nepal belong to the financial sector and hold 62.37 percent of the PE sector’s total assets. In the public utilities sector, the assets of two PEs (Nepal Doorsanchar Company and Nepal Electricity Authority) account for 29.75 percent of all PE assets. Figure 27 presents details for a few large PEs in Nepal.

**FIGURE 27: Selected Public Enterprises in Nepal, 2015/16**



Note: 1 USD = 104.18 NPR.

Source: World Bank staff compilation based on PE websites and MOF (2017a).

<sup>116</sup> There are a few enterprises on the list of 24 in which the government has a majority share. The MOF has confirmed that the list will be revised accordingly.



**Six PEs are listed on the Nepal Stock Exchange.** These include Nepal Telecom,<sup>117</sup> Citizen Investment Trust, Agriculture Development Bank, NIDC Development Bank, Rastriya Beema Company Ltd., and Nepal Bank Ltd. The market capitalization of these enterprises totals NPR 234 billion (approximately USD 2.18 billion), which is equivalent to about 13 percent of the total market capitalization (NPR 1.74 trillion) of the Nepal Stock Exchange.

**Nepal's PEs currently employ approximately 26,600 people.** PE sector employment represents only a small portion (about 0.2 percent) of the total estimated employed labor force in the country, which is concentrated largely in rural agriculture.<sup>118</sup> PE employment peaked in 1990 at approximately 60,000 employees, and has fallen steadily since the initiation of the privatization program in the early 1990s. In 2015/16, the PE sector employed approximately 26,600 workers, which is around 31.8 percent of total public sector employment.<sup>119</sup> PE sector employment was concentrated in public utilities (12,729) and financial sector enterprises (5,663) (MOF 2017a).

### **Macro-Fiscal and Service Delivery Implications**

**Year-on-year PE financial performance improved in 2015/16.** Net PE profits rose from NPR 33.92 billion (USD 325.59 million) in 2014/15 to NPR 34.96 billion in 2015/16 (USD 335.57 million). Of the 39 PEs reported in 2015/16, three are not in operation and financial performance information for one is not available. Out of the remaining 35 PEs, 12 produced net losses and the rest reported a profit. According to the MOF's annual report (MOF 2017a), this increase in profitability is the result of improvements in the financial performance of few companies: in 2015/16, profits were driven primarily by the trading sector (Nepal Oil Corporation),<sup>120</sup> the utilities sector (Nepal Telecom), and the financial sector (Nepal Bank and Agriculture Development Bank) (Figure 28).

**The government's accumulated investment in the PE sector, in terms of both shares and loans, has increased over time.** In 2015/16, the government's total share investment in the PE sector reached NPR 139.5 billion (around USD 1.34 billion), representing an increase of 10.6 percent,

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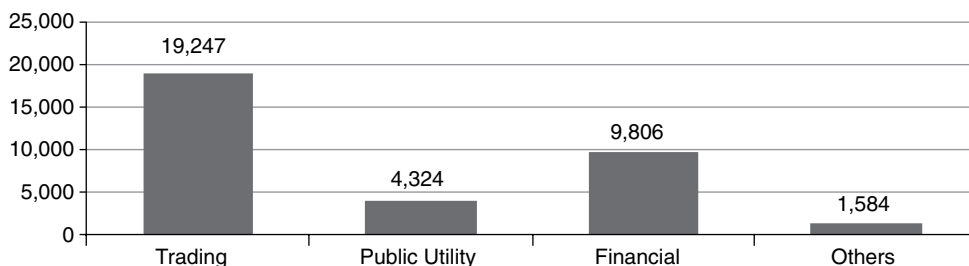
117 Nepal Telecom is known as Nepal Doorsanchar Company Ltd.

118 Calculated using figures from the International Labor Organization and the World Bank. In 2014, the total labor force in Nepal was 15,584,790.

119 There were 83,649 public sector employees in the first eight months of fiscal year 2016/17 (MOF 2017b).

120 Nepal Oil Corporation contributed NPR 15 billion in 2014/15, as lower global oil prices allowed it to boost its import profits significantly.

**FIGURE 28: PE Profits and Losses by Sector, 2015/16 (NPR billions)**



Source: World Bank staff compilation based on MOF (2017a).

compared to 2014/15 (Box 27). Total loans to PEs reached NPR 130.51 billion (around USD 1.25 billion).

**In FY2015/16, the government received NPR 7.81 billion (USD 74.97 million) in dividends, representing 5.44 percent of its total share investment.** Dividend contributions have been relatively stable over the past four years, amounting to NPR 6.965 billion (USD 66.86 million) on average. Overall, PE sector dividends contributed to 5.69 percent of the share investment made by the government over the period from 2012/13 to 2015/16 (Box 27). In 2015/16, practically all dividends (99.9 percent) were generated by only one PE, the public telecommunications company, while marginal

**BOX 27**

**PE Sector Investments, Loans, and Returns**

Fiscal Year	Share Investments	Loan	Dividend Received	Dividend Ratio on Share Investment (%)	Contribution to GDP (%)
	(Billion Rs)			%	
<b>2015/16</b>	139.52	130.51	7.81	5.44	10.7
<b>2014/15</b>	126.16	129.96	6.45	5.12	12.71
<b>2013/14</b>	115.81	111.68	6.61	5.71	13.29
<b>2012/13</b>	107.66	106.50	6.99	6.49	13.17
<b>2011/12</b>	102.41	101.23	6.26	6.11	12.1

Source: MOF (2017a).

contributions were made by Industrial Districts Management Company and Hydroelectricity Investment and Development Co. Ltd (MOF 2017a).

**Furthermore, PEs' unfunded liabilities reached NPR 32.34 billion (USD 310.42 million) in FY2015/16.** Overall, unfunded liabilities<sup>121</sup> such as gratuities, pensions, medical allowances, insurance, and paid leave, have been on an increasing trend in recent years, putting a strain on government finances. The MOF's 2016 Yellow Book states that the main sources of PEs' unfunded liabilities are personnel expenses and retirement benefits. In addition, the government faces contingent liabilities from some of the enterprises that it has been unable to fully privatize.

**Access to public services provided by PEs has risen in recent years, although challenges remain.** The government, through its line ministry interventions and/or PEs, has provided the platforms and guidance on the modality of operations for improving access to basic services such as water, electricity, telecommunications, financial services, education, and health, in partnership with community organizations, the private sector, and special purpose vehicles that have augmented access to these services among the rural population. These efforts have resulted in impressive outcomes, including an improvement in the percentage of the rural population with access to improved water sources from 76 percent in 2002 to 85 percent in 2013 (UNPAN 2002; National Planning Commission 2013). In addition, the percentage of the population with access to electricity increased from 40 percent in 2002 to 76.3 percent in 2015 (UNPAN 2002; World Bank WDI n.d.). Nonetheless, service delivery challenges remain among PEs. For example, the electricity supply does not meet the growth in demand. According to the national census, published in 2013, about 75 percent of the population in Nepal had connections to electricity (50 percent to the grid and 25 percent to off-grid electricity). The lack of grid-supplied electricity is a major barrier to Nepal's efforts to expand access to good-quality electricity services. The government has identified enhancements in basic service delivery as a key pillar in the achievement of its overarching goal of poverty reduction, as spelled out in the Three-Year Interim Plan (FY2014–16).

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121 Unfunded liabilities refer to those liabilities that have been incurred by the concerned PEs but for which the PEs have not made any provision to discharge them.

## Corporate Governance

### Legal Framework

**The Corporations Act of 1964 provides a generic definition of PEs in Nepal, which is further specified in more recent government reports on the PE sector.** The Corporations Act of 1964 states that “the Government of Nepal may, if it appears necessary or appropriate to (carry out) act(s) such as done by any Company as (it contributes) to the health, facility or economic interest of the people generally, establish and form any Corporation.” Official government reports such as the Yellow Book define PEs as commercial entities in which the government holds majority shares and that have been “established with the objective of delivering basic goods and services to the general people.”

**The majority of PEs are commercial companies established under the Companies Act of 2006.** Of Nepal’s 37 PEs, 26 have been established under the Companies Act of 2006 and are commercial companies operating mostly in the manufacturing and trading sectors. Seven PEs are statutory corporations, which are PEs that have been established under special statutes. For example, Nepal Airlines Corporation was established under the Nepal Airlines Corporation Act of 1963, and Nepal Water Supply Corporation under the Nepal Water Supply Corporation Act of 1989. Furthermore, two PEs were formed under the Corporations Act and two under the Communications Act. For banks and financial institutions, the Banks and Financial Institutions Act of 2017 applies and supersedes the Companies Act in case of inconsistencies between the two Acts.

**The Companies Act of 2006 references key aspects of corporate governance for commercial PEs.** The Companies Act guides the establishment of both private and public limited companies, and provides rules on matters related to their boards of directors, management, company accounts, audits, liquidations, and legal acts and penalties. The corporate governance aspects of the other PEs are guided by the respective Acts and the Memorandum and Articles of Association (MAA).

**The Banks and Financial Institutions Act of 2006 (amended in 2017) provides consolidated legislation relating to banks and financial institutions.** The Act sets the rules with regard to: (i) incorporation of banks and financial institutions; (ii) boards of directors and chief executives, including provisions on their mandate, appointments, qualifications, remuneration, disclosure, and responsibilities; (iii) licenses; (iv) capital; (v) operation of

financial transactions; (vi) regulation, inspection, and supervision, specifying the role of the central bank (Rastra Bank); (vii) supply and recovery of credits; (viii) accounts, records, returns, and reports; (ix) mergers of licensed institutions; and (x) sanctions.

## Ownership Arrangements

**The government has a dual ownership model for its PEs, with a central role exercised by the MOF and complementary functions performed by relevant line ministries.** The board of directors of a fully owned PE is nominated by the government and includes representation from MOF and the concerned line ministries. For PEs with major government shareholding, board representation is guided by the respective Acts and the MAA. MOF may be represented. Through the Financial Comptroller General Office, the MOF maintains records of investments made by the government in the share capital of PEs, ensures recovery of installments of principal and interest on loans provided to them, and monitors PEs' collected dividends.<sup>122</sup> The MOF also exercises cross-cutting oversight of PEs through the Corporation Coordination Division (CCD), which is responsible for ensuring coordination among all PEs, formulating and implementing policies, and maintaining overall financial discipline and oversight in the PE sector.

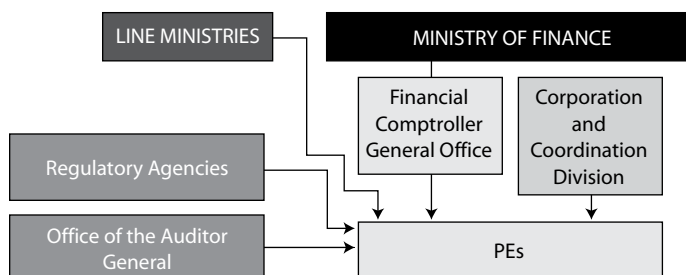
**Line ministries exercise ownership functions through direct representation on PE boards, participation in the selection of other board members, and contributions to PE strategic planning.** Line ministries and concerned regulatory authorities are also responsible for oversight and supervision. In addition to participating in the board selection, particularly for the fully owned PEs, line ministries are involved in strategy and policy setting for their respective PEs. For instance, the Ministry of Industries is involved with six PEs. Other line ministries involved with PEs are the Ministry of Commerce and Supply and the Ministry of Information and Communication. Figure 29 illustrates ownership and oversight arrangements.

**Additional supervision of and directive responsibility for PEs lie with three other government agencies.** The National Planning Commission is the uppermost advisory body under the Government of Nepal and is responsible for preparing periodic long-term strategic plans for the public sector, including PEs. The Public Service Commission is a constitutional body in charge of recruiting civil servants for government agencies, as well as the selection and recruitment of PE staff. In the past, the Public

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122 The Financial Comptroller General Office is the main government agency responsible for the treasury operations of the Government of Nepal.

**FIGURE 29: Ownership and Oversight Arrangements for PEs in Nepal**



Source: World Bank staff compilation.

Enterprises Direction Board, established in 2011, provided additional support to the Cabinet (also called the Council of Ministries) on the nomination of PEs’ chief executive officers (CEOs) on the basis of competition and professionalism for PEs other than those under the Companies Act. The Public Enterprises Direction Board is no longer functional, however, and the CEO appointment process is now based on the respective Acts and the MAA.

### **Performance Monitoring**

**There are currently no performance agreements or similar monitoring tools in place for PEs in Nepal, although these have been used in the past.** Memoranda of Understanding were used in the past as ex ante bilateral agreements between PEs and the government, but the government has gradually moved away from this practice. At present, the government has not established performance agreements with PEs. The CCD periodically monitors PEs’ financial indicators, such as share and loan investments and the status of operating and other expenses. The relevant line ministries and regulatory agencies also monitor PE performance. The process of evaluating the performance of PE CEOs via performance indicators is in place, and the relevant performance indicators are used to select potential CEOs.

### **Board of Directors**

**Board members are selected either at PEs’ Annual General Meetings (AGM) or directly by the government, depending on each PE’s relevant Act and MAA.** For entities formed under the Companies Act and the Banks and Financial Institutions Act, board members are appointed by shareholders at the AGM. For PEs established under the Corporations Act, Communications Act, and specific legislation such as the 1968 National Insurance

Corporation Act, board members can be appointed either by the shareholders at the AGM or directly by the government.

**For all PEs, at least one board member is from the MOF and/or one is from the respective line ministry.** Board composition and representation are guided by the respective Acts and MAA.

**The board chairs and CEOs of PEs, with the exception of those under the Companies Act, are approved by the Council of Ministers.** The government has adopted the policy of nominating the board chair from among only competent and skilled professionals, and the final selection must be approved by the Council of Ministers as guided by the specific Acts and MAA. The government is in the process of introducing selection of qualified CEOs for PEs through open competition.

#### BOX 28

### PE Board Features in Nepal

**Nomination of board members:** Differs by enterprise, depending on the provisions of the Act and MAA under which the PE was formed. For example:

- Corporation Act: Directors nominated by the government and elected by the General Assembly.
- Companies Act: Directors appointed by the General Assembly.
- Communication Corporation Act: Directors nominated by the government and elected by the General Assembly.
- National Insurance Corporation Act: Directors nominated by the government and elected by the General Assembly.
- Banks and Financial Institutions Act: Directors nominated by the government in the bank and financial institutions having government shares and elected by the General Assembly.

**Nomination of board chair:** Determined by the provisions of the Act under which the enterprise was formed.

**Nomination of CEO:** Determined by the provisions of the Act under which the enterprise was formed. Most often requires approval from Cabinet, except for PEs under the Companies Act.

**Mandate of the board:** Broad mandate, including strategy setting, policy guidance, and monitoring.

**Separation between chair and CEO:** Yes.

**Composition of the board:** 3 to 9 members.

**Profile of board members:** Public officials, external experts/specialists in the field.

**Board committees:** Some PEs have the authority to create committees, as needed.

**Remuneration of CEO and board members:** Board remuneration and other conditions of service are specified by the government of Nepal and other shareholders as specified in the relevant Act and MAA.

*Source:* World Bank staff compilation.

**The size of PE boards typically ranges from three to nine members.** The structure, composition, and tenure of PE boards are determined by the provisions of different legislation (Acts) under which a given PE was formed. These acts also determine whether directors may be reelected and how a chairperson is to be selected. In the case of the 21 PEs constituted under the Companies Act, boards are composed of three to eleven directors with a four-year tenure, all eligible for reelection and in charge of the appointment of the chair. Box 29 provides a summary of board-related guidelines provided in the various acts governing PEs.

**BOX 29**

**Structure of PE Boards of Directors by Varying Legislation**

Act	No. of Directors	Tenure	Reelection	Chairman	CEO/General Manager
Company Act (2006)	3–11	Up to 4 years	Eligible	Nominated by board.	Appointed by board.
Corporations Act (1964)	As determined by government.	As determined by government.	–	Nominated by government among the directors.	Appointed by board.
Communication Corporation Act (1972)	5	4 years, but for the directors nominated by government, it is determined by government.	Eligible	Nominated by government.	Nominated by government.

*(box continues on next page)*



**BOX 29** *continued*

<b>Act</b>	<b>No. of Directors</b>	<b>Tenure</b>	<b>Reelection</b>	<b>Chairman</b>	<b>CEO/General Manager</b>
National Insurance Corporation Act (1968)	7	3 years	Eligible	Nominated by government.	Appointed by board.
Citizen Investment Trust Act (1991)	At least 9	5 years, but for the directors nominated by government, it is determined by government.	Eligible	Appointed by government.	Appointed by government.
Banks and Financial Institutions Act (2017)	5 to 7	Up to 4 years	Eligible	Nominated by board.	Appointed by board.
Gorkhapatra Corporation Act (1963)	5	4 years, but for the directors nominated by government, it is determined by government.	Eligible	Nominated by government.	Appointed by government.
Nepal Electricity Authority Act (1984)	8	4 years	Eligible	Minister of relevant ministry of nominated by board.	General Manager appointed by the board; Executive Director by government.

*Source:* World Bank staff compilation based on legal acts.

**The board members are comprised of government officials, experts, and nongovernmental representatives.** While the profile of board members is laid out by the Act under which the PE was formed, in general, board membership comprises a mix of individuals, including government officials, renowned specialists in a field related to the PE's sector, representatives from nongovernmental and interest groups, and PE employee representatives. For PEs under the Corporations Act, board members have to be from the government, well-known in the relevant field, or an employee of these PEs. Some Acts specify further requirements, such as the Banks and Financial Institutions Act, which places an emphasis on educational and professional background—namely, having a master's degree in banking, finance,

economics, or commercial law with at least five years of executive-level experience in the field.

**PE boards have the authority to create board committees.** According to the Companies Act, PEs must form an audit committee consisting of at least three members, and chaired by an external director. Additionally, the Act allows the board of directors to create one or several subcommittees for the discharge of any specific business. The Nepal Water Supply Corporation Act and the Banks and Financial Institutions Act allow PE boards to create committees as required. The latter also states that “the functions, duties, powers and rules of procedure of each committee [. . .] and the remuneration or allowances receivable for attending its meetings shall be as prescribed by the Board.”

**Depending on the legislation, board remuneration and conditions of service are specified directly by the government or by representation at the PE’s AGM.** In the case of PEs formed under the National Insurance Corporation Act, board remuneration is set directly by the government, but for PEs under the Companies Act, board remuneration is determined by the shareholders at the AGM. In addition, the Insurance Act specifies that members will be provided remuneration for each day of attendance at board meetings, while the Companies Act states that members are to receive monthly remuneration. In some cases, board members may receive incentive payments, which should not exceed 5 percent of PEs’ reported net profits.

## Transparency and Disclosure

**The annual “Yellow Book” provides an aggregated financial and non-financial overview of Nepal’s PE sector.** The Yellow Book, elaborated by the MOF, provides detailed information on financial (including annual financial statements) and nonfinancial performance of each PE and the overall PE portfolio. It compares current year data with data from the previous fiscal year and provides comments on progress and challenges.

**All PEs are legally required to submit annual financial statements to the MOF and respective line ministries.** Financial statements disclose the financial status of the enterprise, the number of employees, production capacity, dividends paid, and outstanding loans and liabilities. Financial reports are approved by the board of directors prior to submission.

**The procedures for external audit of PEs differ depending on the share of state ownership.** Fully state-owned PEs follow the regulations and standards of the Office set by the Auditor General (OAG), while majority

**BOX 30**

## **Transparency and Disclosure Practices for PEs in Nepal**

**Accounting standards:** Based on accrual principle. The Nepal Financial Reporting Standards are applicable, but most PEs are not yet in compliance.

**Transmission of financial and activity reports by PEs:** All PEs are required to submit annual financial reports to the MOF, their respective line ministries, and regulatory authorities.

**Aggregated reports:** The MOF publishes an annual aggregated review of PE performance (Yellow Book).

**Disclosure:** Audited financial statements are published on the PE's website; the Yellow Book is published on MOF website; Office of the Auditor General's (OAG) audit reports are published on the OAG website.

**Internal audit:** Internal audits are conducted by the PEs' auditing staff and reports are submitted to the board audit committee. Internal audits can be financial-, performance-, and compliance-based.

**External audit: Fully government-owned PEs:** OAG based on International Organization of Supreme Audit Institutions (INTOSAI) auditing standards; **Majority-owned PEs:** Independent professional auditors in consultation with OAG.

*Source:* World Bank staff compilation.

state-owned PEs are audited by independent auditors appointed in consultation with the OAG. In the case of majority-owned PEs under the Companies Act, if the AGM fails to appoint an auditor in time, the Company Registrar's Office will appoint the auditor at the request of the board of directors upon consultation with OAG. Box 31 provides a summary of the auditing guidelines.

**OAG audit reports are submitted to the president, responsible line ministries, and individual PEs, and published on the OAG's website.** An annual OAG audit report is submitted to the president and forwarded to the prime minister's office to be shared with parliament. When the report is submitted to the president, it is made public by the OAG and published on its website.<sup>123</sup> Requirements with regard to audit report submissions vary,

<sup>123</sup> <http://oagnep.gov.np/auditreports.php> (accessed February 6, 2018).

**BOX 31****Summary of External Audit Procedures for PEs**

Status	Auditor	Frequency	Submission
Fully owned PEs	OAG	Annual	To president, line ministries, and the PE
Majority-owned PEs	Independent professional auditor in consultation with OAG	Annual	To PE (shareholders)

Source: World Bank staff compilation based on legal acts.

although in most cases the auditor's report must be submitted to the corresponding shareholders.

**Although the external audit of PEs' annual financial statements is legally required, implementation remains partial.** The 2016 Yellow Book indicated that several PEs did not complete their external audits on time. For instance, the report showed that only two of the seven industrial sector PEs had submitted their audit reports in 2014/15. Similarly, only three of the six PEs in the trading sector, one of the seven in the services sector, and one of the five in the social sector had completed audits. This information was brought forward at the Public Accounts Committee for review and follow-up action.

**The internal audit function for PEs is either conducted by PE staff or outsourced, and reports are commonly submitted to board audit committees, which may recommend corrective actions.** Senior management from each PE is responsible for appointing staff to conduct internal audits. Internal audit reports may be submitted on a periodic basis as per agreed terms of engagement. Internal audits may cover financial, performance, and compliance aspects. In practice, however, capacity constraints sometimes limit the undertaking of comprehensive, effective, and timely audits.<sup>124</sup>

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124 The Institute for Chartered Accountants provides audit training, known as Continued Professional Education, to its members. All licensed auditors must take this training annually to maintain licensing to perform audits. No other types of formal and/or mandatory training exists for internal and external auditors. The government recently began exploring this issue with external partners.



## CHAPTER 7

# Pakistan

## SOE Sector

### Evolution of SOE Sector and Reforms

**The state-owned enterprise (SOE) sector dates back to the 1970s, when the Government of Pakistan expanded its involvement in economic activity through a nationalization program.** In 1972, the government initiated an extensive nationalization program within the framework of a state-driven industrial policy and broader socialist economic reforms. Initially, 31 manufacturing enterprises in heavy industrial sectors were nationalized. In 1974, another 35 large companies, including all banks and insurance companies, as well as shipping companies, were nationalized. Two years later, over 2,500 small and medium enterprises, such as flour mills and cotton-ginning factories, were also nationalized, although about half of them were later returned to their owners. As a result, by the end of the 1970s, the size of the SOE sector had expanded exponentially.

**Beginning in the 1980s, the government began to redirect the country's industrial policy toward private sector-led growth.** Several formerly nationalized companies were returned to their previous owners in

1978 under the Transfer of Managed Establishments Order. In addition, in 1982–83, the government introduced fiscal incentives such as tax holidays and custom duty rebates to further encourage private sector development. No major industrial units were divested during this period, however, and 90 percent of the financial sector remained under public ownership (ADB 2008). Overall, some 257 enterprises remained under state ownership by the late 1980s.

**During the 1990s, the government introduced structural reforms to further liberalize the economy and privatized some large SOEs from commercial sectors.** Pakistan’s economy went through a structural transformation during the 1990s. The government introduced an ambitious SOE privatization program, which resulted in the divestment of government stakes in several large SOEs in the industrial, energy, and banking sectors. During this period, the government also expanded the role of regulatory bodies, such as the Corporate Law Authority (now the Securities and Exchange Commission of Pakistan, or SECP), and established a number of new independent industry regulators, such as the Oil and Gas Regulatory Authority and the National Electric Power Regulatory Authority (NEPRA).

**From 2000 to 2007, successive governments have continued privatization efforts, further reducing the size of the SOE sector.** Under the regime of General Pervez Musharraf, in 2000, the government passed the Privatization Act and created the Ministry of Privatization and Investment to manage the privatization process. A number of strategic sales were undertaken at this time, including those of two major commercial banks—Habib Bank Limited and United Bank Limited—and several telecommunications companies. In addition, under the “Privatization for the People” program, SOE shares were sold in domestic stock markets. By 2008, all state holdings in the textile and telecommunications sectors had been privatized, along with an estimated 77 percent of the state’s stakes in commercial banking and most state assets in the cement, sugar, automobile, and fertilizer sectors (ADB 2008).

**In the past couple of years, the government has placed an emphasis on divestment, although with limited results, and intensified efforts to improve SOEs’ performance by reinforcing corporate governance rules.** In 2013, the government reconstituted the Board of the Privatization Commission, responsible for restructuring and divesting 69 SOEs. Privatizations encountered several obstacles, however, with only five of the planned transactions having been completed. Since the end of 2015, no privatizations have taken place owing to various combinations of political opposition, workers’ protests, legal challenges, and investors’ limited interest in underperforming enterprises. The government introduced, also in 2013, the Public Sector Companies (Corporate Governance) Rules (amended in April 2017),

which apply to all SOEs registered under the Companies Ordinance of 1984 and are based on the 2005 Organisation for Economic Co-operation and Development (OECD) Guidelines on Corporate Governance of State-Owned Enterprises.

## Economic Significance

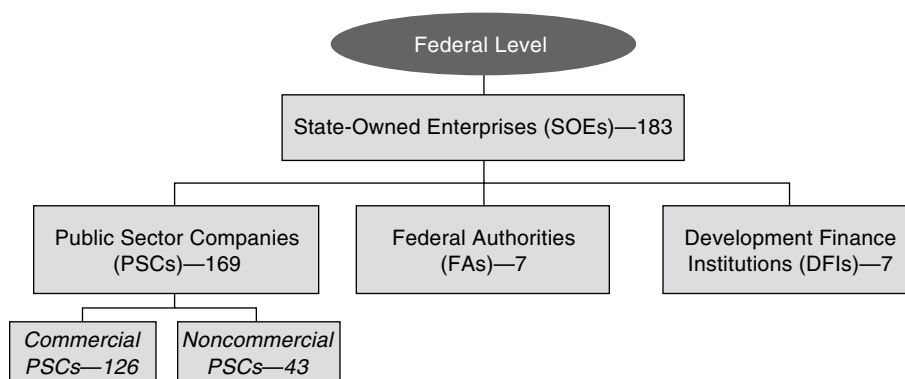
**According to the government’s classification, 183 SOEs are owned by the federal government of Pakistan (Government of Pakistan 2016).**<sup>125,126</sup>

At the federal level, the SOE sector is divided into the following three categories:

- **Public Sector Companies (PSCs):** 126 commercial and 43 noncommercial companies;
- **Federal Authorities (FAs):** 7 entities such as port authorities, railways, post offices, and the Water and Power Development Authority; and
- **Development Finance Institutions (DFIs):** 7 investment and holding companies.

**In 2014–15, the gross revenues of Pakistan’s SOE sector represented 15 percent of gross domestic product (GDP) and net profits represented 0.2 percent of GDP.** SOEs provide important contributions to Pakistan’s

**FIGURE 30: The SOE Sector in Pakistan**



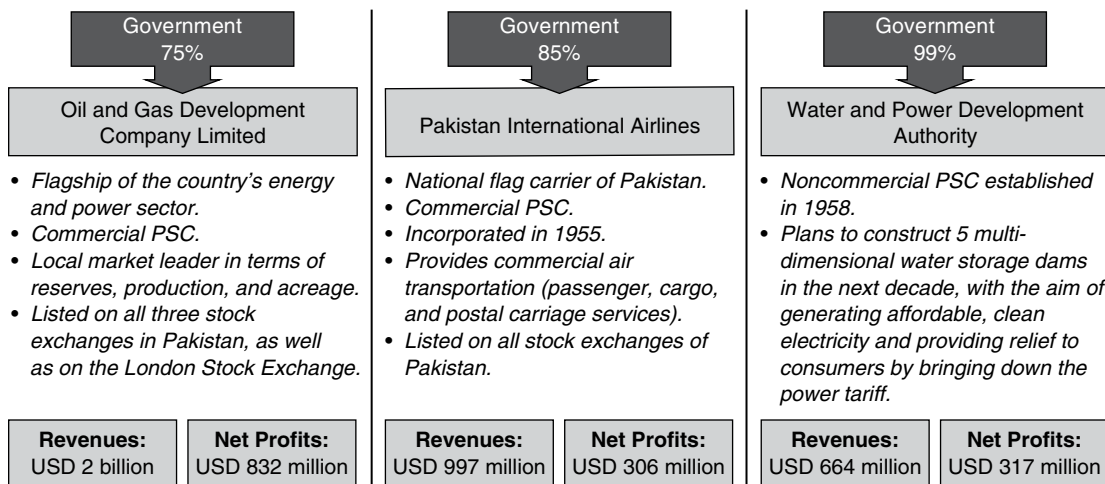
Source: MOF (2016).

<sup>125</sup> This figure does not include SOEs that are active in the defense sector or other sectors that the government deems to be of a strategic nature.

<sup>126</sup> There are also SOEs owned by provincial governments in Pakistan, but they are not registered precisely in some cases, and they are not included in this report.



**FIGURE 31: Selected SOEs in Pakistan, FY2014–15**



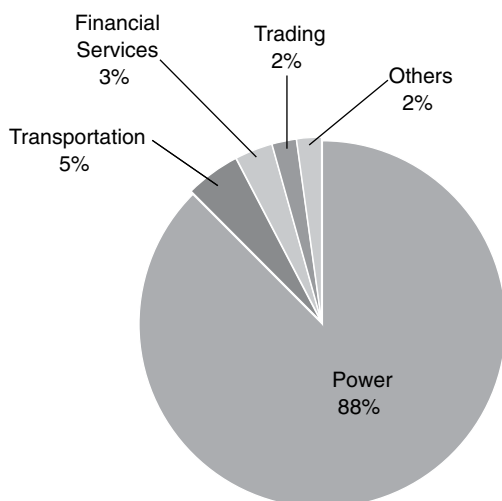
Source: SOEs' websites; MOF (2016).

economy. In FY2014–15, federal-level SOEs' turnover amounted to PKR 4,175 billion (approximately USD 40 billion) and 15 percent of the country's GDP (MOF 2016). In addition, SOEs' total profits (excluding noncommercial PSCs) amounted to PKR 52 billion (around USD 0.5 billion), equal to 0.2 percent of GDP (MOF 2016). Figure 31 presents key statistics and summarizes the primary activities of some of the largest SOEs in the country.

**SOEs in Pakistan operate in most sectors of the economy and are prominent in the power, financial, and transportation sectors.** Per the government's classification, SOEs can be found in the power, hydrocarbon, industrial and engineering, trading, services, financial, transportation, and promotional and advocacy sectors. Of these, the power, financial, and transport sectors are particularly significant to the economy. The power sector's net revenues alone accounted for 88 percent of total revenues in FY2014–15, followed by those of the transport sector (5 percent) and those of the financial sector (3 percent) (Figure 32).

**Among the 169 federal PSCs, only 12 are listed on the stock exchange.** According to the latest government performance report on the SOE sector, twelve PSCs are currently listed. These comprise five oil and gas companies; three financial firms, including the National Bank of Pakistan; two industrial and engineering companies; and two transportation entities. Together, these companies accounted for 33 percent of the total assets and contributed to

**FIGURE 32: SOE Sector Composition, FY2014–15 (net revenues)**



Note: Data include all subcategories of enterprises: PSCs, FAs, and DFIs.

Source: MOF (2016).

44 percent to the total turnover of PSCs in FY2014–15. Total market capitalization from these 12 listed SOEs in February 2017 was PKR 1.13 trillion (USD 10.74 billion).<sup>127</sup>

**SOEs owned by the federal government provide employment to over 400,000 workers in Pakistan.** Federal-level SOEs currently employ 402,543 people, which represents approximately 0.74 percent of the total employed labor force in the country (MOF 2016).<sup>128</sup> Among SOEs, commercial PSCs account for the largest share of employment (255,036), followed by FAs (143,057), noncommercial PSCs (3,832), and DFIs (618). With 41 percent of total PSC employment, the power sector is the largest source of employment among SOEs.

<sup>127</sup> Two additional federal SOEs are listed on the Pakistan Stock Exchange: Mari Petroleum Company (slated for divestment) and First National Bank Modaraba, a subsidiary of the National Bank of Pakistan. If these two companies are included, the total market capitalization of federal SOEs rises to PKR 1.27 trillion (USD 12.12 billion). The reasons for these companies' exclusion from the MOF's SOE report is that the government owns a minority stake of 49% in Mari Petroleum, while First National Bank Modaraba was listed after the period covered by the report.

<sup>128</sup> Data on employment are incomplete.

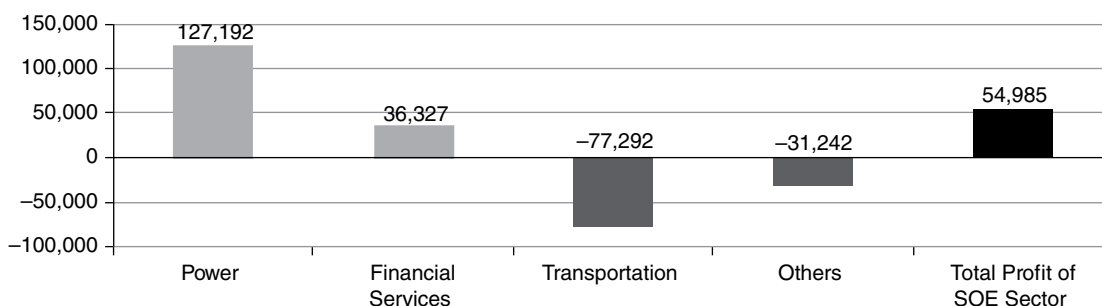
## Macro-Fiscal and Service Delivery Implications

**The financial performance of the SOE sector slowed down in FY2014–15, with gross revenues decreasing by 21 percent and net profits by 73 percent as compared to the previous year.** In FY2014–15, federal-level SOEs reported a gross revenue growth of –21 percent as compared to FY2013–14, with total gross revenue decreasing from PKR 5.3 trillion (USD 50.39 billion) to PKR 4.18 trillion (USD 39.74 billion). Total profits<sup>129</sup> decreased by 73 percent in the same year, to PKR 52 billion (approximately USD 0.5 billion) (MOF 2016). Most of this trend in financial performance was explained by a significant profit reduction in the power sector during this period (Figure 33).

**Among the 126 commercial PSCs owned by the federal government, the Oil and Gas Development Company and Pakistan Petroleum Limited were among the most profitable in 2014–15.** The combined profit of the 10 most profitable companies stood at PKR 208 billion (USD 2 billion), down 35 percent from 2013–14, while the combined losses of the 10 loss-making SOEs stood at PKR 159 billion (USD 1.5 billion). Of these, the Oil and Gas Development Company Limited and Pakistan Petroleum Limited reported the highest profits, whereas Pakistan Steel Mills, Pakistan International Airlines, and several distribution companies (DISCOs) reported the largest losses.

**Dividends from SOEs accounted for 1.7 percent of the government budget in 2014–15.** According to data published by the government (MOF 2016), the sector provided PKR 65.85 billion (USD 627 million) in dividends

**FIGURE 33: SOE Profits and Losses by Sector, 2014–15 (PKR millions)**



Note: Combined profits and losses for PSCs, FAs, and DFIs based on government sectoral classification.

Source: MOF (2016).

<sup>129</sup> As mentioned in the overview, profits only give a picture at a specific point in time and may be impacted by a variety of factors.

to the government in FY2014–15, which was 11 percent more than in FY2013–14. Total dividends are driven largely by the energy sector (hydrocarbons): in 2014–15, the sector paid PKR 56.5 billion (USD 537.17 million) in dividends, representing approximately 85 percent of the total amount of dividends declared.

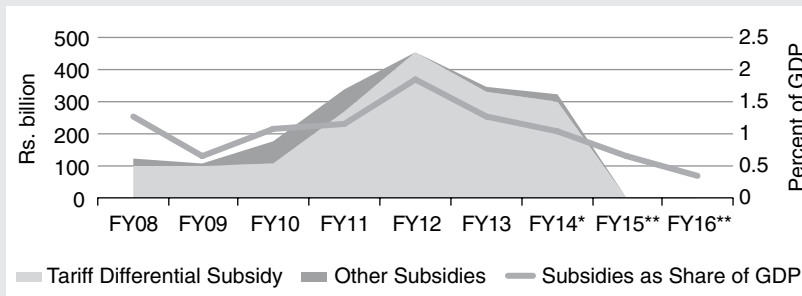
**The SOE sector continues to exert pressure on the country’s limited fiscal resources.** By 2015–16, the overall deficit of the federal government narrowed to 4.1 percent of GDP, owing to increased tax revenues and improvements in the financial performance of some SOEs, especially in the power sector. Despite these improvements, the net contribution of SOEs to the budget remains negative. In 2013–14, budget transfers to SOEs outweighed their contributions through dividends and taxes by a ratio of around 4:1 (MOF 2016).

**BOX 32**

**Power Sector Reforms Aimed at Reducing Subsidies**

**The Government of Pakistan has launched a reform plan to gradually eliminate most energy sector subsidies.** Energy subsidies reached 1.5 percent of GDP in FY2012–13. The government aimed to reduce them to 0.3–0.4 percent by FY2016–17 (see figure below). Tariff increases in 2015 and 2016 have increased the cost recovery of power sector utilities, with the aggregate collection rate increasing to 93 percent (from 87 percent in FY2011–12) and net losses declining from 18.9 of turnover in FY2011–12 to 17.9 percent in FY2015–16.

**Electricity Sector Subsidies in Pakistan**



Note: \* Estimate \*\* Target  
Source: WBG (2014).

**Performance challenges in the SOE sector have important implications for service delivery in Pakistan.** The power and energy sector is a noteworthy example of this. In 2011, electricity shortages exceeded 7,000 megawatts in the country (more than 40 percent of national demand), and the gas shortfall was 2 billion cubic feet per day (Aziz and Ahmad 2015). Power outages (known as “load shedding”) remain common in the country, although growing generation capacity has gradually brought them down to four to six per day for households. Issues such as enduring price distortions, insufficient user rate collections to cover costs, transmission losses, and inadequate regulatory arrangements have all contributed to this challenge. Indeed, service delivery issues in the energy sector are among the foremost constraints affecting Pakistan’s business climate. Power outages have particularly affected the manufacturing sector in recent years; government estimates suggest that power and gas shortages constrained GDP growth by 3 to 4 percentage points in FY2010–11 and FY2011–12 (ADB 2012). In the *Global Competitiveness Report 2016*, Pakistan ranked 137th out of 140 economies on the quality of electricity supply, which investors ranked as the second-most important challenge after security (WEF 2016, 233).

## Corporate Governance

### Legal Framework

**Most SOEs have the legal status of public sector companies established under the Companies Ordinance of 1984.**<sup>130</sup> There are 169 PSCs in which the federal government holds a controlling stake, of which 126 are commercial companies (120 set up under Section 32 of the Companies Ordinance of 1984 and six set up under Special Enactment) and 43 are noncommercial companies (set up under Section 42 of the Companies Ordinance). The Companies Ordinance of 1984 provides the following definition of a PSC: “a company, whether public or private, which is directly or indirectly controlled, beneficially owned or not less than 50 percent of the voting securities or voting power of which are held by the government or any instrumentality or agency of the government or a statutory body, or in respect of which the government or any instrumentality or agency of the government or a statutory body, has otherwise power to elect, nominate or appoint majority of its directors, and includes a public sector association not for

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130 The 1960 Public Investment (Financial Safeguard) Ordinance applies to all SOEs and defines the powers of federal and provincial governments with regard to their SOEs.

profit, licensed under section 42 of the Companies Ordinance, 1984 (XLVII of 1984).”

**The Companies Ordinance of 1984, which has been replaced by the new Companies Act, 2017, includes several provisions related to corporate governance for PSCs.** The 1984 Ordinance, which replaced the Companies Act of 1913, is a broad-ranging piece of legislation consolidating and amending laws pertaining to all companies (public and private) registered at the SECP. The Ordinance includes provisions on the establishment of a company and its incorporation, the powers and duties of boards of directors, financial management and audit, and liquidation.

**The Securities and Exchange Commission of Pakistan regulates all PSCs registered under the Companies Ordinance.** The SECP is the capital markets and corporate sector regulator whose regulatory authority includes all PSCs (that is, SOEs established under the Companies Ordinance and SOEs that have been “corporatized,” or legally converted to PSCs by act of Parliament). The SECP is responsible for monitoring PSCs’ compliance with the provisions of the Companies Ordinance. The SECP also has the authority to issue secondary regulations under the Ordinance. In particular, its main regulatory act is the Code of Corporate Governance, issued in 2002 and amended in 2014. Compliance with the Code is mandatory for all companies listed on Pakistan’s stock exchange, including listed PSCs. In 2016, the SECP issued the Principles of Corporate Governance for nonlisted companies.

**The Public Sector Companies Corporate Governance Rules were issued by the SECP in 2013 and amended in 2017.** Compliance with the Rules is mandatory for all PSCs registered under the Companies Ordinance of 1984, including both commercial and noncommercial enterprises (SECP 2011). The Rules include provisions on board procedures and set mandatory financial reporting and internal and external audit requirements for PSCs.

**According to the government classification, only seven Federal Authorities are considered to be SOEs.** There are currently 29 FAs operating in Pakistan, including entities such as the State Bank of Pakistan (SBP) and the SECP, but the government has designated only seven of these FAs as SOEs. According to the Ministry of Finance’s (MOF) latest SOE sector performance report, the government uses the following criteria for designating FAs as SOEs: (i) impact on fiscal risk; (ii) engagement in commercial activities; and (iii) a significant asset base.

**The seven Development Finance Institutions comprise holding and investment companies that finance development projects.** The MOF defines this category according to OECD definitions and criteria, which state that DFIs “provide a broad range of financial services [. . .] such as loans

or guarantees to investors and entrepreneurs, equity participation in firms or investment funds, and financing for public infrastructure projects (MOF 2016).” DFIs in Pakistan include companies such as Pak China Investment Company Ltd. and the Investment Corporation of Pakistan. All DFIs come under the regulatory authority of the SBP, the country’s central bank.

**Special acts usually cover objectives, functions, ownership and oversight arrangements, and the governance structure of FAs and DFIs.** For example, the Water and Power Development Act of 1958 stipulates that the Water and Power Development Authority’s board members and chair are to be appointed by the government. It also defines the authority’s areas of activity, specifies its sources of revenue, and regulates its operational and financial reporting obligations, as well as external audit procedures. Special acts establishing other FAs and DFIs cover a similar range of issues.

**State-owned banks are subject to the regulatory and supervisory authority of the State Bank of Pakistan.** State-owned banks in Pakistan comprise the SBP, its subsidiaries, and the seven DFIs. There are no special laws or regulations that apply to state-owned banks, which must observe SBP regulations on the same basis as privately owned banks. SBP regulations concern bank licensing, corporate governance, capital adequacy, prudential regulations, and anti-money laundering/combating the financing of terrorism regulations.

**Depending on their activities, SOEs may also be subject to sectoral regulations.** The main sectoral regulators with authority over subsets of SOEs are the SBP and the two main energy sector regulators, the Oil and Gas Regulatory Authority and NEPRA. The regulatory authority of the latter two also extends to privately owned companies active in their respective sectors.

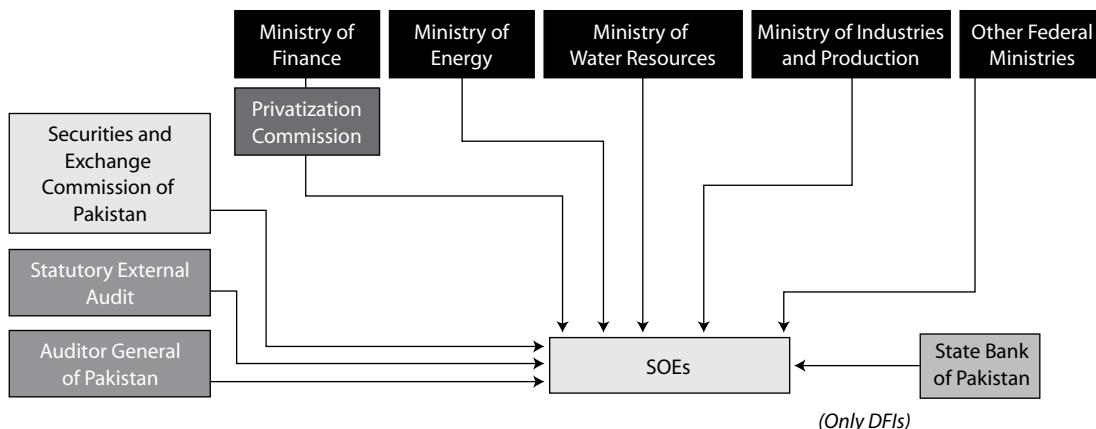
## Ownership Arrangements

**Pakistan follows a decentralized model whereby line ministries exercise the state’s ownership function for SOEs active in their respective sectors.** There are 17 federal ministries responsible for exercising the ownership function of SOEs on behalf of the state, but most federal SOEs are under the purview of the MOF (31 SOEs); the Ministry of Industries and Production (35 SOEs); and the Ministry of Water Resources and Ministry of Energy (26 SOEs). Of the SOEs under the MOF, most are active in the financial sector, including state-owned banks and DFIs.<sup>131</sup> The MOF also manages

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131 The MOF also has financial oversight authority for all SOEs owned by the federal government.

**FIGURE 34: The Ownership and Oversight Function in Pakistan**



Source: World Bank staff compilation.

the government’s minority stakes in various enterprises, which are usually former SOEs that have been privatized. The Ministry of Industries is mostly responsible for industrial and engineering companies, while the Ministry of Water Resources and the Ministry of Energy exercise the state’s ownership and oversight of all SOEs related to irrigation; water supply and sanitation; and power generation, transmission, and distribution. Figure 34 provides a summary of federal ministries’ SOE portfolios.

## Performance Monitoring

**While there is currently no overarching performance framework for all SOEs, some sectors have more systematic performance monitoring than others.** In general, the operational performance of SOEs is monitored by their boards of directors and the responsible line ministries, but without reference to any cross-sectoral standardized indicators or benchmarks.

**Performance for the SOEs active in the power sector, however, is systematically monitored against key performance indicators (KPIs).**<sup>132</sup> Companies engaged in the energy sector are required to submit performance reports to the regulator, NEPRA. There are three sets of performance standards rules and reporting requirements issued by NEPRA on: transmission

132 In the 1980s, Pakistan had applied a performance framework known as the “signaling system” to all industrial SOEs. This system had an elaborate methodology of weighed KPIs and included performance incentives for senior managers. The government abandoned it in the 1990s, however, on the assumption that SOEs would be privatized quickly.



(2005); distribution (2005); and generation (2009). These performance standards apply to both SOEs and privately owned companies operating in the sector.

**In particular, the performance of state-owned energy distribution companies is subject to more rigorous monitoring under performance contracts signed with the Ministry of Energy and Ministry of Water Resources.** These performance contracts require DISCOs to report on their KPIs on a monthly, quarterly, and annual basis against targets agreed between each company and the ministries.<sup>133</sup> DISCOs' performance reports need to be submitted to Ministry of Energy, Ministry of Water Resources, and NEPRA. Monthly reports cover financial KPIs (such as billing amounts, collection rates, and payment arrears), while quarterly reports cover operational KPIs (including the number and duration of unplanned power interruptions, average daily hours of load shedding for different categories of consumers, and average timelines for delivering new connections).

**A special monitoring regime applies to three large loss-making SOEs: Pakistan International Airlines, Pakistan Steel Mills, and Pakistan Railways.** These companies are on the government's list for "fast-track" privatization and/or divestment. In this context, they are implementing restructuring plans that aim to restore them to financial health, reducing their reliance on the budget and thereby paving the way to potential divestment or full privatization. Implementation of the restructuring plans and a range of primarily financial KPIs are part of their performance contracts with the government, which aim to link government financial support to the companies' progress toward established targets. The MOF and the Privatization Commission, in addition to the supervising ministries, monitor the performance of the three companies. The restructuring of these three companies and their progress toward their financial targets were part of the government's three-year Extended Arrangement with the International Monetary Fund, which was completed in September 2016. By the end of FY2015–16, the three companies' cumulative losses amounted to 2.3 percent of GDP, though the pace of the accumulation of losses had slowed to 0.2 percent of GDP (IMF 2016a).

## **Board of Directors and Management**

**Board of directors regulations for all PSCs are governed by the SECP Corporate Governance Rules,<sup>134</sup> and those for DFIs are governed by**

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133 There was a big push for privatization of the DISCOs, which fell through by mid-2016.

134 The rules date from 2013 and were amended in 2017.

**SBP regulations.** The Corporate Governance Rules emphasize the role of boards and provide extensive regulations on boards' main powers and responsibilities; their composition and committee structure; and directors' nominations, appointments, and remuneration. No comparable rules or guidelines exist for FAs, while DFIs are covered by the SBP regulations that apply to all banks. Box 33 outlines the main regulatory requirements related to PSCs' boards of directors per the 2013 Rules.

**BOX 33**

**SOE Board Features in Pakistan**

	<b>PSCs</b>	<b>DFIs</b>	<b>FAs</b>
<b>Mandate of the board</b>	Strategic policy decisions regarding the PSC; fiduciary oversight; appointment of CEO, chief financial officer, and internal auditor.	Approval of strategy, objectives, business plans, and corporate policies; oversight of compliance with laws and regulations.	Not all FAs have boards; for example, the Post Office and Pakistan Railways do not.
<b>Nomination of board members</b>	By ministry exercising the ownership function, MOF, Privatization Commission, and minority shareholders.	By shareholders; appointment subject to SBP clearance.	<ul style="list-style-type: none"> <li>• Mostly appointed by government.</li> <li>• May include representatives of external stakeholders (for example, Karachi Port Trust).</li> </ul>
<b>Nomination of board chair</b>	Elected by the board, except when chair is appointed by the government.	By the board; appointment subject to SBP clearance.	Appointed by government.
<b>Nomination of chief executive officer (CEO)</b>	Board to provide candidates for concurrence by the government, except when CEO is nominated by the government; then appointed by the board upon government concurrence.	By sponsor shareholders (who own at least 5 percent of shares); appointment and dismissal subject to SBP clearance.	Appointed by government.
<b>Separation between chair and CEO</b>	Yes.	Yes.	No.

*(box continues on next page)*

**BOX 33** *continued*

	<b>PSCs</b>	<b>DFIs</b>	<b>FAs</b>
<b>Composition of the board</b>	<ul style="list-style-type: none"> <li>• 5–9 board members.</li> <li>• Executive, nonexecutive.</li> <li>• At least one-third of total members to be independent directors.</li> </ul>	<ul style="list-style-type: none"> <li>• Number of executive directors limited to two, including the CEO.</li> <li>• At least 25 percent independent directors.</li> </ul>	<ul style="list-style-type: none"> <li>• Senior civil servants.</li> <li>• May include representatives of private sector stakeholders (such as chambers of commerce).</li> </ul>
<b>Structure of the board</b>	Single unitary body.	Single unitary body.	
<b>Profile of board members</b>	<ul style="list-style-type: none"> <li>• Active and retired civil servants.</li> <li>• Businesspersons.</li> <li>• Professionals (auditors, lawyers).</li> <li>• Must meet “fit and proper” criteria set by Corporate Governance Rules.</li> </ul>	<ul style="list-style-type: none"> <li>• Senior officials of federal ministries and agencies.</li> <li>• Representatives of the foreign stakeholder (in DFIs established with foreign countries, such as Pak-China Investment Company).</li> <li>• Businesspersons/ professionals.</li> </ul>	<ul style="list-style-type: none"> <li>• Senior civil servants.</li> <li>• Businesspersons (in the case of port authorities).</li> </ul>
<b>Board committees</b>	<ul style="list-style-type: none"> <li>• 5 (required) committees.</li> </ul>	<ul style="list-style-type: none"> <li>• 4 (required) committees.</li> </ul>	n/a.
<b>Remuneration of CEO and board members</b>	<p><b>Board members:</b> determined by shareholders or the board.</p> <p><b>CEOs:</b> subject to board approval.</p>	Remuneration of nonexecutive directors linked to number of board meetings.	Civil service pay scale.
<b>Training of board members</b>	Certification encouraged; PSC-specific orientation course for new directors required.	Two weeks of training recommended.	Not required.
<b>Evaluation of the board</b>	Annual self-evaluation.	Annually, based on SBP guidelines.	Not required.

Source: World Bank staff compilation based on review of relevant regulations.

**According to the Corporate Governance Rules, PSC Boards are responsible for making strategic policy decisions.** Boards are responsible for establishing internal corporate governance arrangements; appointing senior executives, including the CEO, chief financial officer, and internal auditor; approving investment, divestment, and borrowing decisions;

monitoring the company's performance with reference to its objectives; and exercising fiduciary oversight, including approving the company's financial statements and reviewing internal audit reports to ensure that the company's resources are used efficiently to achieve the company's objectives.

**To perform these functions, PSC Boards are required to establish five essential committees.** The Corporate Governance Rules specify the following mandatory committees: (i) audit committee; (ii) risk management committee; (iii) human resources committee; (iv) procurement committee; and (v) nominations committee. These committees must be chaired by non-executive board members, and the majority of the committees' members must be independent. Committees must also have written terms of reference that outline their duties and authority. Finally, the minutes of all committee meetings must be circulated to all board members.

**The Corporate Governance Rules define the process and criteria for the appointment of PSCs' board members.** Depending on the government's stake in a PSC, it may nominate a majority or all members of the company's board of directors. Minority shareholders may also nominate board members. Candidates are vetted by the board's Nominations Committee with reference to the "fit and proper" criteria defined in the Rules. These criteria include a university degree; relevant professional experience in government, business, or one of the professions; and lack of court convictions and conflicts of interest. Directors are appointed for three-year terms and may be removed in the event of misconduct, poor performance, or any administrative reasons.

**The Rules' provisions on the composition of the boards are intended to provide robust checks and balances on the management of the PSCs.** In particular, the Rules provide for a separation between the positions of CEO and board chair. They also require that the board chair be selected from among a company's independent board members. The Corporate Governance Rules require that at least one-third of board members be independent. Independent board members may not be shareholders in the company or government employees. In practice, however, many PSCs do not currently meet this requirement. Most government nominees are active or retired senior civil servants. They include nominees of the supervising ministry, the MOF, and—if the company is on the privatization list—also a nominee of the Privatization Commission. The Rules also require that PSC boards include both executive and nonexecutive directors. In addition, the Rules include detailed provisions on conflicts of interest and misconduct, which apply to board members and senior company executives.

**Depending on a PSC's Articles of Association, the remuneration of board members may be approved by the shareholders or by the board**

**itself.** The Rules require remuneration packages to be established through a formal and transparent process. They do not set any benchmarks but state that remuneration levels be adequate to attract and retain the caliber of directors needed to run the company successfully. PSCs are required to disclose their remuneration-setting criteria and the details of directors' remuneration in their annual report, including salaries, benefits, and performance-related incentives. PSC boards are also required to establish performance evaluation processes for board members, the chair, and the CEO. Evaluations must be held once a year on the basis of established criteria.

**The prudential rules of the SBP include provisions on the mandate and appointment of boards of banks and DFIs.** These rules also set “fit and proper” criteria for board members and senior executives, including a university degree and at least five years of professional experience at a senior level and absence of conflicts of interest. The SBP rules require a separation between the positions of CEO and board chair and limit the number of executive directors to two. They require that independent directors represent at least one-quarter of board members and recommend that board committees be composed by nonexecutive directors.

## **Transparency and Disclosure**

**In 2016, the MOF published an aggregated performance report on the federal government's SOE portfolio.** This was the first report of its kind since the abandonment of the “signaling system,” which had been used to track the performance of SOEs during the 1980s. The recent report provides detailed information on the financial performance of the overall government portfolio, groups of SOEs by sector of activity, as well as each of the 183 SOEs covered by the report for the period FY2013–14 to FY2014–15. The report also provides information on the amounts and types of financial support (operating subsidies and grants, loans, and debt guarantees) provided by the government to individual SOEs and at the portfolio level. Going forward, this type of report is expected to be published annually based on data to be reported by federal ministries that are responsible for SOEs.

**Mandatory transparency requirements apply to PSCs and DFIs, but not to FAs.** The requirements for PSCs are set in the SECP Rules, while those for DFIs are set by the SBP. The Corporate Governance Rules require PSCs to provide quarterly balance sheets to the board, and to publish annual financial statements on their websites. The Rules also require PSCs to implement the International Financial Reporting Standards (IFRS). In practice, however, not all PSCs have yet complied with this requirement. The board of directors is also required to submit an annual report to the shareholders.

#### BOX 34

### Transparency and Disclosure Practices in Pakistan

**Accounting standards:** IFRS for PSCs; no framework specified for FAs.

**Transmission of financial and activity reports by SOEs:** To the board, the SECP (for PSCs), the SBP (for banks/DFIs), and supervising ministries.

**Aggregated reports:** Annual report prepared and published by the MOF since 2016.

**Disclosure:** Annual financial statements required.

**Information system:** Automated reporting and monitoring system to be developed.

**Internal audit:** Internal Auditor, Board Audit Committee.

**External audit:** By auditors with a satisfactory rating by the Institute of Chartered Accountants of Pakistan; the Auditor General of Pakistan may also audit SOEs.

*Source:* World Bank staff compilation based on regulations.

The report should cover the company's operational and financial performance, major investments, government financial support, as well as the board's assurance regarding compliance with the company's corporate governance policies and fiduciary requirements.

**Corporate Governance Rules require all PSCs to develop an internal audit function.** The Rules require that PSC boards establish an Audit Committee and mandate the appointment of a qualified internal auditor. The board chair and the company's CEO may not be members of the Audit Committee. The Committee's functions include reviewing internal audit reports and choosing the company's external auditor. The internal auditor reports directly to the Audit Committee. SBP regulations also make internal audit mandatory for all banks and DFIs. In addition to an internal auditor, banks and DFIs are required to appoint a compliance officer whose role is to ensure that the bank complies with all applicable laws and regulations. Compliance officers report to the CEO, while internal auditors report directly to the board.

**According to the 2013 Corporate Governance Rules, all PSCs are required to have their accounts reviewed by external auditors.** Only audit firms that comply with the International Federation of Accountants'

Guidelines on Code of Ethics and have received a satisfactory rating by the Institute of Chartered Accountants of Pakistan may be hired as external auditors. Audits are conducted in accordance with international standards (ISA) and in a highly developed professional environment (ROSC) (WBG 2017). SECP regulations also require the mandatory rotation of external auditors every five years to safeguard auditors' independence. PSCs are required to provide the external auditors with full financial information, including the company's internal audit reports. In addition to the completeness and accuracy of financial accounts, external auditors need to review a PSC's compliance with applicable laws and regulations, including the Corporate Governance Rules. External auditors' reports are to be submitted to the board and disseminated to all shareholders. External audit by a firm accredited with the SBP is also mandatory for all banks and DFIs. Like other public sector units, SOEs may also be subject to external audit by the Auditor General of Pakistan.

**PSCs' compliance with the accounting and audit requirements of the Corporate Governance Rules has been improving.** By 2016, 60 percent of PSCs filed the annual statement of compliance with the SECP. Regarding compliance with specific provisions of the Corporate Governance Rules on accounting and audit, 58 percent of PSCs had submitted their accounts to the SECP, 32 percent had established Internal Audit Committees, and 72 percent reported holding regular Annual General Meetings of shareholders.

## CHAPTER 8

# Sri Lanka

### SOE Sector

**State-owned enterprises (SOEs)—denominated Public Enterprises (PEs)—were established after Sri Lanka’s independence in 1948 to improve social welfare and manufacture import substitutions.** To raise the standard of living, the state invested directly in key sectors such as transport, telecommunications, electricity, banking, plantations, and manufacturing by establishing SOEs. Under successive governments, these investments created employment and provided essential goods and services at affordable prices. Political developments in the 1950s reinforced the dominance of the state in the economy.

**By the late 1970s, interventionist policies waned, and economic liberalization began.** While the standard of living had risen since independence, the economic rationale for import substitution became unclear. SOE industrial production was hampered by insufficient imported inputs, limited domestic investment, and low product quality. The financial viability of many SOEs was in question, as overstaffing and limited management led to large losses. Following a political transition in 1977, liberalization policies were implemented to attract private sector investment. The banking system



was expanded with the establishment of several private commercial banks and the expansion of public financial institutions. Concessions such as investment-promotion zones were established.

**Large-scale privatization of SOEs took place from the late 1980s to the early 2000s.** Policy makers sought to improve efficiency and reduce the fiscal burden of loss-making SOEs through privatization. From 1989 to 2002, 86 SOEs in the manufacturing, trade, agriculture, plantation, petroleum, finance, utility, and services sectors were privatized. Privatization continued throughout the 1990s, under successive governments, targeting increased domestic investment, employment generation, and improved service delivery.

**Policy shifted from privatization to improved management and efficiency in 2005.** This new economic strategy targeted continued state ownership of SOEs in sectors such as banking, oil, transport, and electricity to drive economic growth strategically. Public dissatisfaction with privatization supported this shift. For example, the Sri Lanka Insurance Corporation was renationalized in 2009, after being privatized only six years earlier. Financial irregularities and unsatisfactory post-privatization performance generated public support for this change in policy. The 2011 Revival of Underperforming Enterprises or Underutilized Assets Act called for strategic reform of 37 SOEs through restructuring or entering into management contracts.

**Fiscal pressures and rising SOE debt have prompted corporate governance reforms in Sri Lanka, including the negotiation of performance agreements with major SOEs.** Under a 2016 International Monetary Fund (IMF) program, a series of reforms will be implemented to introduce performance agreements for five major SOEs. The 2016 budget announcement also called for disinvestment in nonstrategic enterprises to focus on key sectors. A new Public Enterprise Act has been proposed to introduce a supportive legal framework and to improve performance management. This approach targets commercial viability, pricing reform, and clear identification of noncommercial obligations for Sri Lanka's 55 largest SOEs (MOF 2016).

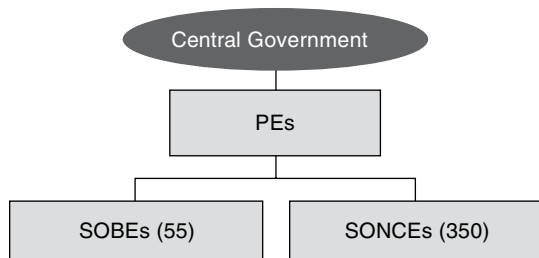
## **Economic Significance**

**Out of over 400 SOEs, 55 large SOEs called State-Owned Business Enterprises (SOBEs) account for the majority of state-owned assets.**<sup>135</sup> SOBEs are strategically important business-related commercial enterprises

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135 Several state-owned banks are also considered to be SOBEs.

**FIGURE 35: Universe of the SOE Sector in Sri Lanka**



Source: World Bank staff compilation.

and represent the bulk of SOE assets and revenues. They are the focus of this analysis. Sri Lanka’s remaining 350 SOEs are mostly noncommercial public agency-type institutions, referred to as State-Owned Noncommercial Enterprises (SONCEs). These include statutory boards; regulatory bodies; promotional, educational, and development agencies; and research institutions.<sup>136</sup>

**Total SOBE revenue was LKR 1.54 trillion in 2016 (USD 10.02 billion) (MOF 2016), or 13 percent of gross domestic product (GDP), with SOBEs predominant in the finance, energy, and utilities sectors.** With assets equal to 54.4 percent of GDP, SOBEs are a large component of Sri Lanka’s economy. When measured by assets, the banking and financial sector is particularly significant, representing 64 percent of SOBEs’ assets along with eight state-owned banks. The energy sector represents 16 percent of SOBEs’ assets, including the Ceylon Electricity Board and Ceylon Petroleum Corporation.<sup>137</sup> Figure 36 presents key statistics and activities of selected SOBEs.

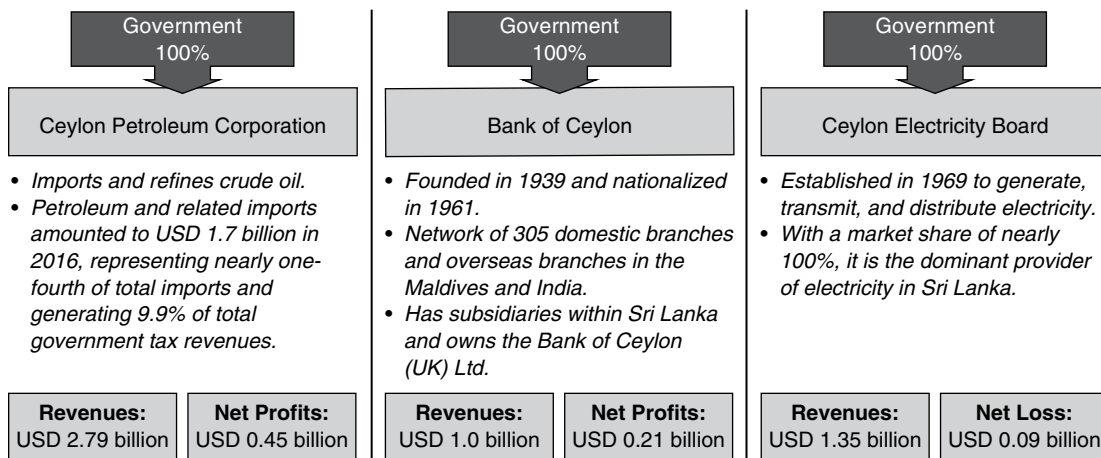
**Only two SOBEs are listed on the Colombo Stock Exchange.** The Housing Development Finance Corporation and Hotel Developers PLC represented only 0.15 percent of market capitalization on the Colombo Stock Exchange in 2015. While SOBEs are economically significant, few are listed publicly. Under current practices, most SOBEs would not meet public listing transparency and corporate governance requirements, although proposed reforms may help firms meet listing requirements in the future.

**SOBEs employ approximately 123,381 people, representing 9 percent of public sector employment (MOF 2016).** Major employers include the financial sector (People’s Bank, 11,000 employees; Bank of Ceylon,

136 There are two types of SONCEs: Budgetary-Funded SONCEs, which come under the purview of the National Budget Department, and Self-Funded SONCEs, which are under the purview of the Public Enterprises Department.

137 The Ceylon Petroleum Company is Sri Lanka’s largest SOBE.

**FIGURE 36: Selected SOBEs in Sri Lanka, 2016**



Source: World Bank staff compilation based on SOE websites; MOF (2016).

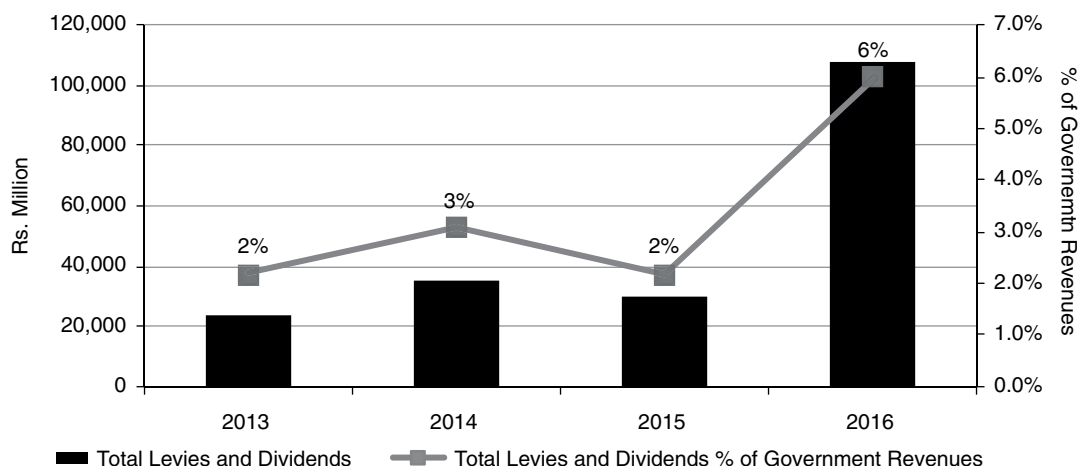
8,800 employees) and utilities (Ceylon Electricity Board, 16,000 employees; National Water Supply and Drainage Board, 9,000 employees).

### Macro-Fiscal and Service Delivery Implications

**While some SOBEs are highly profitable, others show large and persistent losses.** On aggregate, SOBEs generated pretax profits of LKR 136.58 billion (USD 889 million) in 2016. The banking and financial sector was by far the most profitable and best capitalized, followed by the energy sector. SOBEs from other sectors generated large losses in the same year. Sri Lankan Airlines, for example, lost LKR 28.14 billion (USD 183 million) in 2016, ending the year with a negative net worth of LKR 88 billion (USD 573 million) after seven years of continued losses. Other loss-making SOBEs include Ceylon Electricity Board, Lanka Sathosa Ltd., and Sri Lanka Transport Board, which faced with overstaffing and legacy debt servicing costs.

**SOBEs' levies and dividends contributed approximately 6 percent of government revenues in 2016, primarily from the financial sector.** Of the LKR 32.75 billion (USD 213 million) in levies and dividends paid in 2015, 80 percent were contributed by the National Savings Bank, Bank of Ceylon, the People's Bank, and Sri Lanka Insurance Corporation. In 2016, the contribution of levies and dividends increased significantly to 108.16 billion (USD 704 million), and the banking and financial sector remained the largest contributor. The evolution of levies and dividends paid by SOBEs from 2013–2016 is presented in Figure 37.

**FIGURE 37: SOBE Levies and Dividends, 2013–2016 (LKR millions)**



Source: World Bank staff compilation based on MOF (2016); IMF (2017).

**In 2015, SOBEs had significant debt of LKR 1,007.1 billion (USD 7.0 billion), or 9.2 percent of GDP, part of which was explicitly guaranteed by the state.** Approximately, one-third of this, LKR 301.1 billion of SOBE debt, is state guaranteed. The bulk of the debt was from Ceylon Petroleum Corporation (LKR 359.3 billion), Sri Lanka Ports Authority (LKR 233.2 billion), Ceylon Electricity Board (LKR 209.7 billion), and Sri Lankan Airlines (LKR 63.2 billion).<sup>138</sup>

**With limited access to private capital, SOBEs rely heavily on government budget transfers.** The Government of Sri Lanka provides support to SOBEs in the form of recurrent and capital budgetary support, subsidies and grants, treasury guarantees, and capital contributions. In 2016, the government provided budgetary support to SOBEs of approximately LKR 23.3 billion (USD 152 million), of which LKR 3.3 billion was for capital investments and LKR 20 billion for associated recurrent costs. This was a decrease from LKR 95 billion (USD 618 million) in 2015. The government also supported the Sri Lanka Transport Board with a cash infusion of LKR 9.25 billion (USD 60 million) and a treasury subsidy of LKR 25.16 billion (USD 164 million) in 2016.

**Subsidies to SOBEs are used frequently in Sri Lanka to reduce price fluctuations in sensitive areas such as fuel, electricity, water, and transportation.** SOBE losses in the fuel, utilities, and transportation sectors were

<sup>138</sup> Loans excluding finance leases and bank overdrafts, financial year 2015–16. See Sri Lankan Airlines annual report.

estimated at LKR 23 billion (USD 150 million) in 2016. These losses are sometimes covered through direct subsidies to avoid major price fluctuations due to external factors, mainly in the transportation sector. Recently, the Ministry of Finance (MOF) committed under an IMF program to introduce a fuel and energy price formula to avoid subsidies.

**While significant corporate governance challenges remain, SOBEs have played a primary role in the provision of basic services and infrastructure in Sri Lanka.** Many accomplishments have been realized since independence. A stable and well-capitalized financial system has been established, electricity coverage grew from 70 percent of households in 2005 to 99 percent of households in 2016 (CEB 2015), and pipe-borne water now reaches 47.7 percent of the population. Sri Lanka's major ports, airports, and public transportation systems all originated with SOEs. As mentioned above, however, some SOBEs produce persistent financial losses and have limited access to private capital. Reinforced corporate governance practices, such as the introduction of performance agreements for major SOBEs, could address these challenges.

## Corporate Governance

### Legal Framework

**SOEs are either Government-Owned Companies, Commercial Corporations, or Statutory Boards.** Government-Owned Companies are under the Companies Act where the government holds a controlling interest. Firms that are established under the Companies Act vary in the share of government ownership. Commercial Corporations are entities established through a specific Act of the Parliament, capitalized by the government and engaging in commercial activities. Statutory Boards are established through an Act of the Parliament whose activities are of noncommercial nature.<sup>139</sup> The legal and regulatory framework varies by the nature of activities. Key statutory provisions and regulations are listed in Box 35.

**The Public Enterprises Department (PED) of the MOF published the “Public Enterprises Guidelines for Good Governance” in 2003.**<sup>140</sup>

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139 Based on the legal categorization, 55 strategically commercial SOEs are grouped as SOBEs and the remaining noncommercial entities as SONCEs, which includes regulatory bodies, promotional agencies, educational agencies, development agencies and research institutions.

140 See <http://www.treasury.gov.lk/web/department-of-public-enterprises/publications> (accessed February 16, 2018).

**BOX 35**

**Statutory Provisions and Regulatory Frameworks of SOEs in Sri Lanka**

Statutory Provisions	Regulatory Frameworks
<ul style="list-style-type: none"> <li>• The Constitution</li> <li>• Annual Appropriation Act</li> <li>• Enabling Acts of Parliament</li> <li>• Companies Act No. 17 of 1982</li> <li>• Finance Act No. 38 of 1971</li> <li>• Conversion Act No. 23 of 1987 (Public Conversion Act)</li> <li>• Accounting &amp; Auditing Standards Act No. 15 of 1995</li> <li>• Fiscal Management Responsibility Act No. 03 of 2003</li> </ul>	<ul style="list-style-type: none"> <li>• Financial Regulations</li> <li>• Establishment Code</li> <li>• Treasury Circulars</li> <li>• Ministry Directives</li> <li>• Manual of Procedures</li> </ul>

*Source:* World Bank staff compilation based on MOF (2003a, b).

These Guidelines provide orientation and guidance on the definition of SOEs and draw from all relevant statutory provisions and regulations for corporate governance issues such as accountability and transparency, board procedures, committees, plans, budgets, reports, accounts, and human resources for all nonlisted SOEs.

**In addition, the PED published the “Code of Best Practice on Corporate Governance”<sup>141</sup> in 2003, updated most recently in 2012.** The Code, published jointly by the PED, the Securities and Exchange Commission of Sri Lanka, and the Institute of Chartered Accountants of Sri Lanka, aims to improve the performance of listed companies through greater accountability and transparency, improved board practices, and adequate internal controls. It outlines the generic components of corporate governance and calls for professional boards and management to enjoy greater operational autonomy. The Code also incorporates guidelines to support its practical implementation.

**Procurement Guidelines set the procedures for carrying out procurement actions in all SOEs.** The National Procurement Agency published Procurement Guidelines in 2006. Under the 19th Amendment to the Constitution, the National Procurement Agency was replaced with the

<sup>141</sup> See <http://www.treasury.gov.lk/web/department-of-public-enterprises/publications> (accessed February 16, 2018).

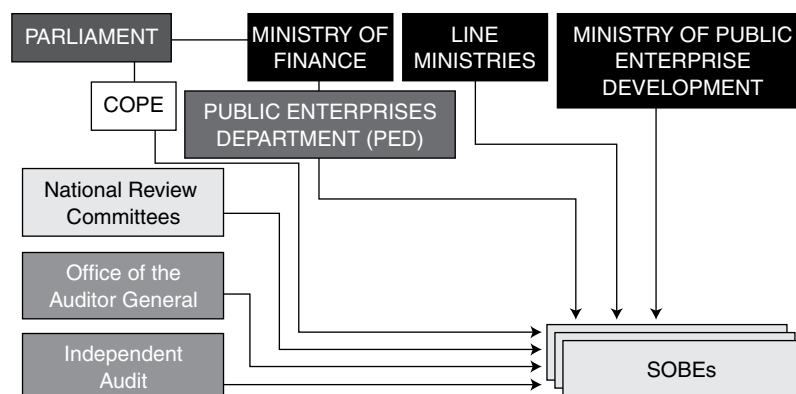
National Procurement Commission, which aims to enhance the transparency of the government procurement process by establishing governing principles and procedures to ensure value for money in an efficient, fair, equitable, transparent, competitive, and cost-effective procurement process. These guidelines apply to all public enterprises, including projects financed by the government and foreign funding agencies.

## Ownership Arrangements

**Although the ownership and strategic oversight of SOBEs is split between multiple entities, most responsibilities are shared by the MOF and line ministries under a dual ownership model.** Ownership of all SOEs, including SOBEs, is vested in the secretary to the treasury, leaving an oversight role for line ministries. The MOF acts as a proxy for the government as a shareholder on the board of SOEs. MOF representatives are often the link between the company and the government. They are appointed to the boards to monitor performance and ensure compliance with statutes, regulations, and rules. The secretary to the treasury or his/her proxy is entrusted with the power to seek clarification on any relevant issues at Annual General Meetings.

**The MOF's PED operates as a hub for financial information and performance monitoring of SOBEs.** The aim of the PED is to strengthen corporate governance as a means to optimize performance, safeguard the public interest, and enforce fiscal discipline. It is structured into three clusters: (i) energy, transport, marketing and distribution, and restructuring; (ii) port,

**FIGURE 38: The Ownership and Oversight Function in Sri Lanka**



Source: World Bank staff compilation.

banking, insurance, plantations, and livestock; and (iii) aviation, water, construction, lotteries, health, media, and nonrenewable resources.<sup>142</sup> Each cluster is headed by a supplementary director general, who reports directly to the Director General of the PED. Latest available figures on personnel indicate that the PED comprised 68 employees, including 30 staff officers, in 2016.<sup>143</sup>

**Line ministries co-lead, along with the MOF, major policy decisions for SOBEs, and nominate board members.** Ministries recommend candidates for board positions to the MOF. After approval by the Cabinet Subcommittee on Appointments, chaired by the prime minister, candidates are appointed to boards by the secretary to the treasury of the MOF. A presidential subcommittee has been set up by the Ministry of National Policies and Economic Affairs to advise on board appointments. Line ministries are also responsible for making major policy decisions for SOBEs, with the concurrence of the minister of finance. Secretaries of line ministries are appointed as chief accounting officers of SOBEs under their purview and ensure that annual reports and accounts are submitted to parliament. They review corporate plans and budgets, performance reports, auditor general's reports, development activities, petitions and media issues, and issues arising from the parliament's Committee on Public Enterprises (COPE).

**The COPE was established in 1979 to improve governance in the public sector and has a clear mandate related to public enterprises.** The COPE is mandated to ensure financial discipline in government-owned entities.<sup>144</sup> It is empowered to review the annual accounts and performance of public enterprises, to ascertain the extent to which enterprises achieve performance targets and fulfill social responsibilities (MOF 2003a, b). The COPE submits an annual report to the parliament on accounts examined, budgets and estimates, financial procedures, performance and management of corporations, and other government business undertakings.<sup>145</sup> The COPE has 31 members reflective of the party composition in the House, nominated by parliament's Committee on Selection.<sup>146</sup> The committee chair is elected by the members of COPE.

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142 See <http://www.treasury.gov.lk/web/department-of-public-enterprises/home> (accessed February 16, 2018).

143 See <http://www.treasury.gov.lk/documents/63940/182153/Performance+Report-2016/97d54e7d-b432-465f-9874-53f0e24ddd98> (accessed February 16, 2018).

144 See <http://www.Parliament.lk/uploads/comreports/1429514499040835.pdf#page=1> (accessed February 16, 2018).

145 See <http://fmepsl.org/FM%20Guide%20Book.pdf>.

146 See <http://unpan1.un.org/intradoc/groups/public/documents/apcity/unpan034367.pdf> (accessed February 16, 2018).



**In 2015, the Ministry of Public Enterprise Development was established to reform SOBEs (MOF 2015a, b).** Acknowledging cases of financial underperformance, this new ministry was created to restructure some SOBEs and to concentrate on reforming the administration model of SOBEs. It presented market-based pricing formulas in selected public utilities and streamlined recruitment, while embracing measures to enhance the profitability of the current workforce and to explore increased private sector financing through various mechanisms, including public-private partnerships (MOF 2015a, b). The Ministry of Public Enterprise Development has oversight over 19 SOEs, including the state-owned financial institutions, along with the MOF as a shareholder and the Central Bank of Sri Lanka as regulator. Complementarily, the 2016 Budget Speech announced the government's intention to bring SOBEs under a centralized ownership framework.

### **Performance Monitoring**

**As of 2015, performance agreements did not exist, but SOBEs' financial performance is monitored closely by the PED and line ministries (WBG 2015a, b).** The MOF's PED focuses on financial monitoring of the 55 SOBEs and serves as a secretariat for monitoring their financial performance. Under these arrangements, SOEs are required to prepare—in consultation with their respective line ministries—a corporate plan that articulates the future direction of the enterprise over the next three years (MOF 2003a, b). Comments are also requested from the PED before sending the final draft to the cabinet for approval.<sup>147</sup> Based on these multiannual corporate plans, SOBEs prepare their annual budgets. The recently created Ministry of Public Enterprise Development conducts performance reviews of SOBEs under its purview on a quarterly basis.

**In 2016, the government signed a three-year IMF Extended Arrangement that includes the introduction of statements of corporate intent with five major SOBEs.**<sup>148</sup> The statement of corporate intent is a tripartite memorandum of understanding signed by the SOBE, its respective line ministry, and the MOF for enhancing transparency in the management of public resources and accountability for results. The statement includes key perfor-

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<sup>147</sup> However, many SOEs have not, for various reasons, been able to submit these documents on time.

<sup>148</sup> These five SOBEs include Ceylon Petroleum Corporation, Ceylon Electricity Board, National Water Supply and Drainage Board, Airport and Aviation Services Limited, and Sri Lanka Ports Authorities.

**BOX 36****SOBE Corporate Plans in Sri Lanka**

<b>Tools</b>	<b>Corporate Plans</b>	<b>Annual Budgets</b>
<b>Scope</b>	All SOBEs.	All SOBEs.
<b>Timespan</b>	Not less than 3 years.	Annually.
<b>Components</b>	<ul style="list-style-type: none"> <li>• Vision, Mission Statement, and objectives.</li> <li>• Current resources available to the enterprise: land and buildings, production and operating facilities, human resources and management skills, technical know-how, markets and suppliers, finance, and so on.</li> <li>• Organizational structure.</li> <li>• Strengths and weaknesses in the organization and the external threats and opportunities.</li> <li>• Review of the preceding three years' operating results.</li> <li>• Strategic plans for the period under review.</li> <li>• Action plan clearly identifying the responsibilities of managers, with goals and targets to be achieved during the plan period.</li> </ul>	<ul style="list-style-type: none"> <li>• Budgeted income and expenditure statement for the year.</li> <li>• Budgeted balance sheet as at the end of the year.</li> <li>• Cash flow statement for the year.</li> <li>• Budgeted capital expenditure, together with an action plan.</li> </ul>

Source: World Bank staff compilation.

mance indicators in line with the SOBE's Corporate Plan. This includes targets for each indicator for the next three years, forecasts for the financial impact of all noncommercial goods and services, detailed budget and financial forecasts for the next three years, and a capital investment plan.

### **Board of Directors and Management**

**All SOBEs are mandated to have a board of directors to lead and oversee their management and operations.**<sup>149</sup> The board of directors has a statutory responsibility in the stewardship of the enterprise on behalf of the government and its stakeholders. Boards operate within applicable legal and regulatory norms and under the direction and control of the MOF or the treasury under the supervision of the relevant line ministry.

<sup>149</sup> See PE Guidelines at <http://www.treasury.gov.lk/documents/63940/182428/guidelines.pdf/53c33d35-1f6d-4e78-81da-ad281304f1a4> (accessed February 16, 2018).

**BOX 37**

## **Board Features in Sri Lanka**

**Nomination of board members:** Appointed on the basis of the relevant Acts with respect to public corporations and Articles of Association, with the approval of the Cabinet Subcommittee on Appointments.

**Nomination of board chair:** Either appointed by the minister, or elected by the board with the approval of the Cabinet Subcommittee on Appointments.

**Nomination of chief executive officer (CEO):** Appointed by the board of directors.

**Mandate of the board:** To lead and oversee the management and operations of the enterprise.

**Separation between chairman and CEO:** Unless otherwise stated, the CEO can be a full-time chair or a full-time director concurrently. A full-time chair is considered an executive director.

### **Composition of the board:**

Unless otherwise stated specifically in the enabling acts or Articles of Association:

- One finance specialist and one in the enterprise's subject area;
- One member from the ministry in charge of finance/policy planning/general treasury; and
- Maximum of two executive directors.

**Structure of the board:** Single unitary body.

**Profile of board members:** Can include both civil service and private sector. Recently decided to approve a set of criteria for nomination and appointment of directors.

**Board committees:** The PED calls for a minimum of: Audit Committee, Senior Management Committee, Tender Board, Training Committee, and Board of Survey. Other committees may be established as required.

**Remuneration of board members:** Determined by and dependent on the specific enterprise. Remuneration of board members based on a circular by the PED.

*Source:* World Bank staff compilation based on interviews and regulations.

**Board members are nominated by line ministries, approved by the cabinet, and appointed by the MOF.** The size and profile of the board is outlined in the enabling legislation and/or articles of association. In all cases, a MOF representative is required to be a member of the board.<sup>150</sup> Board members often rotate with changes in government. Unless otherwise specified in enabling acts or articles of association, PED guidelines indicate the ideal size and composition of the board. As reported by the PED, the board chair is either appointed by the minister or elected by the board with the approval of the Cabinet Subcommittee on Appointments.<sup>151</sup> In some cases, the chairman and directors can be appointed without meeting requirements for specific skills or competencies. Certain sectors, however, such as the banking sector, require specific skills and expertise for appointment as a board member (PED 2015). Moreover, guidelines for appointing professionals to SOBE board positions were issued by the Ministry of National Policies and Economic Affairs, in keeping with Cabinet Decision No.16/0640/706/023, dated April 8, 2016, to strengthen the proficiency of these SOBEs.

**Chief executive officers (CEOs) are appointed by the board of directors.** The CEO and the senior management team are responsible for implementing policies and decisions made by the board of directors.<sup>152</sup> It is the responsibility of the board of directors to appoint the CEO and to inform the corresponding line ministry and the PED. Unless otherwise stated, the CEO can be a full-time chair or director concurrently within the same SOE.<sup>153</sup>

**Board meetings are held monthly to formulate policy and review financial performance.** The board makes strategic decisions, guides operations, and sets policy for cash management, debt management, and quarterly financial reports.<sup>154</sup> Quarterly financial reports are forwarded to the line ministry, PED, and treasury at least 30 days before the end of the quarter.

**Remuneration of board members is determined by a circular released by the PED.**<sup>155</sup> Monthly allowances are generally payable to the chairs, executive directors, and working directors. Fees are also payable per

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150 See <http://documents.worldbank.org/curated/en/363391467995349383/pdf/103246-SCD-P152526-PUBLIC-NON-BOARD-VERSION-SriLankaCompleteFinal-1225151r-2.pdf> (accessed February 16, 2018).

151 See <http://www.treasury.gov.lk/documents/63940/182428/guidelines.pdf/53c33d35-1f6d-4e78-81da-ad281304f1a4> (accessed February 16, 2018).

152 See <http://fmeps.l.org/FM%20Guide%20Book.pdf>.

153 See PE Guidelines, <http://www.treasury.gov.lk/documents/63940/182428/guidelines.pdf/53c33d35-1f6d-4e78-81da-ad281304f1a4> (accessed February 16, 2018).

154 See <http://www.treasury.gov.lk/depts/ped/circulars/PED-03.pdf>.

155 See <http://www.treasury.gov.lk/documents/10181/49167/PED-2015-03E/c185353c-6325-4d8f-bf7c-3d2c0dccc2c39?version=1.0> (accessed February 16, 2018).

sitting to nonexecutive directors and observers for attending board meetings, audit meetings, and management meetings.

## **Transparency and Disclosure**

**The MOF publishes an annual assessment of SOBEs' financial performance.** The MOF Annual Report consolidates financial statements from all SOBEs and provides profiles of the operations of each SOBE. The assessment of financial performance is based on the evolution of assets, net worth, investments, revenue growth, profitability, and the SOBEs' contribution to government revenues (taxes and dividends). One of the inputs used for the MOF's Annual Report on SOBEs is the PED Performance Report, which also reviews PED staff strength and human resources training activities. Both the MOF Annual Report and the PED Performance Report are available online (MOF 2015a, b).<sup>156</sup>

**SOBEs are required to prepare their own annual reports.** Individual SOBEs' annual reports provide a snapshot of the enterprise's financial and nonfinancial performance over the previous fiscal year. They assess the effectiveness of the stewardship of the board of directors and the efficiency of management (MOF 2003a, b). Annual reports are prepared in consultation with the respective line ministries and submitted to the cabinet for approval before submission to parliament.

**SOBEs follow the Sri Lankan Public Sector Accounting Standards (SLPSAS), and listed SOBEs follow International Public Sector Accounting Standards (IPSAS).** The Public Sector Accounting Standards Committee of the Institute of Chartered Accountants of Sri Lanka, together with the Auditor General and MOF, have formulated the SLPSAS on the basis of the IPSAS. The SLPSAS consist of ten accounting standards, providing a framework for the preparation and presentation of financial statements under the accrual accounting system, in compliance with international best practices for quality accounting and reporting, in order to facilitate and improve financial analysis, planning, and management within the public sector.

**The (internal) Audit Committee supports board oversight functions.** All SOBEs are required to have Audit Committees, which report to the board of directors regarding compliance with financial rules and regulations. The Audit Committee is empowered to oversee due diligence and control over the financial aspects of the SOBE's operations and performance (MOF

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156 See <https://www.Parliament.lk/uploads/documents/paperspresented/performance-report-department-of-public-enterprises-2015.pdf> (accessed February 16, 2018).

**BOX 38**

## **Transparency and Disclosure Practices for SOBEs in Sri Lanka**

**Accounting standards: SOBEs:** Sri Lanka Public Sector Accounting Standards (SLPAS); **Listed SOBEs:** International Public Sector Accounting Standards (IPSAS).

**Delivery of financial and operational reports by SOEs:** SOBE reports approved by line ministries and sent to PED/MOF. PED submits them to COPE/parliament.

**Aggregated reports:** Financial statements for all SOBEs are aggregated in an Annual Report. The reports are submitted and tabled in parliament.

**Disclosure:** All SOBEs are mandated to prepare the Annual Report and audited statement (prepared in consultation with the auditor general) and table it in parliament annually. SOBEs are expected to maintain a website with relevant data and information, including salient financial trends from Annual Reports.

**Internal audit:** Audit Committees.

**External audit:** Auditor General's Office or any qualified external auditor acting under his/her direction and control.

*Source:* World Bank staff compilation based on interviews.

2003a, b). The Committee is comprised of a minimum of three nonexecutive board members, including a treasury representative, preferably with financial management skills. It should meet at least once every three months with the Chief Internal Auditor as convenor, and report its findings and recommendations to the board soon thereafter.

**The annual external audit of SOBE's financial statements is under the responsibility of the Auditor General, in accordance with the mandate provided by Article 154 of the Constitution of the Democratic Socialist Republic of Sri Lanka.** The Auditor General may employ the services of any qualified external auditor acting under his/her direction and control. The audit report is made available to the board of directors within 30 days of completion. The board is then responsible for informing the Auditor General on any steps it proposes to take to address the findings. The COPE utilizes the PE's audited reports as a basis for its investigations. The final audited accounts, together with the auditor's report in all three

languages,<sup>157</sup> should be tabled in parliament within 150 days following the close of the financial year.

**Under the Right to Information Act, SOBEs are directed to release annual reports and accounts online.**<sup>158</sup> These reports cover the enterprise's mission statement and vision, profiles of the directors and senior management, the chair's review of opportunities and constraints, the directors' report, the audit committee report, audited financial statements, the report of the Auditor General and private auditors, and financial highlights in the preceding five years. All SOBEs are mandated to prepare this report and the audited statement for annual submission to parliament. Subsequently, SOEs are expected and encouraged to maintain their own websites with all relevant data and information, including main financial trends.<sup>159</sup> Additionally, in accordance with the Right to Information Act and Regulation 20, SOBEs are required to routinely disseminate key information such as institutional and operational information, budget information, and information on subsidies through a digital or electronic format.

#### BOX 39

### Components of SOBEs' Annual Report and Accounts

Annual Report and Accounts should cover, among others:

- Mission statement and vision of the enterprise's future direction.
- Brief profile of the directors and senior management.
- Review by the chair outlining the opportunities and constraints faced in the year under review.
- Directors' report.
- Audit Committee report.
- Audited financial statements.
- Report of the Auditor General/private auditor.
- Financial highlights in the preceding five years.

*Source:* MOF (2003b).

157 Sinhala, English, and Tamil.

158 For example, the 2011 Annual Report of the Ceylon Petroleum Corporation, containing the audited financial reports, can be accessed at [http://www.ceypetco.gov.lk/Annual\\_Report\\_2011.pdf](http://www.ceypetco.gov.lk/Annual_Report_2011.pdf).

159 See PE Guidelines, <http://www.treasury.gov.lk/documents/63940/182428/guidelines.pdf/53c33d35-1f6d-4e78-81da-ad281304f1a4> (accessed February 16, 2018).

PART 2

**LESSONS LEARNED  
FROM EAST ASIA**





## CHAPTER 9

# China

### SOE Sector

#### Economic Relevance of SOEs

**State-owned enterprises (SOEs) in China play a significant role in the economy and are present at all levels of government.** In 2015, China was estimated to have around 150,000 SOEs at the national, provincial, and municipal levels, employing over 35 million people and controlling USD 17 trillion in assets. Of the 98 Chinese companies that made the Fortune Global 500 list, the top 12 were SOEs (Cendrowski 2015).

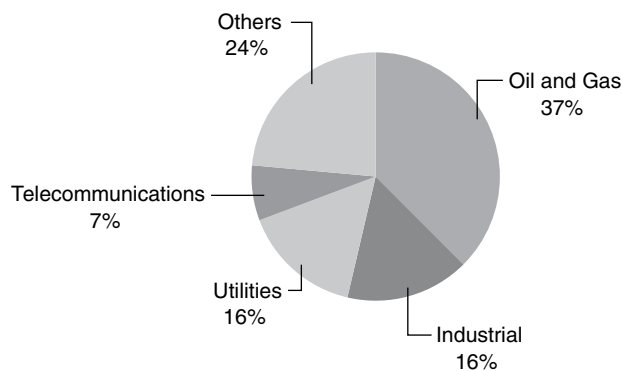
**At the central government level, the economic relevance of the SOE sector is led by 103 nonfinancial SOEs and 18 financial SOEs.** The non-financial SOEs are supervised centrally by the State-Owned Assets Supervision and Administration Commission (SASAC), and the financial SOEs are overseen by the Ministry of Finance through Central Huijin Invested Ltd., a subsidiary of China Investment Corporation (CIC), the country's sovereign wealth fund. Some of these SOEs, in turn, own large networks of subsidiaries, and by the end of 2016, 81 nonfinancial and 11 financial SOEs were listed on the Shanghai or Shenzhen Stock Exchanges.

**Chinese SOEs are involved in strategic activities such as oil and gas, utilities, materials, and banking.** In 2015, the SOE sector generated CNY 27 trillion (USD 4 trillion) in gross revenues, which contributed to 39 percent of GDP.<sup>160</sup> Additionally, the government received a total of CNY 3 trillion (USD 448 billion) in dividends from central-level SOEs during the same year. In 2015, the oil and gas sector was a major revenue contributor to the economy, followed by the industrial and utility sectors (Figure 39). In addition, SINOPEC (the China Petrochemical Corporation), China Mobile, and the so called “big four” state-owned banks<sup>161</sup> were the largest tax contributors.

**Nonfinancial SOEs play a crucial role in generating employment, contributing to 19 percent of total public sector employment in 2015.** Nonfinancial SOEs employed 12 million people in 2015, representing 19 percent of total public sector employment, which includes employees at the communist party, government departments, SOEs, public institutions, and other state organizations.

**SOEs also play an important role in providing public goods and services such as electricity and water.** The development plan on the coverage of basic goods and services is implemented at both central and local levels.

**FIGURE 39: Central-Level Nonfinancial SOE Sector Distribution, 2015 (revenues)**



*Note:* Owing to data limitations, only 59 of the 103 nonfinancial SOEs are included. The “oil & gas” sector also includes nuclear energy.

*Source:* World Bank staff compilation based on annual reports.

<sup>160</sup> Data based on World Bank Indicators and China’s Ministry of Finance.

<sup>161</sup> These include Bank of China, Agricultural Bank of China, China Construction Bank, and Industrial and Commercial Bank of China.

For instance, State Grid Corporation of China, a central-level SOE, provides power to over 1.1 billion people, covering 88 percent of the national territory. On the other hand, drinking water is provided by local SOEs. Overall, SOEs have performed well on public service delivery: by 2015, almost all of China's population had access to electricity, and 93 percent of the population had access to improved water sources.<sup>162</sup>

## Origins of the SOE Sector and Key Reforms

**The SOE sector in China finds its roots in the centrally planned economy that has been implemented since the 1949 Revolution.** SOEs were originally used by the Government of the People's Republic of China as a vehicle to build the country's economy and provide citizens with employment, public goods, and social services. Implementation of a centrally planned economy in 1949 led to the collectivization and nationalization of all industries, managed as government units under the direct control of the central government.

**During the 1980s, amid the transition toward a market-oriented economy, Chinese SOEs were progressively granted broader autonomy.** The first step aimed to broaden their autonomy by allowing SOEs to retain a portion of their profits, above a threshold decided by the state. This initiative was expanded during the implementation of gradual price liberalization, called the "dual-track system," in 1984. SOEs were given greater decision-making power with regard to sales and human resources management. In addition, the separation of ownership from management took place through the progressive development of contractual relationships. During this period, while some enterprises were gradually deprived of their public administrative functions with no ownership change, a few public corporations were established in key industries.

**In the 1990s, the state started a process of SOE ownership reform through the introduction of the "Company Law," which encouraged SOE corporatization, mergers, and acquisitions.** Many Chinese SOEs began to underperform financially as a result of the opening policy. The "Company Law," introduced by the government in 1993, aimed to establish a modern corporate structure and allow the rescue of loss-making SOEs through mergers and acquisitions, as well as the use of capital markets for SOE financing. Since 1997, many financially underperforming SOEs were sold or allowed to transform into mixed-capital firms through mergers and acquisitions. Corporatization of SOEs continued, while the government encouraged SOEs to reform

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162 World Bank, World Development Indicators.

their ownership structure by absorbing private investments. The SOE divestment process peaked in the late 1990s, although the government still maintained control over the largest and most strategic SOEs.

**In 2003, the Chinese government strived to improve the corporate governance of SOEs by consolidating central SOE ownership under SASAC and issuing corporate governance regulations.** The SASAC was created to centralize the ownership and oversight of nonfinancial SOEs at the central level of government. At its establishment, ownership of 189 central-level nonfinancial SOEs was transferred from the line ministries to SASAC. At present, SASAC administers 103 nonfinancial central SOEs. The Interim Regulations on Supervision and Administration of State-Owned Assets of Enterprises set requirements regarding the roles and responsibilities of shareholders as well as SOE board members and management. Since its creation, SASAC has issued 16 rules and over 40 normative documents on enterprise restructuring, asset appraisal, performance assessment, and financial supervision and administration of state-owned assets.<sup>163</sup>

**In September 2015, China's central authorities issued guidelines for deepening SOE reforms (Leutert 2016).** The objectives of these “Guiding Opinions of the Communist Party of China Central Committee and the State Council on Deepening the Reform of State-Owned Enterprises” include promoting mixed ownership, mergers, and acquisitions of central SOEs; marketization of board of directors nominations; and increased transparency. According to the guidelines, SOEs in China will be divided into two categories: for-profit entities and those dedicated to public welfare.<sup>164</sup> While the former are expected to operate as independent market entities, the latter will continue to provide public goods and services.

## Corporate Governance

### Legal Framework

**The Company Law of 1993 sets out rules for the corporate governance of all business companies in China, including fully owned SOEs.** The Company Law of the People's Republic of China, adopted at the Fifth Session of the Standing Committee of the Eighth National People's Congress on December 29, 1993, became fully effective in 2006, and was last amended in

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<sup>163</sup> Speech by Mr. Li Rongrong, Chairman of SASAC, December 19, 2006.

<sup>164</sup> See <http://hk.lexiscn.com/law/guiding-opinions-of-the-central-committee-of-the-communist-party-of-china-and-the-state-council-on-deepening-state-owned-enterprise-reform.html>.

2013. This Law governs all business companies in China, including fully owned SOEs, and provides a common structure with core characteristics, including legal personality, limited liability, transferable shares or equity interest, centralized management under a board structure, and shared ownership by contributors of capital.

**Chinese business companies, including some SOEs, are subject to a wide range of other legal instruments.** These include, among others, the PRC Securities Law (Zhengquan Fa), the Accounting Law, self-regulatory rules applying to firms listed on the Chinese Stock Exchanges, a number of administrative regulations issued by the State Council,<sup>165</sup> and a voluminous body of ministerial rules.

**Qiyue Guoyou Zichan Fa, or the State Assets Law, also regulates ownership aspects of central government SOEs, including the role of SASAC.** State assets, including equity interests in SOEs, belong to the state, namely the Chinese people as a whole. The State Council, representing the Chinese people as the “investor,” performs the investor’s functions and responsibilities exercises the powers and interests of the investor. The State Council further authorizes—or delegates its powers to—SASAC to exercise these aforementioned rights, duties, and responsibilities. SASAC, however, is not entitled to receive the benefits that are ordinarily given to a shareholder; for example, SASAC cannot take distributed dividends. Instead, the dividends distributed to the state shareholder go directly to the government’s SOE operational budget.

**Since 2003, SOE corporate governance in China has been strengthened through the issuance of further laws, regulations, and guidelines.** As mentioned above, the Interim Regulations on Supervision and Administration of State-Owned Assets of Enterprises outline the requirements regarding the roles and responsibilities of the shareholder, SOE board members, and management. In addition, SASAC has issued a variety of rules and guidelines on enterprise restructuring, asset appraisal, performance assessment, and financial supervision and administration of state-owned assets.<sup>166</sup>

**Some financial SOEs are subject to the Commercial Banking Law of the People’s Republic of China.** This law, introduced in 1995, provides financial regulation standards and defines a commercial bank as an autonomous entity with legal person status that is sufficiently capitalized to engage in banking services.

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<sup>165</sup> The State Council of the People’s Republic of China is the chief administrative authority of the country, chaired by the premier and including the heads of each governmental department and agency.

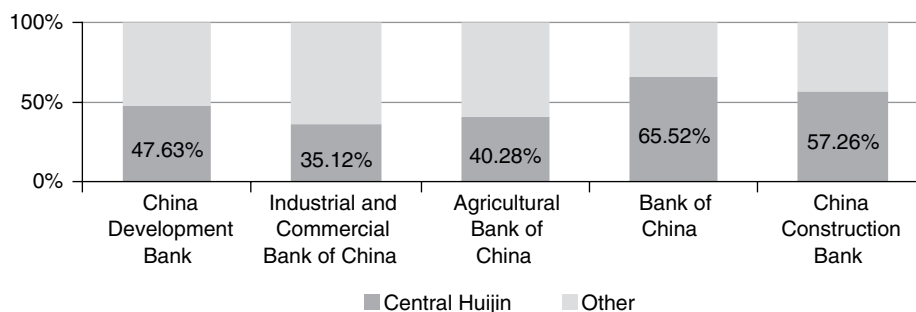
<sup>166</sup> Speech by Mr. Li Rongrong, Chairman of SASAC, December 19, 2006.

## Ownership Arrangements

**In 2003, SASAC was established to manage and oversee the nonfinancial central SOEs.** The objective was to build an institutional framework to separate the fiduciary role of the state from the management of SOEs (CGMA 2012). SASAC was established to manage SOEs registered under the Company Law “on the principle of separating ownership from management.”<sup>167</sup> Through the transfer of ownership from line ministries to SASAC, which is directly subordinate to the State Council, a centralized ownership system was created.<sup>168</sup> Further details on SASAC’s main functions and major achievements are offered below.

**The Ministry of Finance, through Central Huijin Investment Ltd., oversees financial SOEs in China.** Central Huijin is one of the three subsidiaries of the China Investment Corporation (CIC),<sup>169</sup> which was founded in 2007 under Company Law as a fully state-owned company. It invests in both overseas and domestic enterprises, seeking maximum returns for its shareholders.<sup>170</sup> Central Huijin, created in 2003, was mandated to exercise its rights and obligations as an investor in key financial SOEs on behalf of the state. It became a subsidiary of the CIC in 2007 and was placed in charge of equity investments through these financial SOEs domestically. Central Huijin’s shareholdings in major Chinese banks are illustrated in Figure 40. Central Huijin operates under the supervision of the Ministry of Finance with regard to strategic planning and investment decision making for its portfolio of financial SOEs. The Ministry of Finance is the direct owner (shareholder)

**FIGURE 40: Major Portfolio Holdings of Central Huijin Investment Ltd., 2014**



Source: CIC (2014).

<sup>167</sup> <http://en.sasac.gov.cn/n1461859/c1463753/content.html>.

<sup>168</sup> SASAC was also established for local SOEs, but in this chapter we refer only to the central level of government.

<sup>169</sup> The CIC has three subsidiaries: CIC International, CIC Capital, and Central Huijin.

<sup>170</sup> See CIC website, available at <http://www.china-inv.cn>.

of remaining financial SOEs at the central level of government, including security and insurance firms.

## Performance Monitoring

**Performance monitoring was introduced in 2006 for central government SOEs overseen by SASAC.** The Interim Measures for the Administration of Comprehensive Performance Evaluation of Central Enterprises, issued by SASAC in 2006, provide the main guidance for performance monitoring of SOEs in China. This topic is developed further below.

## Board of Directors and Management

### BOX 40

#### **Board and Management Features for Fully State-Owned SOEs under Central SASAC**

**Nomination of board members:** Representatives of staff and workers selected by the company's staff and workers' congress; other board members selected directly by SASAC.

**Nomination of SOE board chairman:** SASAC.

**Nomination of chief executive officer (CEO):** SASAC.

**Separation between chair and CEO:** Sometimes. Subject to approval by the state-owned assets supervision and administration authority, the board chair may serve concurrently as CEO.

**Composition of the board:** 5–13 members.

**Structure of the board:** One chair, one vice chair (not mandated), representatives of staff and workers (at least one-third of board members).

**Profile of board members:** Representatives of the SOE's staff and workers.

**Board committees:** Not required.

**Evaluation of the board:** n/a.

*Source:* World Bank staff compilation, based on SASAC-reported information and the Company Law.

**Since 2004, there have been efforts to implement a pilot exercise to gradually establish a standardized board of directors across all nonfinancial SOEs under SASAC's supervision.** It focuses on SOEs registered as fully state-owned limited liability corporations, under the 1988 Law of



People's Republic of China on Industrial Enterprises Owned by the Whole People, and those SOEs established under the Company Law where there is clear overlap among the members of the board of directors and management. The pilot set up clear requirements for the composition of boards of directors, aiming to separate the SOE's strategic decision making from its daily operations. According to the latest available information, 51 central SOEs had established a standardized board of directors by 2013.<sup>171</sup>

**In the case of fully state-owned SOEs, the board of directors is required to consist of five to thirteen members, with one-third of the members being representatives of the SOE's staff and workers.** As stated in the Company Law, fully state-owned SOEs are required to set up a board of directors. The board must have a chair and may have a vice chair. Board members' tenure should not exceed three years. It is required by law that the share of representatives of staff and workers should not be lower than one-third, and the specific ratio should be specified by the SOE.

**For these SOEs, members of the board of directors—except the representative(s) of staff and workers—are designated directly by SASAC.** SASAC is responsible for the appointment, dismissal, and remuneration of board members. Exceptionally, however, the representative(s) of staff and workers is (are) elected by the personnel of each SOE. Subject to approval by the state-owned assets supervision and administration authority, a member of the board of directors may serve concurrently as manager within the same SOE.

**For SOEs regulated by the Company Law, a quasi-two-tier board structure, comprised of a separate board of directors and supervisory board is required (Kang et al. 2008; Tong, Junarsin, and Li 2015).** Both the board of directors and the supervisory board are on the same level in the SOE's internal governance structure. However, the board of directors, headed by its chair, is in charge of final decisions, even beyond management authorities, while the supervisory board exercises independent supervisory power over the board of directors and executive officers. The supervisory board is in charge of analyzing the SOE's financial status and can propose the removal of directors and senior executives in case of underperformance (Wang 2014). The supervisory board does not participate directly in the selection and dismissal of members of the board of directors or management.

**In practice, the government exerts significant influence on the appointment of the members of the SOE board of directors.** Complex governance issues have emerged with respect to board structure and the

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171 See <http://www.sasac.gov.cn/n85881/n85901/c342941/content.html>.

independence of the board of directors from the management team. Although SASAC has *de jure* rights to appoint SOE managers and members of the board of directors, the State Council in practice oversees the appointment of independent directors, the board chair, the CEO, and senior executives (Tong, Junarsin, and Li 2015).

## Transparency and Disclosure

**Since the creation of SASAC, China has made progress toward improving transparency in SOE practices.** As described in greater detail below, mandatory reporting mechanisms have been established for SASAC-controlled fully owned SOEs, and further reporting and information disclosure standards are in place for listed SOEs whose annual financial statements are audited by both the National Audit Office of the People's Republic of China and a qualified accounting firm.

## Highlights and Good Practices

### The Case of Central SASAC

**In 2003, China undertook a critical step toward concentrating ownership authority over central-level nonfinancial SOEs through the creation of SASAC.** The State Council is the sole owner of nonfinancial SOEs through SASAC, which directly manages its portfolio of 103 SOEs.<sup>172</sup> Financial SOEs are supervised by the Ministry of Finance through Central Huijin, which currently centralizes the ownership of 18 financial SOEs.

**SASAC was established as a special SOE unit in charge of the state investor's main duties and responsibilities.**<sup>173</sup> SASAC is directly subordinate to the State Council. In 2013, the Third Plenary Session of the 16th CPC Central Committee required the role of the government as a regulator to be separated from its function as an investor and urged SOEs to preserve and increase the value of state-owned assets (Sheng and Zhao 2012). SASAC is responsible for investment decisions, and for the supervision and management of the state-owned assets of the 103 nonfinancial SOEs. The Interim Regulations on the Management of Enterprise State-Owned Assets defines

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172 The number of Central SASAC SOEs declined from 189 in 2003 to 103 in 2015, and as announced by Li Rongrong, head of SASAC, the number of central-level nonfinancial SOEs is expected to be further reduced to “well under one hundred” within the next few years.

173 SASAC was also established for local SOEs, but in this chapter we refer only to the central level of government.

SASAC's role as a "special public services unit" representing the State Council in "exercising the duties and responsibilities of the state investor" (Donald 2014).

**SASAC is in charge of the supervision of state-owned assets and corporate governance-related functions.** Authorized by the State Council, in accordance with the Company Law of the People's Republic of China and other administrative regulations, SASAC: (i) shoulders the responsibility for supervising the preservation and increment of the value of the state-owned assets of the supervised enterprises; (ii) is responsible for the management work of wages and remuneration of the supervised enterprises and formulates policies regulating the distribution of SOE income among top executives; (iii) guides and pushes forward the reform and restructuring of SOEs, and improves corporate governance; (iv) appoints and removes top executives of the supervised enterprises, and evaluates their performance; and (v) works out draft laws and regulations on the management of state-owned assets; among other functions.<sup>174</sup>

**The main guidance for performance monitoring of SOEs under SASAC is provided by the Interim Measures for the Administration of Comprehensive Performance Evaluation of Central Enterprises, issued by SASAC in 2006.**<sup>175</sup> The Interim Measures set the general criteria and indicators used to evaluate both the financial and management performance of SOEs.<sup>176</sup> Each SOE is evaluated annually by SASAC, graded separately on its financial and management performance, and categorized into five possible scores, which are published in the SASAC Year Book<sup>177</sup> and have been made available on SASAC's website since 2008.<sup>178</sup>

**In 2010, SASAC adopted an SOE performance measurement system based on quantitative and qualitative indicators.** This system fits into the requirements of the Interim Measures for Assessment of the Operational Performance of Persons in Charge of Central Enterprises,<sup>179</sup> and it is applied

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174 Further details on SASAC's functions are available at: <http://en.sasac.gov.cn/n1408028/n1408521/index.html>.

175 See [http://www.gov.cn/gzdt/2006-04/30/content\\_271734.html](http://www.gov.cn/gzdt/2006-04/30/content_271734.html).

176 A total of 22 indicators are used to evaluate SOEs' financial performance, and 9 to evaluate their management performance. See [http://www.mof.gov.cn/zhengwuxinxi/caijingshidian/zgxxww/200805/t20080519\\_24549.html](http://www.mof.gov.cn/zhengwuxinxi/caijingshidian/zgxxww/200805/t20080519_24549.html).

177 SASAC's Year Book can be requested online by the interested public, through the payment of a fee.

178 See [http://www.gov.cn/guowuyuan/2014-11/20/content\\_2781118.html](http://www.gov.cn/guowuyuan/2014-11/20/content_2781118.html).

179 The Interim Assessment is based on the Law of the People's Republic of China on the State-Owned Assets of Enterprises, and the Supervision and Administration of State-Owned Assets of Enterprises Tentative Regulations, both issued by the State Council.

through “operational performance agreements” signed between Central SASAC and each of the 103 nonfinancial SOEs under its supervision. SOEs are assessed by SASAC on two dimensions:

- the *operational performance* of the enterprise (based on quantitative indicators), focusing on four areas related to financial performance: profitability, asset quality, default risk, and growth potential; and
- the enterprise’s *performance management* (based on a list of qualitative indicators of managerial aspects) assessed over a three-year period, focusing on strategic management, decision making, risk control, social contributions, and others.

On the basis of registered scores from these assessments, SOEs are then classified into five categories (excellent, good, average, fair, and poor),<sup>180</sup> which correlate directly with executive salaries, bonuses, and promotions.

**The annual execution of operational performance agreements is monitored centrally by SASAC.** SASAC sets forward objectives, indicators,

**BOX 41**

**Performance Monitoring for SOEs under Central SASAC**

<b>Tools</b>	Annual operational performance agreements.
<b>Scope</b>	103 SOEs owned by SASAC.
<b>Time span</b>	Annual (operational performance), every 3 years (performance management).
<b>Indicators</b>	<ul style="list-style-type: none"> <li>• Quantitative: profitability, assets quality, default risk, growth potential.</li> <li>• Qualitative: strategic management, development and innovation, decision making, risk control, management fundamentals, human resources, industrial influence, social contribution.</li> </ul>
<b>Reporting</b>	Annual (operation performance), every 3 years (term performance of the management).

*Source:* World Bank staff compilation based on Interim Measures for Assessment of the Operational Performance of Persons in Charge of Central Enterprises, and SASAC-reported information on SOE performance evaluation.

180 See [http://www.mdjf.gov.cn/data/t\\_pshow2128.html](http://www.mdjf.gov.cn/data/t_pshow2128.html).

and associated targets in the operational performance agreements, which are then signed by a representative of SASAC's directorate and by the management of the SOE. SOE operational performance is assessed and reported annually, while the management's term performance is assessed every three years by a team of SASAC officials.<sup>181</sup> During each assessment term, SASAC monitors the execution status of the agreement and issues warnings to SOEs that show signs of underperformance. SOE management is required to report to SASAC annually on the execution of the SOE's agreement, and to provide the supervisory panel with a copy. Supervisory panels are dispatched by SASAC to monitor SOE performance on behalf of the State Council.

**SASAC has promoted improvements in SOE transparency and disclosure.** Fully owned SOEs must report regularly to SASAC on their financial position. In particular, the Interim Regulations on Supervision and Administration of State-Owned Assets require fully owned SOEs to report to SASAC on their financial position, production, and operations, as well as on the maintenance and increase in the value of state-owned assets. If an SOE fails to report the required information, a warning will be issued and disciplinary measures can be implemented.

**A significant increase in the profitability of China's nonfinancial SOEs was achieved after the creation of SASAC in 2003.** The overall profitability of the group of SOEs under SASAC has increased steadily since its creation. Back in 2003, when SASAC had just been established, its portfolio of supervised central government SOEs earned an estimated CNY 300 billion (USD 45 billion) in profits, equivalent to 2.2 percent of GDP. In 2007, these firms earned CNY 1 trillion (USD 149 billion) in profits, a little over 4 percent of GDP, and in 2015, profits from the same portfolio of SOEs reached CNY 1.6 trillion (USD 239 billion).<sup>182</sup>

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181 Measures for Assessment of the Operational Performance of Persons in Charge of Central Enterprises (in Chinese): <http://www.sasac.gov.cn/n85463/n327265/n327728/n327747/c2504293/content.html>.

182 <http://www.sasac.gov.cn/n86302/n326735/n326740/c2234923/content.html>.

## CHAPTER 10

# Malaysia

## SOE Sector

### Economic Relevance of SOEs

**State-owned enterprises in Malaysia, referred to as government-linked companies (GLCs), comprise a significant share of the economy, representing 15 percent of GDP (OECD 2013).**<sup>183</sup> GLCs have been drivers of economic policy in Malaysia, building national ownership in key sectors such as plantations, chemicals, pharmaceuticals, and construction. In addition, GLCs have played a central role in expanding service delivery through transportation, communication, and electricity infrastructure. A review by Malaysia's National Economic Advisory Council indicates that there was a total of 445 GLCs in 2010 (NEAC 2010).<sup>184</sup> Twenty of the largest GLCs, known as the "G20," account for the majority of SOE sector revenues. As of 2013, a total of 35 GLCs, including 17 companies from the G20, were listed on the Bursa

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183 This includes all GLCs, including the G20.

184 Including 332 at the federal level and 113 at the state level.

Malaysia Kuala Lumpur stock exchange (OECD 2013),<sup>185</sup> comprising 36 percent of total market capitalization.

**Malaysia's GLCs are dominant players in financial services, energy, and telecommunications sectors.** GLC domestic market share includes 93 percent of the utilities sector, 80 percent of the transportation and warehousing sector, and more than 50 percent each in agriculture, banking, information and communications technology, and retail trade (Menon et al. 2013). GLCs' consolidated investment income (including interest payments, dividends, and capital gains) is estimated to have contributed to 14.5 percent of total government revenues (MYR 32 billion; USD 8 billion) in 2015 (MOF 2016).<sup>186</sup>

**GLCs contribute significantly to public employment.** Recent statistics indicate that GLC employment represents approximately 5 percent of total employment in Malaysia. In 2014, the G20 alone employed 373,627 people (PCG 2015b).

## The Origins of the SOE Sector and Key Reforms

**After Malaysia's independence in 1957, a majority of the country's corporate sector remained under foreign ownership.** The government considered foreign investors to be an integral part of its economic growth, and foreign investment was encouraged. Most companies remained under foreign ownership after independence, including many British-era enterprises (Yacob and White 2010).

**The 1971 New Economic Policy set out a national economic vision in which GLCs would play a central role.** The policy sought to build national unity by reducing poverty and inequality between ethnic groups, targeting an increase in equitable ownership of corporate stock.<sup>187</sup> As part of this policy agenda, a Foreign Investment Committee was established to limit foreign equity to 30 percent of projects targeting the domestic market (OECD 2013). Permodalan Nasional Berhad, a state holding company, was created in 1978 to purchase strategic corporations. The holding company held shares in trust, sold ownership units to indigenous investors, and set targets for the employment of underrepresented groups in GLCs (PNB 2014).

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185 This figure includes all 35 listed GLCs, including the G20. In total, GLCs comprise 36 percent of the market capitalization of the Bursa Malaysia Kuala Lumpur stock exchange.

186 While not exclusive to GLCs, investment income is contributed mainly by Petronas, Bank Negara Malaysia, and Khazanah.

187 Social unrest between ethnic groups culminated in a political crisis in 1969, when riots forced a reconsideration of economic policy. See Hirshman (1975); Wan Jan (2011).

**Between the mid-1980s and the 1997 Asian financial crisis, government policy shifted toward privatization of GLCs.** Many GLCs faced persistent losses in the mid-1980s, with limited government oversight and uneven corporate governance practices. To address these challenges, several GLCs were corporatized, becoming independent legal entities listed on the Bursa Malaysia stock exchange. The government sold blocks of shares at market prices to establish partial private ownership, introducing market discipline (Perkins and Woo 2000). Furthermore, large government-funded infrastructure projects were awarded to private companies, rather than being executed through government bodies. The wave of privatizations was partially reversed in 1997, however, when a financial crisis forced the government to make strategic interventions in the economy (Khazanah 2011). The crisis directly resulted in significant consolidation among GLCs, especially in the financial sector.

**In 2004, the Malaysian government launched the GLC Transformation Program to improve enterprise performance under a centralized ownership structure.** The 10-year program was divided into four phases. In the first phase (2004–05), the government restructured ownership entities and GLC corporate boards, instituted leadership changes in GLC management, and introduced key indicators for measuring GLC performance. In the second phase (2006), the government established new policy guidelines and developed the Transformation Manual for GLCs, consisting of 10 books of guidance on corporate governance and performance management. The third phase (2007–10) focused on the implementation of the new policy guidelines. In the fourth phase (2010–14), GLCs were expected to sustain previously undertaken reforms and demonstrate improved performance (ADB 2013). The program ended in 2014 with the “graduation” of the targeted GLCs. The task now is to focus on how to improve the performance of GLCs and to sustain the reforms, for both targeted GLCs and those not included in the program.

## **Corporate Governance**

### **Legal Framework**

**The Malaysian government defines GLCs as companies in which the government has a controlling stake.** In the Malaysian context, controlling stake does not refer to percentage ownership but rather to “ability to exercise control.” In other words, the government’s ability to appoint board members and senior management, award tenders and contracts, or make major decisions



related to restructuring, financing, acquisitions, and/or divestments in the company. This definition also applies to GLC subsidiaries and affiliates.

**Most GLCs are incorporated under the Companies Act of 1965 and must abide by its provisions, while further requirements hold for those GLCs that are listed on Malaysia's stock exchange (Bursa Malaysia).**

The Companies Act sets rules for the incorporation of all Malaysian companies, including GLCs. It defines corporations and their subsidiaries and sets out a framework for the constitution of companies, the issuance of shares, management and administration requirements (including directors and officers of companies), legal remedies available to creditors and owners, investigations of company activities, reorganization, accounting, and winding up of operations.<sup>188</sup> Moreover, GLCs that are listed on the stock exchange must legally comply with its listing requirements, which include financial prerequisites for admission to the stock exchange and rules for the sale and buy-back of shares on the market, as well as rules regarding board procedures, audits, and publication of financial reports, among others.

**Other significant applicable regulations include the Competition Act of 2010 and the Corporate Governance Code of 2012.** The Competition Act stipulates that companies (including GLCs) must not abuse their

#### BOX 42

### Corporate Governance Laws and Regulations in Malaysia

- The Companies Act 1965 and amendments in 2007 ([www.ssm.com.my](http://www.ssm.com.my))
- Banking and Financial Institutions Act 1989 ([www.bnm.gov.my](http://www.bnm.gov.my))
- Development Financial Institutions Act 2002 (Act 618) ([www.bnm.gov.my](http://www.bnm.gov.my))
- The Financial Reporting Act of 1997([www.masb.org.my](http://www.masb.org.my))
- The Bursa Malaysia Listing Requirements ([www.bursamalaysia.com](http://www.bursamalaysia.com))
- Securities Commission Act 1993
- Commission Amendment Act 2010
- Capital Markets and Services Act 2007 ([www.sc.com](http://www.sc.com))
- Malaysian Code on Corporate Governance released in 2012 (SCM)

Source: OECD (2013).

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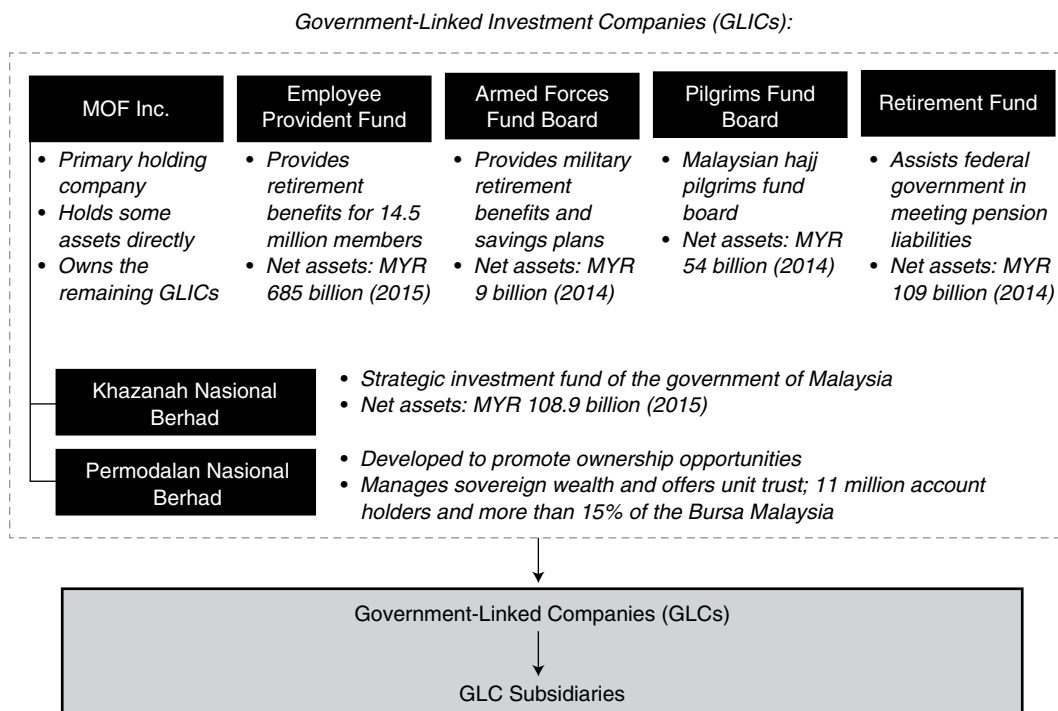
<sup>188</sup> Petronas, Malaysia's largest GLC, is an exception to the Companies Act, as it was established through its own legislation in 1974.

dominant market positions through price fixing, unfair pricing, limiting entry of competitors, or artificially limiting production. Special exceptions to these rules are fixed for enterprises that have been given explicit monopoly service delivery responsibility. The Corporate Governance Code of Malaysia's Securities Commission, released in 2012, applies to listed companies, outlining broad recommendations and best practices for board responsibilities, structures, independence, education, risk management, reporting and disclosure, and relationships with shareholders.

## Ownership Arrangements

**The Malaysian government exercises ownership of its GLCs under a centralized model through a two-tier framework.** At the top are seven government-linked investment companies (GLICs) under which all of Malaysia's GLCs fall (Figure 41). MOF (Inc.) was established in 1957 to hold,

**FIGURE 41: Malaysia's GLICs**



Source: World Bank staff compilation based on Ministry of Finance website and Institute for Democracy and Economic Affairs (IDEAS) website.

invest, acquire, and dispose of assets and shares on behalf of the government; it is a corporate body of the Ministry of Finance, operates as a GLIC, and retains ownership of Khazanah and Permodalan Nasional Berhad. The other GLICs are controlled directly by the Ministry of Finance (Employee Provident Fund and Retirement Fund), the Prime Minister's Office (Pilgrims Fund Board), or the Minister of Defense (Armed Forces Fund Board). As owners, GLICs can influence the appointment of GLC board members and senior management and request that they report directly to the government. In addition, GLICs can provide operational funds and/or capital guarantees to GLCs. MOF (Inc.) directly owns some large-scale GLCs as well, including Petronas (a major oil and gas company) and IMDB (a sovereign wealth fund).

### **Performance Monitoring**

**Through the Transformation Program, Malaysia implemented a strong performance monitoring system for GLCs that is considered good practice by international standards.** As part of the GLC Transformation Program, the Blue Book on Intensifying Performance Management was developed to outline guiding principles for performance monitoring in GLCs. The Blue Book focused on six themes: (i) establishing key performance indicators (KPIs) and setting targets linked to GLC strategy; (ii) establishing KPIs and setting targets for senior management; (iii) reviewing business performance; (iv) reviewing individual performance of senior managers; (v) establishing appropriate compensation frameworks for senior management; and (vi) clarifying eligibility for intensified performance management (PCG 2006). Following implementation of the Blue Book's guiding principles, Malaysia now appears to present a case of good practices in performance monitoring of SOEs. The section below on Highlights and Good Practices covers the functioning of Malaysia's GLC performance monitoring system in greater detail.

### **Board of Directors and Management**

**GLCs' board performance has improved since the implementation of the Transformation Program.** The implementation of board guidelines as defined in the Green Book on Enhancing Board Effectiveness (one of the 10 books of the GLC Transformation Program) was launched in 2005 and brought about several key changes, with an emphasis on separating the government's regulatory and ownership functions and recruiting experienced

## BOX 43

### GLC Board Features in Malaysia

**Nomination of board members:** A Nomination Committee, which includes a GLIC nominee, is responsible for developing clear criteria and nominating board members.

**Nomination of GLC board chair:** A Nomination Committee is responsible for developing clear criteria and nominating a board chair.

**Nomination of chief executive officer (CEO):** GLC boards of directors are responsible for nominating, evaluating, and selecting CEOs.

**Mandate of the board:** GLC Boards have six responsibilities: (i) enhancing shareholder value; (ii) contributing to corporate strategy development; (iii) monitoring the performance of the company and its management; (iv) developing senior management succession plans; (v) understanding and managing risk; and (vi) managing stakeholder interests in line with government policies.

**Separation between chair and CEO:** Yes.

**Composition of the board:** One-third of members must be independent directors, and no more than two directors may be from management.

**Structure of the board:** Preferably not more than 10 members (up to 12), led by a chair and following the composition outlined above.

#### **Profile of board members:**

- Professionals with sectoral or functional expertise from the private sector
- Other CEOs
- Experienced directors from international companies

**Board committees:** At least three committees on nomination, remuneration, and audit.

**Remuneration of CEO and board members:** Set by a remuneration committee on the basis of market rates and in line with KPIs and performance pay objectives, if applicable.

*Source:* World Bank staff compilation based on interviews and current regulations.

and professional GLC board members. Another book of the Transformation Program envisaged the creation of an academy for strengthening GLC board members' capabilities. These aspects are covered in more detail below.

## Transparency and Disclosure

### BOX 44

#### **Transparency and Disclosure Practices in Malaysia**

**Accounting standards:** Malaysian Financial Reporting Standards, which are equivalent to the International Financial Reporting Standards (IFRS) apply to all companies.

**Transmission of financial and activity reports by GLCs:** All listed companies publicly publish annual financial reports following robust listing requirements. Nonlisted companies provide financial reports to GLICs and are not required to publish reports.

**Aggregated reports:** GLICs publish annual performance reports at an aggregate level. However, MOF (Inc.) does not publish an aggregated report for its total holdings.

**Disclosure:** Listed companies publish reports publicly. Nonlisted companies are not required to publish reports.

**Information system:** GLICs use advanced information technology systems to track and manage data.

**Internal audit:** GLCs are directed to establish audit committees that address internal audit.

**External audit:** GLCs are directed to establish audit committees. External audits are conducted by private sector audit firms.

*Source:* World Bank staff compilation based on interviews and regulations.

**At the portfolio level, Malaysia's GLICs provide annual financial reports that publicly disclose the performance of GLCs.** Khazanah, for example, produces a detailed annual report highlighting results within its portfolio of companies.<sup>189</sup> These reports describe detailed company-level

<sup>189</sup> See <http://tkr.khazanah.com.my/2015/>.

performance for the G20 companies and provide summary figures for the remaining GLCs. In addition, all GLCs under the Transformation Program are required to report to the Putrajaya Committee on GLC High Performance (PCG Committee). In addition to following all the transparency and disclosure requirements expected of other companies in the country, GLCs are required to disclose progress against their headline KPIs to the PCG Committee (PCG 2015b). In addition, the PCG Committee has provided reporting on the implementation of the Transformation Program, including a comprehensive “Graduation Report” describing 10 years of progress for G20 companies.<sup>190</sup>

**Publicly listed companies are subject to a higher standard of transparency and disclosure than those that are not listed.** Both the Companies Act and the Financial Reporting Act of 1997 specify requirements related to transparency and disclosure for publicly listed companies in Malaysia (including listed GLCs). In addition, the Bursa Malaysia Listing Requirements provide details on the timely and accurate disclosure obligations of listed companies, and noncompliance can result in sanctions. In the case of nonlisted GLCs, they provide audited financial reports to the GLICs and MOF (Inc.) but are not required to publish them.

**The accounting profession in Malaysia is well-developed, and accounting standards are equivalent to International Financial Reporting Standards (IFRS).** As established by the 1997 Financial Reporting Act, the Malaysia Accounting Standards Board is responsible for issuing accounting standards. In 2012, the standards board fully aligned its accounting framework with IFRS. Listed companies and their affiliates implemented the IFRS standards in phases. As of 2016, nonlisted companies, including GLCs, follow the Malaysian Private Entities Reporting Standard, which is identical to the IFRS SMEs Standard for small and medium enterprises (IFRS 2016).

**GLC boards are tasked with establishing a committee to oversee an external audit, which is performed by private sector firms.** The Securities Commission Act of 1993, amended in 2010, established an Audit Oversight Board and gave it responsibility for overseeing and regulating all external auditors in the country. The board registers auditing individuals and firms, and enforces compliance with the auditing and financial reporting standards that apply to them. Externally audited financial statements are required for publicly listed companies. However, the level of development of the internal audit function is not covered under GLIC or GLC reporting.

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190 See <http://www.pcg.gov.my/>.

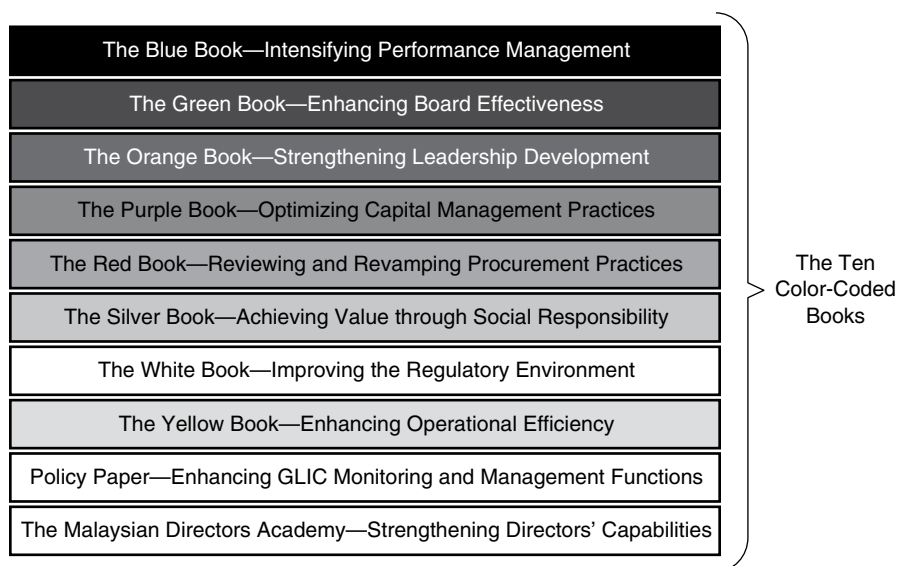
## Highlights and Good Practices

### Malaysia's GLC Transformation Program

**In 2004, the Malaysian government launched the GLC Transformation Program to improve the performance of public enterprises under a centralized ownership structure.** The government created the Putrajaya Committee on GLC High Performance in 2005 to lead the GLC Transformation Program. The PCG Committee is chaired by the Second Minister of Finance and includes the heads of the five GLICs participating in the Transformation Program, as well as representatives from the Ministry of Finance and the Prime Minister's Office. Under the direction of the PCG Committee, transformation initiatives were undertaken by the Malaysian government, with policy guidance captured in 10 color-coded books (Figure 42).

**Khazanah Nasional Berhad (Khazanah) became a driver of reforms for the GLC Transformation Program.** As one of the seven GLICs, Khazanah was established in 1994 as a passive manager of government-owned shares in privatized companies. In 2004, its role was expanded significantly, as the government sought to improve performance at underperforming GLCs and Khazanah took on a lead role among GLICs, becoming the

**FIGURE 42: Policy Guidance for Malaysia's GLC Transformation Program—Ten Color-Coded Books**



Source: PCG (2015b).

#### BOX 45

### An Overview of Khazanah's Functions

- Incorporated in 1993 as a limited liability company and governed by the Companies Act, Khazanah is a wholly owned entity of the government, entrusted with holding and managing the state's commercial assets and undertaking strategic investments in new markets and sectors in order to promote economic growth in the country.
- Khazanah holds investments in more than 80 GLCs in which the government has a direct controlling stake. These investments are in a range of sectors, including finance, telecommunications, utilities, communication services, property development, and transportation.
- Khazanah's nine-member board, made up of public and private sector representatives, is chaired by the prime minister (who is currently also the minister of finance) and assisted by executive and audit committees. The management team consists of professionals with financial sector experience.
- Khazanah does not participate directly in GLC management. Instead, its main role is to ensure the appointment of qualified boards and senior management, push through high-quality business strategies, develop key systems and controls, and monitor progress and performance.
- Since 2004, one of Khazanah's most significant roles has been as secretariat to the PCG Committee, an interministerial committee formed to oversee the GLC Transformation Program. Under this program, Khazanah has been tasked with improving the corporate governance of GLCs and increasing their shareholder and strategic value.

*Source:* WBG (2014a).

secretariat to the PCG Committee in the GLC Transformation Program and setting standards to manage investments on behalf of the government. Box 45 provides a brief overview of Khazanah's special role in this program.

**The Transformation Program was highly successful, although it focused only on a group of large GLCs known collectively as the "G20."** The program targeted five of the seven GLICs,<sup>191</sup> covering a selection of the

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<sup>191</sup> Khazanah, Employee Provident Fund, Armed Forces Fund Board, Pilgrims Fund Board, and Permodalan Nasional Berhad.



largest GLCs controlled by these entities, collectively known as the “G20.” Over the program’s 10-year implementation period, shareholder returns for the G20 grew by 11.1 percent annually, matching the performance of private sector firms while delivering important public services. At the same time, it is important to note that not all GLCs were subject to the Transformation Program and that the benefits of the program were not universally realized. For instance, Petronas, the large state oil company, depends on a GLIC (MOF (Inc.) that was not directly involved in the program, and 1MDB, a state-owned sovereign wealth fund established in 2009 to make strategic investments in Malaysia and abroad, did not implement the required reforms.<sup>192</sup> A 2010 recommendation from Malaysia’s National Economic Advisory Council to establish a single GLC Oversight Authority (or to expand the PCG Committee) with control over all GLCs and reporting to the Prime Minister’s Office was not implemented.

**Reforms carried out under the Transformation Program have helped to improve performance monitoring of GLCs.** While year-on-year performance has varied, the latest Graduation Report of the Transformation Program shows that, on average, the G20 GLCs achieved 66 percent of their headline KPIs from 2006–2014 (PCG 2015b). In addition, these KPIs were announced publicly each year, which enhanced public sector accountability. Box 46 provides an illustrative example of a performance agreement with Malaysia Airports.

**Improving the performance and oversight capacity of the board of directors was another key element of the Transformation Program.** The Green Book on Enhancing Board Effectiveness, launched in 2005, established guidelines along three main dimensions: (i) structuring a high-performing board; (ii) ensuring effective board operations and interactions; and (iii) fulfilling fundamental board roles and responsibilities (PCG 2006).

**Implementation of the Green Book on Enhancing Board Effectiveness brought about several key changes in GLC boards.** To separate the government’s regulatory and ownership functions, for example, regulators, members of parliament, and former civil servants were removed from GLC boards, and GLICs recruited experienced and professional board members to fill in these positions. As a result, within the first two years of the program,

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192 Recent challenges in the corporate governance performance of 1MDB have underscored the importance of continued investment in the corporate governance of GLCs. A public accounts committee report to parliament in 2016 noted that “the Board of Directors failed to discharge their responsibilities and safeguard the interests of the company and shareholders.” See <http://www.parlimen.gov.my/pac/review/docs-110-116.pdf>.

#### BOX 46

### **Key Performance Indicators in Malaysia Airports Holdings Berhad**

**Reform background:** In 2004, Malaysia Airports Holding Berhad adopted KPIs as part of the GLC Transformation Program. In addition, management linked compensation to performance against KPIs in the company. Later, in 2007, a short list of these headline indicators began to be included in corporate reporting.

The chosen KPIs reflected both financial and service delivery objectives of the company. Earnings before interest, tax, depreciation, and amortization; return on equity; and airport service quality global rankings were initially adopted as headline KPIs. (Return on equity was dropped from this list in 2012.) The KPIs were reported against on an annual basis.

**Results:** Reports show that Malaysia Airports Holding Berhad has generally met or exceeded its KPI targets, and has experienced robust growth from 2004–2015, pioneering the low-cost airlines market in the region. Since the implementation of KPIs in the company, total shareholder returns have averaged 17.6 percent.

*Source:* World Bank staff compilation based on Malaysia Airports Holding Berhad annual reports and PCG (2015b).

58 member changes had taken place in GLC boards, and by the end of the 10-year program, 198 board members had been changed (PCG 2015b). GLCs were required to complete periodic Board Effectiveness Assessments to target continuous improvements in board operations. By 2008, 83 percent of the G20 had completed this assessment and 67 percent had subsequently developed an actionable improvement program (OECD 2013).

**Remarkably, one of the 10 books of the GLC Transformation Program envisaged the creation of an academy for strengthening GLC directors' capabilities.** The Malaysian Directors Academy (MINDA) was launched in 2006 to train and support GLC board members. As part of its operations, MINDA conducted 85 programs between 2006 and 2015, which were attended by 1,776 participants (PCG 2015b). Further details on this distinctive initiative are provided below.

## Performance Monitoring of GLCs

### BOX 47

### Performance Monitoring in Malaysia

<b>Tools</b>	GLCs are directed to set KPIs, which are agreed between GLICs and GLCs. GLCs report against these KPIs, which become the main measure for performance benchmarking.
<b>Scope</b>	All GLCs are directed to set KPIs. Enforcement is limited, however, to those that are included in the GLC Transformation Program, including all of the G20 companies.
<b>Time span</b>	KPIs are established and reported on annually. Internal performance monitoring takes place on a quarterly and semiannual basis.
<b>Indicators</b>	Indicators vary between GLCs, but include financial (such as earnings before interest, tax, depreciation, and amortization, and return on equity) and nonfinancial indicators (such as service delivery indicators, international rankings, and so on).
<b>Reporting</b>	Business performance reviews and personal performance reviews. Listed companies report on headline KPIs in published annual reports.

Source: World Bank staff compilation.

**GLCs in Malaysia are instructed to establish KPIs in order to monitor their value creation.** According to the Transformation Manual, all GLCs should set “between five to eight KPIs with outcome targets along financial, customer, operational and organizational dimensions that are tightly linked to its specific strategy” (PCG 2006). These KPIs must be weighted according to their importance and benchmarked against comparable international peers. In addition, responsibility for implementing the KPIs and for reporting headline KPIs to the market rests with the chief executive officer (CEO) of each corporate entity.

**GLCs must also abide by rigorous performance review standards.** The Transformation Manual provides detailed guidelines for performance reviews. GLCs must undertake two types of reviews: business performance reviews and personal performance reviews. The first type includes a quarterly review of GLC performance against preestablished targets, which would allow the company to develop concrete action plans for its future trajectory. The second consists of a semiannual review of managers against their preestablished performance targets. Feedback and evaluations during

this review stage are tied to performance rewards for managers whenever targets are met.

**Differentiated rewards and performance incentives are used to manage and improve performance in GLCs.** Under the Transformation Program, GLCs are instructed to have market-competitive base pay and then performance bonuses on top that vary significantly with individual performance. Further, per the Transformation Manual, “promotion, recognition and other non-financial rewards should be based on merit (not tenure) and highly correlated with performance.” Individuals with consistently low performance are expected to be reskilled and remapped within the organization, or transitioned out of the organization in a fair manner.

**The PCG Committee oversees the overall scheme, while GLICs directly ensure implementation by GLCs.** Performance agreements are negotiated between GLICs and GLCs. Under this approach, GLICs negotiate high-level performance agreements with GLCs. CEOs are responsible for the overall design and implementation of performance management, subject to board approval. Internal management systems support the achievement of these performance agreements. Notably, boards use achievement of KPIs to reward or discipline senior managers.

### **GLCs’ Board Academy (MINDA)**

**Increasing board effectiveness under the GLC Transformation Program required a significant investment in training.** The Green Book on Enhancing Board Effectiveness required boards to undertake an effectiveness assessment and set out an improvement program. To support directors in meeting the knowledge, skills, and mindset profile targeted by the program, MINDA was conceived.

**MINDA was launched in 2006 to train and support GLC board members.** MINDA was established with a mandate to “equip directors of GLCs with the world-class knowledge, skills and mindset required to perform to a consistently high standard” (MINDA 2017). GLC board members are required to be trained upon appointment to the position or when their company is seeking listing on a public exchange. This good practice facilitated sharing of lessons learned during the transformation process with a pipeline of future directors.

**MINDA’s focus on GLC boards allowed it to develop highly targeted training to support the objectives of the GLC Transformation Program.** MINDA programs include traditional training, national and regional case studies, on-the-job learning, and coaching. These programs have built general capacity to effectively lead public enterprises while also addressing

the specific technical requirements of the Transformation Program in Malaysia. MINDA has partnered with international institutions such as INSEAD, Harvard University, and the International Institute for Management Development. By 2012, MINDA began accepting training requests from private sector listed companies (PCG 2015b).

**MINDA now operates as a prestigious institution in Malaysia and offers several kinds of assessments to guide directors' professional development.** These assessments include Board and Director Assessments, designed to allow boards to prioritize their own key strategic issues and implementation plan; Individual Director Evaluations, a feedback-oriented tool to evaluate individual directors' contributions as board members; and a Directors Gap Analysis, a tracking mechanism to evaluate the progress of individual directors over a given period of time.<sup>193</sup>

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193 See [www.mynda.com.my](http://www.mynda.com.my).

## CHAPTER 11

# Singapore

## SOE Sector

### Economic Relevance of SOEs

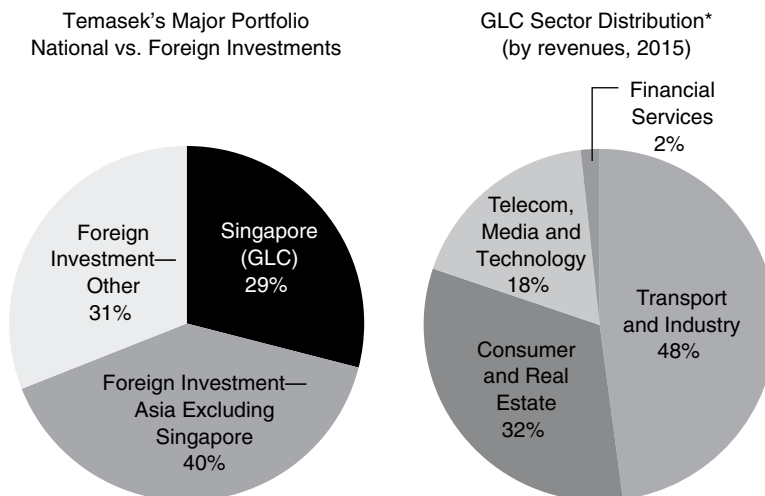
**State-owned enterprises (SOEs) in Singapore, referred to as government-linked companies (GLCs), are dominated by 21 firms held by the state investment company, Temasek Holdings.** According to Temasek's list of major investments, the state-owned enterprise sector in Singapore in 2016 comprised 21 GLCs, including seven fully owned, eight majority-owned, and six minority-owned companies (Temasek 2016).<sup>194</sup> Unlike in many other countries, Singaporean GLCs<sup>195</sup> operate on a fully commercial basis, and some of them are large conglomerates with extensive local and international networks. In addition to GLCs, Temasek owns a significant part of its assets

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194 Major investments include GLCs where the percentage of state-owned shares surpasses 20 percent.

195 There are other enterprises that are fully or majority-owned by statutory boards and can be classified as GLCs to the extent that their shares are owned ultimately by the government (Ramírez and Tan 2003).

**FIGURE 43: Overview of Temasek's Investment Portfolio, 2015**



\*Note: Temasek's sector classification.

Source: World Bank staff compilation based on Temasek (2016).

outside Singapore. In fact, by 2015, more than 70 percent of its total assets were held in foreign enterprises (Figure 43).<sup>196</sup>

**GLCs are critical to the Singaporean economy, with consolidated revenues representing 29 percent of gross domestic product (GDP) in 2015.** The 21 GLCs alone generated SGD 117 billion (29 percent of GDP) in 2015, and were predominant in three sectors: transport and industry; consumer and real estate; and telecommunications, media, and technology. Figure 44 provides key statistics for selected major and highly profitable GLCs. By 2016, 9 GLCs<sup>197</sup> were listed on the Singapore Stock Exchange, accounting for 19 percent of total market capitalization.<sup>198</sup>

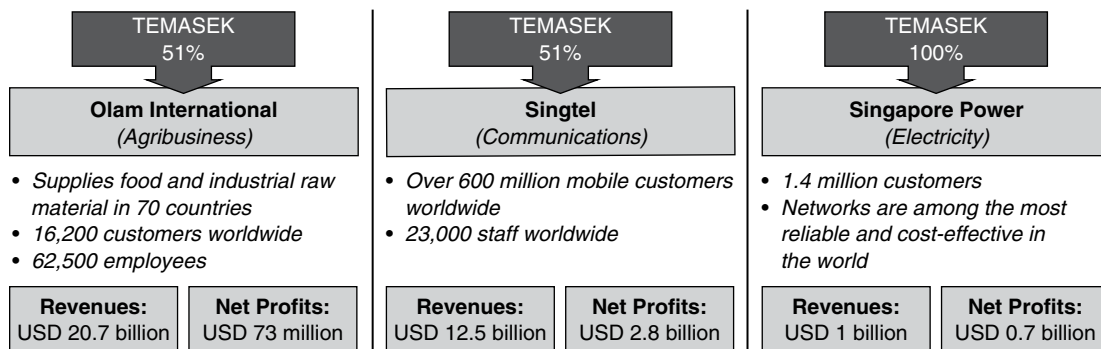
**While GLCs are run fundamentally as commercial companies, taxes and dividends paid by Temasek to the national treasury provide a significant source of revenues, which the government uses to achieve social and economic objectives.** Temasek's taxes and dividends are among the main sources of funding for essential public services in Singapore,

196 Some major current investments include a 2 percent stake in Alibaba Group Holdings (China), 25 percent shares in A.S. Watson Holdings (Hong Kong), and 41 percent shares in Intouch Holdings Public Company (Thailand).

197 Singapore Airlines Ltd., Singapore Technologies Engineering Ltd., Singtel, Olam International Ltd., Sembcorp Industries Ltd., SATS Ltd., CapitaLand Ltd., DBS Group Holdings Ltd., and Keppel Corporation Ltd.

198 By 2016, total market capitalization surpassed SGD 900 billion (USD 667 billion).

**FIGURE 44: Selected GLCs in Singapore, 2015**



Source: World Bank staff compilation based on Temasek (2016) and GLCs' annual reports.

ranging from defense and education to health care and social services (for example, the Pioneer Generation Package). In 2015, Temasek Group<sup>199</sup> paid SGD 2.5 billion (USD 1.8 billion) in taxes to the government, and dividends declared by the 21 dominant GLCs amounted to SGD 9.6 billion (USD 6.8 billion), which was equivalent to 2.4 percent of GDP.

### Origins of the SOE Sector and Key Reforms

**In the late 1960s, the Singapore government promoted the establishment of SOEs to stimulate the country's industrialization process.** The rationale behind the creation of GLCs was to compensate for the inadequate capital, expertise, and human capital of the private sector (Ramírez and Tan 2003). GLCs were established in key economic sectors such as manufacturing, finance, trading, transportation, shipbuilding, and services, and used as a means for the government to take the lead in establishing new industries and obtaining control over key domestic sectors. Many GLCs were set up with investments from foreign firms as joint ventures, with the objective of stimulating domestic employment and promoting national economic growth (Tan, Puchniak, and Varotttil 2015).

**GLCs have been run on a commercial basis, and have contributed substantially to the development of the economy.** GLCs function similarly as private enterprises, which run on a commercial basis with a focus on financial performance. The government has clearly identified competition as the key to promoting GLCs' efficiency and has aimed to build a competitive,

<sup>199</sup> Group financials are a compilation of the financial information of Temasek as an investment company, and that of its majority-owned operating subsidiaries.



enabling market where these public companies are built to mobilize private investment and compete with private firms. The government also recommends that GLCs become listed publicly so that they are subject to the rules of market competition. The economic development model supported by the creation of GLCs has helped Singapore jump from average per-capita gross domestic product (GDP) of USD 449 in 1961 to USD 52,889 by 2015.<sup>200</sup>

**In 1974, Temasek Holdings was set up as a centralized ownership entity to hold and manage GLCs and other public sector investments.**

Temasek was incorporated under the Companies Act as an investment holding company to commercially own and manage GLCs.<sup>201</sup> The objective was to transfer government assets—investments made in the first decade of nation building—to the holding in order to allow the Ministry of Finance (MOF) to focus on its role as policy maker and regulator, while Temasek would own and manage these investments (Tan, Puchniak, and Varotttil 2015). At inception, 36 GLCs were transferred to Temasek’s control. In the 1980s and 1990s, additional state-owned entities were corporatized into GLCs and brought under Temasek management.<sup>202</sup> In addition, two other state holdings, Sheng-Li Holdings (now Singapore Technologies) and MND Holdings, established in 1967 and 1974 in the defense and financial sectors, respectively, were restructured and merged with Temasek.

**In 1985, the Public Sector Divestment Committee announced a privatization program, which defined the government policy toward GLCs until the early 2000s.** The policy set the guidelines and time frame for divestment of GLCs and was implemented gradually until the early 2000s. The Public Sector Divestment Committee began with the examination of 99 GLCs, of which 26 were recommended for partial or full privatization and 15 were suggested for listing (Mak n.d.). By 2002, close to 60 Temasek GLCs were divested (Rajan 2003), mostly through capital markets and direct sales (PSDC [1987]). Reasons behind the privatization process included: (i) to withdraw enterprises that no longer needed to be carried out by the public sector; (ii) to develop the stock exchange; (iii) to limit competition with the private sector; and (iv) to raise revenues by selling inefficient enterprises (Mak n.d.).

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200 World Bank, World Development Indicators.

201 See Temasek website at: <http://www.temasek.com.sg/abouttemasek/faqs#> <http://www.temasek.com.sg/>.

202 These included the Telecommunications Authority of Singapore (1992) and the Port Authority of Singapore (1997).

# Corporate Governance

## Legal Framework

### BOX 48

#### GLC-related Laws and Regulations

- The Company Act, 1967 (latest revision in 2004)
- The Code of Corporate Governance, 2001
- The Competition Act, 2004
- Guide to sustainability reporting for listed companies, 2011
- Risk governance guidance, 2012
- Guidebook for audit committees of companies listed on the Singapore Exchange (second edition)
- The Singapore code on Take-Overs and Mergers (third edition, amended in 2016)

*Source:* World Bank staff compilation.

**While no official definition of GLCs is available, the term generally refers to enterprises in which the state has a controlling interest through Temasek<sup>203</sup> or a related entity.** Singaporean SOEs, denominated GLCs, are defined as companies in which the government holds a controlling interest via the state investment company (Temasek) or a related body. GLCs owned directly by Temasek are generally large companies, sometimes controlling broad networks of subsidiaries.

**GLCs operate on a commercial basis; they are registered under the Companies Act and subject to the same legal requirements as private firms.** GLCs do not benefit from specific advantages as compared to private firms. The Companies Act, first enacted in 1967, includes provisions related to the constitution of companies in Singapore, including GLCs, and on several related aspects such as shares debentures and charges, management and administration (including the appointment and removal of companies' board

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203 Temasek is one of the seven so-called Fifth Schedule entities in Singapore, which refer to key statutory boards and government companies that are listed in the Fifth Schedule under the Constitution. The reserves of these entities are protected under the Reserves Protection Framework.

members), and financial reporting and audit (including disclosure practices, accounting standards, and appointment and remuneration of auditors).

**Listed GLCs are encouraged to follow corporate governance principles as defined by the Code of Corporate Governance.** The Code, issued in 2001, provides principles and guidelines on different corporate governance-related aspects such as board practices and remuneration, accountability and audit, communication with shareholders, and disclosure mechanisms. Listed companies are required by the Singapore Exchange to disclose their corporate governance practices and provide explanations in case of deviations from the Code in their annual reports.<sup>204</sup>

**Several other legal and regulatory instruments are linked to GLCs.** One of these instruments is the Competition Act, whose main objectives were defined in such a way as to ensure that GLCs would not benefit from special privileges and would compete on the market on an equal basis against private sector firms. Moreover, in the case of listed companies, the Singapore Monetary Authority has recently provided additional regulations and guidance with regard to risk management, internal control, audit mechanisms, and takeovers and mergers.

## **Ownership Arrangements**

**Singapore has a centralized ownership model for public enterprises, with Temasek—a holding owned by the MOF—acting as a central ownership and oversight entity for GLCs.** Established to act as an investment company under the MOF, Temasek owns, controls, and oversees all GLCs in Singapore. Temasek manages a large and diverse portfolio, including GLCs. Further details on Temasek’s ownership arrangements, in particular relating to GLCs, are provided below.

## **Performance Monitoring**

**Temasek and its portfolio companies, including GLCs, are evaluated annually by their respective boards on the basis of financial goals.** Although Temasek does not sign performance agreements with individual GLCs, an effective annual financial monitoring mechanism takes place under which Temasek as a whole and its portfolio companies, including GLCs, are evaluated each year by their respective boards on the basis of a set of financial indicators and associated targets (OECD 2016).

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204 Monetary Authority of Singapore. Code of Corporate Governance, 2001.

**To evaluate performance, the boards of Temasek portfolio companies are guided by a set of predefined financial indicators that aim to maximize risk-adjusted returns over the long term.** While specific information on the actual indicators used by GLC boards is not available publicly, an economic value-added indicator is provided annually by the companies, or calculated by Temasek based on their respective annual filings. Also, as reported in OECD (2016), performance evaluation indicators vary from company to company and for Temasek itself, and a key measure used in most cases is total shareholder return (TSR), measured against a risk-adjusted hurdle rate. While the performance evaluation results from the previous fiscal year do not affect the settlement of the next fiscal year's remuneration for GLC management and executives, short-term incentives are provided annually on a company, team, and individual basis and medium- to long-term incentives based on an individual's performance over a period of time (OECD 2016).

## **Board of Directors and Management**

### *Temasek's Board of Directors*

**Temasek is governed by a board of directors that is composed of 14 members,<sup>205</sup> most of whom are independent private sector business leaders.** Temasek's board is composed of people from several backgrounds across various industries, from the public and private sectors, in Singapore and overseas. In 2016, Temasek's board included a chair, deputy chair, executive director and chief executive officer (CEO), and 11 additional board members. The board appoints or removes Temasek's CEO, subject to the concurrence of the President of the Republic.<sup>206</sup> The minister of finance, as the shareholder, also has the right to appoint or remove Temasek board members, subject to the president's concurrence.

**Temasek does not intervene directly in the appointment of board members for its GLCs.** Temasek is not directly involved in the process of

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205 The number of board members has changed slightly over the past few years, as an additional member joined in 2016.

206 According to the Temasek Review (Temasek 2017), the president has an independent custodial role, under the Singapore Constitution, to safeguard the respective past reserves of the Singapore Government and the Fifth Schedule entities, including Temasek. The concurrence of the elected president of Singapore is required over certain governance matters concerning Fifth Schedule entities. These include the appointment and removal of board members and the CEO, and the drawdown of past reserves built up by the entity before the term of the current government.

selecting and nominating GLC directors, and is not explicitly represented on GLC boards. The role of Temasek in this regard is to advocate for high-caliber, experienced, and diverse board members to complement GLC management's leadership. Given its network, Temasek encourages the boards of its portfolio companies, including GLCs, to identify and consider potential directors with relevant backgrounds and experience, and to conduct annual reviews of their succession plans. Temasek also recommends board independence from management.

### *GLCs' Boards of Directors*

**The Code of Corporate Governance (CCG) specifies the composition of GLC boards and encourages separation between the chair and CEO.** To ensure objectivity and independence in decision making power, the CCG provides that independent directors<sup>207</sup> should represent at least one-third of total members. In addition, the Code encourages that the positions of chair and CEO be assigned to different persons, and that the division of responsibilities be clearly established to ensure an appropriate balance of power, increased accountability, and greater capacity for the board's independent decision making.

**GLCs are required to establish a Nomination Committee (NC), which is in charge of making recommendations to the board on all board members' appointments.** According to the CCG, at least three directors are required to be part of the NC, where the majority, including the NC chair, should be independent. The NC should be in charge of the eventual renomination of a board member, based on his/her contribution and performance (such as attendance, skills, and participation); of ensuring that directors have the necessary independence for decision making; and of verifying that they have allocated enough time and attention to carry out their tasks effectively.

**The NC should implement a process for evaluating board performance.** As required by the CCG, this process aims to assess annually the actual contribution and commitment of the chair and individual directors, which should be evaluated and disclosed in the corresponding GLC annual report. Responsibilities of the NC include the selection of a system for evaluating the overall effectiveness of the board, as well as evaluation criteria for its members.

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207 As per the CCG, an independent director is one who has no relationship with the company, its related companies, or its officers that could interfere, or be reasonably perceived to interfere, with the exercise of the director's independent business judgement with a view to the best interests of the company.

**BOX 49****GLC Board Features in Singapore**

**Nomination of board members:** The Nomination Committee selects candidates and reports to the annual general meeting of shareholders. Temasek does not intervene in the appointment processes but can suggest qualified candidates based on a network of contacts.

**Nomination of GLC board chair:** Board of directors of GLCs.

**Nomination of CEO:** Board of directors of GLCs.

**Mandate of the board:**

- Manage, direct, and supervise the business of the company.
- Set strategic goals, provide entrepreneurial leadership, and ensure the necessary resources to meet objectives.
- Establish a framework for risk management, review management performance, and set the company's values and standards.

**Separation between board chair and CEO:** Yes; GLCs are invited to disclose the relationship between the chair and CEO.

**Composition of the board:** Typically, around 10 (including CEO); at least one member should be from Singapore.

**Structure of the board:** Single unitary body.

**Profile of board members:** Appropriate balance and diversity of skills, experience, gender, and knowledge of the company. Core competencies include accounting or finance, business or management experience, industry knowledge, strategic planning experience, and customer-based experience.

**Board committees:** Audit Committee (AC); Nomination Committee (NC); Remuneration Committee (RC).

**Remuneration of members:** Remuneration packages often include salary, fees, allowances, bonuses, options, and other benefits that are usually on par with private corporations.

**Evaluation of the board:** The Nominating Committee is to implement a process and select objective performance criteria to assess the performance of the board. Performance criteria are to be in place for a long period, and should allow for comparison with peers.

*Source:* World Bank staff compilation based on the Code of Corporate Governance.

**Additionally, a Remuneration Committee (RC) and an Audit Committee (AC) should be part of GLC boards.** In accordance with the CCG, both the RC and the AC should be comprised of three directors, from which at least two (including the chair) must be independent. The RC reviews all remuneration matters and makes recommendations to the board accordingly, while the AC’s mission includes reviewing financial reporting issues and judgements; reviewing and reporting at least annually the adequacy and effectiveness of the company’s internal controls; and other tasks related directly to the audit function.<sup>208</sup>

## Transparency and Disclosure

**Temasek issues and publishes annually the “Temasek Review,” which offers an aggregate report on the financial performance of its overall portfolio, including GLCs.** Though exempted by law from the requirement to disclose financial information,<sup>209</sup> Temasek has published an annual report,

### BOX 50

#### Transparency and Disclosure Practices

**Accounting standards:** Singapore Standards on Auditing (SSA 700), which comply with International Financial Reporting Standards (IFRS).

**Transmission of financial and activity reports by GLCs:** GLCs report directly to their shareholders with quarterly, half-yearly, and yearly reports, all of which are published.

**Aggregated reports:** Temasek Review, annual.

**Disclosure:** Quarterly, half-yearly, and yearly reports of GLCs are all published.

**Internal audit:** Audit Committee.

**External Audit:** International auditors, Auditor General’s Office.

*Source:* World Bank staff compilation.

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208 As noted in other parts of this chapter, the Temasek board has its own Audit Committee, as well as an Executive Committee and a Leadership Development and Compensation Committee.

209 Temasek is an Exempt Private Company, meaning that it has 20 or fewer shareholders and no corporation holds beneficial interest in the company’s shares. As an Exempt Private Company, Temasek is not subject to the audit of its financial statements.

known as the Temasek Review, since 2004 (Temasek 2016). The report provides a summary of financial results for its portfolio of GLCs,<sup>210</sup> based on audited financial statements, and detailed information on the financial performance of Temasek's major investments, both domestically and overseas. A statement by auditors is included in the annual review to report the external auditor's opinion on GLCs' financial statements according to International Financial Reporting Standards (IFRS).

**Temasek's board works through its Audit Committee to ensure the quality of information.** According to the Temasek Review, the Temasek board's AC is responsible for the internal audit function, as well as for reviewing Temasek's system of internal controls and processes used for financial reporting and monitoring compliance with laws and regulations. The Temasek board's AC also reviews the scope and results of external audits, and gives an opinion on the independence of external auditors. It may also carry out special reviews upon request from the board.

**The Singapore Financial Reporting Standards, which comply with IFRS standards, set auditing standards for GLCs.** The Singapore Standards on Auditing (SSA 700) outline the rules for preparation of financial statements for GLCs. Following these standards, GLCs are audited by international auditing firms, which conduct audits in accordance with IFRS.

**According to the Companies Act, an external audit entity can be appointed at the annual general meeting of GLCs.** The board shall appoint an external auditor within three months after the company's incorporation, and can appoint or remove an external auditor at each annual general meeting. If the board does not appoint an auditor, the registrar<sup>211</sup> can make the appointment.

**GLCs are required to set up an AC with written terms of reference that clearly set out its responsibilities.** The AC should be responsible for reviewing audit results, verifying the independence and objectivity of external auditors, checking the integrity of financial statements, and evaluating the effectiveness of internal control systems. In addition, the Guidebook for Audit Committees, issued by the Audit Committee Guidance Committee,<sup>212</sup> provides practical guidance for the ACs of listed companies.

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210 GLCs under Temasek report directly to Temasek, while their subsidiaries report to their GLC parent.

211 The Supreme Court Registry is currently headed by the Registrar of the Supreme Court.

212 Established in 2008 by the Monetary Authority of Singapore, the Accounting and Corporate Regulatory Authority, and Singapore Exchange Limited.



## Highlights and Good Practices

### Temasek Holding

**Temasek was incorporated in 1974 under the Company Act to own and manage assets that were previously held directly by the MOF.** The initial objective of Temasek was to allow the MOF, its sole shareholder, to focus on its core policy making and regulatory role. As a result, Temasek was established to take over investments made in the years of nation building, which at the time included assets in diverse economic sectors.

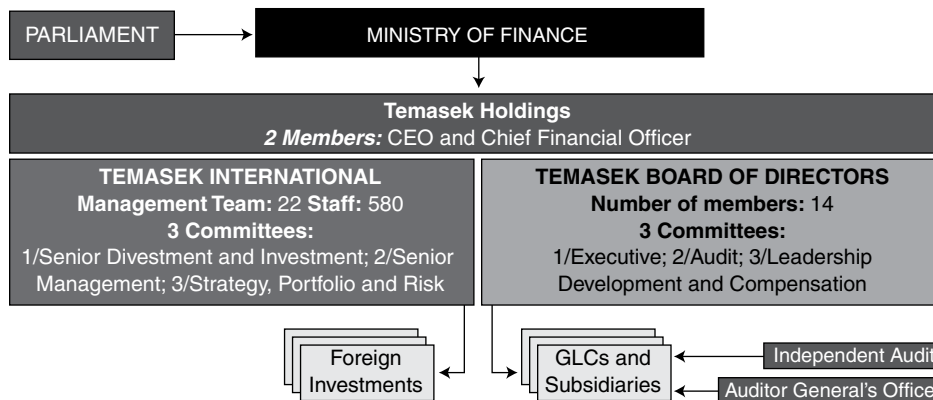
**Over time, Temasek has become responsible for the management of a large portfolio of state investments, both domestically and overseas, and including fully and partially owned GLCs.** The net portfolio value of Temasek was officially declared at 266 billion SGD (USD 197 billion) as of March 2015. Of this total value, 28 percent was invested domestically, 42 percent in other Asian countries, and 30 percent elsewhere around the world. The key sectors in Temasek's investment portfolio, according to their economic size, include financial service and real estate (OECD 2016). As explained above, GLCs account only for a fraction of Temasek's total portfolio. As such, they are closely involved in some of these sectors (including transportation and industrials), and have negligible participation in others (such as financial services).

### *Ownership Arrangements*

**Singapore has a centralized ownership model for public enterprises, with Temasek Holdings acting as a central ownership and oversight entity for GLCs.** Established to act as an investment company under the MOF, Temasek owns, controls, and oversees GLCs, following best practices in corporate governance. Its management team, called "Temasek International," includes 22 members working with the support of three committees that specialize in divestment and investment; management, organization, and control; and risk. The team is mandated to implement the strategy decided by the board of directors, which is composed of 14 members, including the chair. By 2016, Temasek employed 580 staff members in total.

**On the one hand, Temasek enjoys a high level of autonomy.** Temasek's investments, divestments, and other business decisions are conducted without the involvement of Singapore's president and government. Temasek's business decisions, including both long-term strategic aspects and daily operations, are taken by its board of directors and management with a high

**FIGURE 45: Temasek Ownership Arrangements**



Source: World Bank staff compilation.

degree of independence from the government.<sup>213</sup> As a Fifth Schedule Entity, however, some decisions taken by Temasek are subject to the president's concurrence, including the appointment, renewal, or removal of board members; appointment or removal of the CEO; and any transaction that could result in a significant drawdown of Temasek's reserves.<sup>214</sup>

**On the other hand, Temasek delegates most of its functions as legitimate owner of its portfolio companies, including GLCs.** Temasek appears as a distinctive owner of its portfolio companies by delegating several key ownership functions. The holding company is not involved in exercising traditional ownership functions such as nominating and appointing board members and management of its constituent companies, signing performance agreements with them, or participating in their major investment decisions. On the contrary, GLCs and private companies owned by Temasek enjoy a high level of autonomy in both corporate governance-related practices and business decisions and operations.

**This apparent contradiction with a typical centralized ownership model can be explained by the fact that GLCs operate on a fully commercial basis and have highly professionalized boards and management.** Unlike many SOEs around the world, GLCs are fully commercially

213 See Temasek's website at: <http://www.temasek.com.sg/abouttemasek/faqs#> <http://www.temasek.com.sg/>.

214 Fifth Schedule entities have a constitutional responsibility to manage and safeguard company reserves.

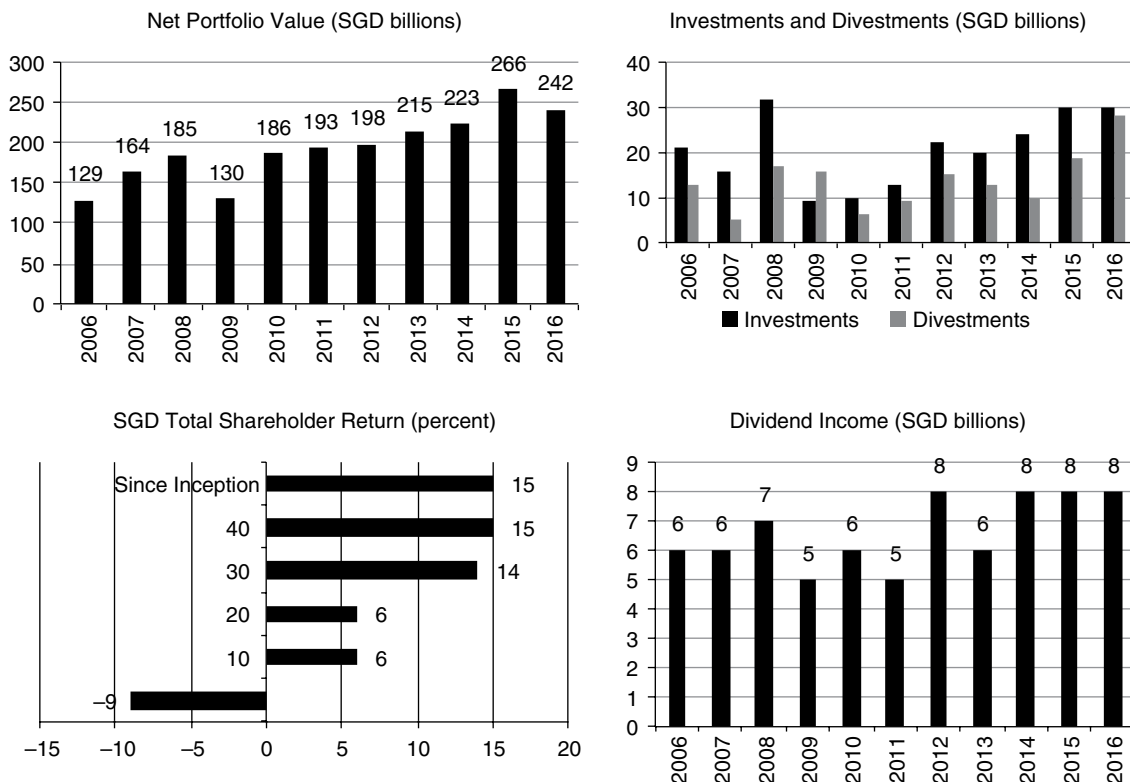
oriented and operate under the same rules, regulations, and market conditions as private companies. Therefore, the separation of commercial and social objectives, which is widely advocated but difficult to achieve in many countries, is not a challenge for Singaporean GLCs. For the same reason, GLC boards and management enjoy great autonomy in commercial decision making, without interference from Temasek (or the government) and thus facing low risk of board politicization or similar suboptimal practices. Moreover, the implementation of strict legal and sound corporate governance procedures has led Temasek portfolio companies, including GLCs, to be managed by high-caliber and diverse boards, as well as skilled management, both enjoying a high level of autonomy in decision making.

### *Temasek's Financial Performance*

**Temasek has earned a reputation as a well-consolidated investment holding based on commercial principles, and has almost doubled the net value of its portfolio over the last decade.** According to the Temasek Review (Temasek 2016), the net value of Temasek's investment portfolio has grown from SGD 129 billion (USD 96 billion) in 2006 to SGD 242 billion (USD 179 billion) in 2016. Average shareholder annual returns over this decade reached 6 percent, providing relatively stable returns over the long term. Temasek's net portfolio value is highly diversified, showing a 60:40 underlying exposure to mature economies (including Singapore, Japan, North America, Europe, Australia, and New Zealand) and growth regions (Asia, excluding Singapore, Japan, and Korea; Latin America; and Africa and the Middle East).

**As of March 31, 2016, Temasek's net portfolio value was SGD 242 billion, down SGD 24 billion from 2015, but the holding remains financially solid from a medium- to long-term outlook.** The drop in the total portfolio value between 2015 and 2016 was due in large part to the fall in market values of listed companies during a challenging year, in financial terms, for the global economy, with increased volatility in global equity markets, depressed commodities prices, and rising uncertainty around policy toolkits and their effectiveness (Temasek 2016). Temasek's investment policy remains largely unchanged as an owner and investor over the longer term, even after expanding its portfolio beyond Singapore, particularly since 2002. Its 20-year TSR reached 6 percent, versus Singapore's 20-year annualized inflation of under 2 percent.

**FIGURE 46: Temasek's Portfolio Performance**



Note: Includes all portfolio investments, including GLCs.

Source: World Bank staff compilation based on Temasek (2016).

**Temasek uses the TSR as a key efficiency indicator for its overall portfolio (Temasek 2016).** The TSR measures the compounded annual returns to its shareholder (the MOF) by including dividends paid to the shareholder but excluding capital injections made from the shareholder. Each year, Temasek compares the TSR against the risk-adjusted hurdle rate<sup>215</sup> to measure its financial performance (OECD 2015).

215 According to the Temasek Review (Temasek 2016), the risk-adjusted hurdle rate is derived using a capital asset pricing model. The hurdle rate is built bottom-up, and aggregated over all the investments.



## CHAPTER 12

# South Korea

## SOE Sector

### Economic Relevance of SOEs

**In 2016, the Republic of Korea<sup>216</sup> designated 321 state-owned enterprises (SOEs),<sup>217</sup> which are referred to as Public Institutions (PIs) and comprise 30 public corporations, 89 quasi-governmental institutions, and 202 nonclassified institutions.** Public corporations are companies with more than 50 employees and more than 50 percent of their total revenues generated from nongovernment sources. Public corporations are subdivided between those that primarily serve the public with a large asset base (market-based) and those with a mixed client base (quasi-market-based). Quasi-governmental institutions have more than 50 employees and receive more than half of their revenues from government sources. These are subdivided between institutions that manage national funds (fund-managing) and

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216 The current chapter covers the Republic of Korea, subsequently also referred to as “South Korea” or “Korea.”

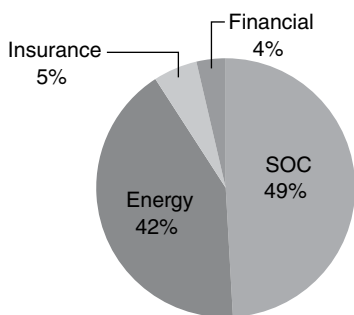
217 The government reviews and newly designates PIs at the beginning of each year; as such, the number of PIs has increased to 332 in 2017.

those with other purposes (commission-based). Finally, nonclassified institutions are typically smaller in size, with fewer than 50 employees.

**The PI budget was more than 40 percent of gross domestic product (GDP) in 2014,<sup>218</sup> and PIs are dominant in critical economic sectors such as energy, public goods, and finance.** In 2014, PIs' consolidated gross sales reached KRW 281 trillion (USD 267 billion), which was equivalent to 20 percent of GDP (KIPF 2015). PIs are primary providers of a range of public services, including electricity, natural gas, low-income housing, and transportation. The largest Korean public corporations, classified by total assets, operate in the energy sector (Korea Electric Power Corporation (KEPCO), Korea Gas Corporation, and Korea National Oil Corporation), and in the social overhead capital sector, which focuses on the provision of public goods such as water, housing, and train services (Land and Housing Corporation (LH), K-Water, Incheon International Airport Corporation (IIAC), Korail, Busan Port Authority (BPA), and Korea Expressway Corporation). Figure 47 illustrates the sector distribution of the 10 largest PIs in Korea.

**Korean PIs play a significant role in terms of public employment.** PIs have been important vehicles for implementing government job creation programs. Between 2011 and 2015, PI employment rose from 254,780 to 287,046, representing approximately 40 percent of the total public service workforce.

**FIGURE 47: Sector Distribution of the 10 Largest PIs in Korea, by Assets, 2015**



**In 2014, the assets of the 10 largest public institutions amounted to KRW 779 trillion (52 percent of GDP):**

- **Social Overhead Capital (SOC):** Public goods—Korea Land and Housing Corp., Korea Expressway Corp., Korea Water Resources Corp., Korea Rail Network Authority, and Korail
- **Energy:** Mining and utility companies—Korea Electric Power Corp., Korea Gas Corp., and Korea National Oil Corp.
- **Insurance:** Pensions—National Health Insurance Service
- **Financial:** Korea Deposit Insurance Corporation

Source: MOSF (2016).

<sup>218</sup> The budget of the public institutions came to KRW 665 trillion (USD 612 billion) in 2014, or 44.8 percent of GDP.

**Eight PIs are listed on the Korean Stock Exchange.**<sup>219</sup> As of January 2017, the ratio of market capitalization of the eight listed PIs to the total market capitalization of the Korean Stock Exchange was about 4 percent.<sup>220</sup> These companies remain controlled by the state, either through direct majority equity ownership or through a combination of public entity ownership. Cross-ownership between PIs is also common, as financial PIs hold positions in other PIs. Stock market listings have been undertaken both as part of privatization initiatives and to mobilize private capital as a means to strengthen PIs' financial positions and to drive financial and managerial improvements through private-sector scrutiny (Park and Heo 2014).

### Origins of the SOE Sector and Key Reforms

**PIs have played a central role in the development of the Republic of Korea and the expansion of key industries.**<sup>221</sup> At the end of the Korean War in 1953, the country's major industries were distressed and per-capita GDP was among the lowest in the world. In the 1960s, Korea's government launched a series of five-year economic plans in which PIs were established in finance and infrastructure to lead a manufacturing-driven industrialization program. In addition to driving economic growth, PIs also became an important source of government revenue (Yu 1994).

**In the 1980s and 1990s, privatization was at the center of SOE policy discussions as part of market-based SOE reforms and Korea's response to the Asian financial crisis.** Private sector participation in PIs was promoted through public share offerings from as early as the late 1960s. With economic growth and the wave of liberalization, privatization was considered a realistic policy option and targeted sectors such as manufacturing, transport, banking, and energy. The Asian financial crisis in 1997 then became a major catalyst for urgent reforms to improve the efficiency of the public sector, in particular among PIs. The government pushed hard for public sector efficiency as public sector deficits mounted. As a result, the privatization process was accelerated and long-planned privatizations were completed.<sup>222</sup>

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219 KEPCO, Korea Gas Corporation, Kangwon Land, Industrial Bank of Korea, KEPCO Plant Service and Engineering, Grand Korea Leisure, KEPCO Engineering and Construction, and Korea District Heating Corporation.

220 Korea Exchange (KRX), February 23, 2017. <http://marketdata.krx.co.kr/mdi#document=10020204>.

221 Most findings from this section are based on KIPF (2015).

222 The revenues that resulted from privatization aided the government in the recapitalization of the financial sector.



**From the late 1990s, the government began to shift the focus of SOE reforms toward improving the corporate governance of PIs.** Although privatization resulted in some improvement in PI efficiency and performance, the profit-making orientation of privatized firms (characterized by an increase in the price of goods and a decrease in public service obligations) created bureaucratic and public resistance to privatization. Planned privatizations faced strong political opposition and were therefore delayed or even cancelled. In 1999, performance agreements between the chief executive officers (CEOs) of PIs and line ministers were introduced to enhance accountability. To improve SOE accountability and transparency, the government ownership function for PIs was legally centralized under the Ministry of Strategy and Finance (MOSF) through the Management of Public Institutions Act, legislated in 2007. In 2005, the government introduced the first integrated information disclosure system, the Public Institution Management Information System, which evolved into the current All Public Information in One (ALIO) disclosure system in 2007.

**Public demand for improved PI performance and accountability continues to drive the Korean government's reform agenda for PIs.** Following the introduction of the 2007 legal framework, subsequent administrations advanced with related reform programs that were oriented toward increasing PIs' performance and accountability. The Advancement of Public Institutions program (2009–2013) focused on privatizations, functional overhauls, disposal of stocks, and workforce reductions. The Normalization of Public Institutions program (2014 to the present) focuses on: (i) debt reduction and moderation of employee benefits,<sup>223</sup> and (ii) continuous reviews of PI functions, together with the introduction of a peak wage and performance-based salary system (Choi and Park 2014).

## **Corporate Governance**

### **Legal Framework**

**Approximately 80 percent of Korea's PIs have been established through specific legislation.** For example, KEPCO was created through the KEPCO Act, Korea Gas Corporation through the Korea Gas Corporation Act, and

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<sup>223</sup> Excessive employee benefits and rapidly increasing debts in PIs were a highly debated issue.

Korea National Oil Corporation through the Korea National Oil Corporation Act. Other PIs, such as the Korea Elevator Safety Technology Institute, are established through the Civil Act. A small number of PIs have been founded as stock companies (or limited liability companies), based on the Commercial Act, including six electricity companies affiliated with KEPCO.<sup>224</sup>

**Since 2007, the Act on the Management of PIs covers legal entities, organizations, and institutions that are owned or established by the government.** The Act on the Management of PIs works as the umbrella legislation for all PIs, which takes precedence over all specific legislation for the creation of PIs unless the Act mentions the specific legislation. Under this legal instrument, PIs are designated by the MOSF (RCSOE 2011, 8) each year in consultation with line ministers and the Ownership Steering Committee, a body chaired by the minister of strategy and finance and comprised of vice ministers of line ministries and up to 11 experts from fields such as law, economics, the media, and labor.

**The Act on the Management of PIs is also the main legal framework for their corporate governance.** The Act refers to the designation of PIs, board member appointments, external oversight, and evaluation mechanisms. As determined by the Act, Korea's PI board structure is based on a one-tier system,<sup>225</sup> in which the board comprises a maximum of 15 members, including the CEO. The Act includes statutory provisions for ALIO disclosure and the Management Performance Evaluation System (see below), and improves internal audit procedures. In addition, the Act provides a definition of public institutions, following a standardized classification based on their workforce, assets, and sources of revenue.

**In addition to statutory legislation, many PIs are subject to supplementary legislation.** Personnel management follows labor laws such as the Employment Insurance Act, the Labor Standards Act, and the Occupational Safety and Health Act. Procurement adheres to the Government Procurement Act. Listed PIs also conform to listing requirements, as do listed private companies. In addition, PIs are regulated by the Monopoly Regulation and Fair Trade Act.

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224 Korea Hydro and Nuclear Power Corporation, Korea East-West Power Corporation, Korea South-East Power Corporation, Korea Western Power Corporation, Korea Southern Power Corporation, and Korea Midland Power Corporation. For further details, see MOSF and KIPF (2015).

225 Under a one-tier system, a company is governed by one corporate body that undertakes both management and supervisory functions.

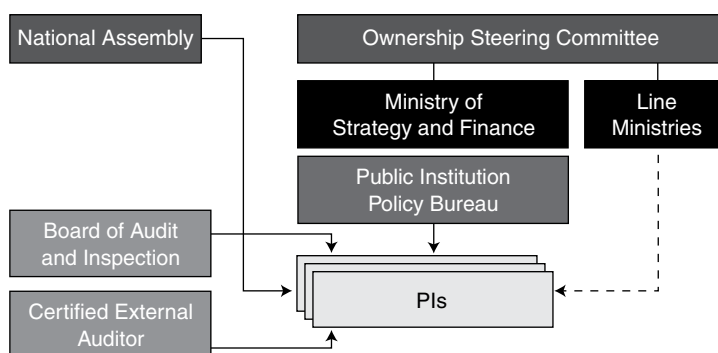
## Ownership Arrangements

**Korea has a centralized ownership model led by the MOSF.** The state ownership functions of PIs are centralized in the MOSF, which delivers the ownership functions of all types of PIs as authorized by the 2007 Act on the Management of Public Institutions (RCSOE 2011, 12). It oversees the operation of PIs and manages the performance evaluation process of public corporations and quasi-governmental institutions.

**The Ownership Steering Committee is a decision-making body for the ownership function of PIs.** The committee is a collegiate body chaired by the Minister of Strategy and Finance and composed of vice ministers of line ministries and civil experts from relevant fields. The steering committee oversees and makes decisions regarding the creation of PIs and recommendations for the appointment and dismissal of executive officers. In addition, it outlines information disclosure requirements and sets managerial guidelines. Figure 48 illustrates the ownership and oversight structure of PIs.

**The Public Institution Policy Bureau is the unit within the MOSF that is in charge of managing PIs' performance monitoring and other corporate governance-related aspects.** The bureau, staffed by 62 public officials in 2016, manages performance evaluations for two kinds of PIs: public corporations and quasi-governmental institutions. It sets rules for the disclosure of performance information, controls the size and organizational structure of PIs, and reviews their budgets and remuneration policies.<sup>226</sup>

**FIGURE 48: The Ownership and Oversight Function in Korea**



Source: World Bank staff compilation.

226 See <http://english.mosf.go.kr/>.

**Line ministries oversee the core businesses of the PIs under their purview.** Line ministries provide critical policy direction to the PIs. They also sign performance contracts with the CEOs of their respective PIs. For smaller public corporations and quasi-governmental institutions, the relevant line ministers directly appoint the CEOs of PIs. Performance monitoring for nonclassified institutions is conducted by line ministries.

## **Performance Monitoring**

**Korea has implemented an effective Management Performance Evaluation System for its PIs for over thirty years.** The evaluation is conducted by a performance evaluation team consisting of independent civilian experts appointed by the MOSF from relevant fields. It targets all public corporations and quasi-governmental institutions, evaluating them in three areas: (i) organizational performance of the institution; (ii) CEO performance; and (iii) auditor performance. Further details on this monitoring and evaluation system for PIs are provided below.

## **Board of Directors and Management**

**The Act on the Management of Public Institutions stipulates the composition and functions of PI boards of directors.** As determined by the Act, Korea's PI board structure is based on a one-tier system, under which the board is composed of a maximum of 15 members, including the CEO. The Act also refers to the process for nomination and removal of directors and specifies procedures for board meetings, including attendance criteria.

**PI boards of directors are in charge of both medium- and long-term strategic decisions and operational aspects.** The board decides on medium- and long-term financial management plans, production, pricing, articles of association, and remuneration policies, as well as on management objectives, budget, and finance. The CEO is charged with informing the board of audit and inspection outcomes, corrective measures, and collective agreements.

**The composition of and nomination process for PIs' boards are specified in the Act on the Management of Public Institutions.** The Act classifies directors into "standing" and "nonstanding" categories,<sup>227</sup> and the ratio between the two categories differs depending on the designated

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<sup>227</sup> Standing directors are inside directors and nonstanding directors are outside directors. Nonstanding directors are not affiliated with the controlling shareholders or the management of the company.

classification and asset size of the PI. In public corporations and large quasi-governmental institutions, for example, standing directors (including the CEO) make up less than half of the total number of board members. Board nomination and appointment processes for nonstanding directors in public corporations consist of three steps: (i) a nominating committee<sup>228</sup> nominates candidates; (ii) the Ownership Steering Committee reviews them and determines the successful candidate; and (iii) the Minister of Strategy and Finance officially appoints the chosen candidate as a nonstanding director. Standing directors for boards of public corporations and quasi-governmental institutions are appointed by the CEO.

**The Guideline for Human Resources Management in public corporations and quasi-governmental institutions specifies eligibility requirements for PI board members.** The Guideline is elaborated by the MOSF based on the Management of Public Institutions Act. The Act provides qualification criteria for candidates to be nominated by the nomination committee; candidates are required to have the knowledge, experience, and competencies necessary for performing their duties as directors.

**The CEO is appointed by the President of the Republic or by the corresponding line minister from among the candidates recommended by the nomination committee.**

- In large public corporations, the president appoints the CEO candidate who has been recommended by line ministers after the nomination is made by the board nomination committee and the deliberation and resolution is issued by the Ownership Steering Committee.
- In large quasi-governmental institutions, the appointment process skips the deliberation and resolution by the Ownership Steering Committee.
- In other public corporations and quasi-governmental institutions, CEOs are appointed directly by the corresponding line ministers.

**Separation between the CEO and board chair depends on the PPs classification and asset size.** In market-based public corporations and quasi-market-based public corporations with over KRW 2 trillion (approximately USD 1.9 billion) in assets, the chair is elected by and among nonstanding directors. In quasi-market-based public corporations with less than KRW 2 trillion in assets, the chair is the CEO.

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228 The executive officers are directors, including the CEO, and auditors. The nomination committee, composed of nonstanding directors and other outside members appointed by the board of directors, recommends candidates for director and auditor positions, and negotiates the terms and conditions of the performance agreement with the candidate for the CEO position.

**PI board members are appointed for a two-year term, whereas the CEO is appointed for a three-year term.** The term of office may be extended by one year, depending on performance. CEOs of public corporations and quasi-governmental institutions are not removed until they complete their term, except in special circumstances.

**PI boards of directors may establish committees, and must establish an Audit Committee in the case of market-based public corporations and quasi-market-based public corporations with over KRW 2 trillion in assets.** The composition and authority of committees, including the Audit Committee, are subject to the Commercial Act and the Guidelines on Management of Audit Committee in public corporations and quasi-governmental institutions. The Audit Committee should be composed of three or more members. Two-thirds of members should be nonstanding executives, and the committee should include one or more experts in accounting or finance. In addition, the chair of the Audit Committee should be a nonstanding director.

## Transparency and Disclosure

**The Korean Internet-based ALIO<sup>229</sup> system is a modern and effective disclosure system that allows public access to PIs' financial and management information.** Launched in 2006, the ALIO system soon became the primary information source on PIs with a high degree of acceptance from the public. As of 2014, the number of average monthly visitors surpassed 100,000, increasing progressively. Further details on this innovative system are provided below.

**The MOSF plays a key role in the information disclosure process for PIs.** The MOSF sets out guidelines regarding the kind of information that should be disclosed and how information should be provided. Next, each PI uploads the data online as guided by the MOSF. Finally, the MOSF provides data access to the public through the ALIO system. The MOSF is also in charge of reviewing the dataset and imposing penalties in cases of incomplete or inaccurate information. Penalties are ranked on a scale from one to five points and feed into the final score of the institution's performance evaluation. If a public institution accumulates 40 penalty points or more in a given fiscal year, the public institution is declared to be "negligent in disclosure" on the ALIO system for a period of three months. Although the ALIO system discloses information on all individual PIs online, an aggregated annual PI report is still not elaborated by the government.

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229 ALIO is a contest-winning title, which sounds like the Korean expression of "inform."

BOX 51

## Transparency and Disclosure Practices in the Republic of Korea

<b>Accounting standards</b>	<ul style="list-style-type: none"> <li>• <b>Public corporations and quasi-governmental institutions:</b> International Financial Reporting Standards (IFRS).</li> <li>• <b>Nonclassified public institutions:</b> IFRS and Generally Accepted Accounting Principles.</li> </ul>
<b>Transmission of financial and activity reports</b>	<ul style="list-style-type: none"> <li>• <b>Public corporations and quasi-governmental institutions</b> report to the minister of strategy and finance.</li> <li>• <b>Nonclassified public institutions</b> report to line ministers.</li> </ul>
<b>Aggregated reports</b>	<ul style="list-style-type: none"> <li>• None.</li> </ul>
<b>Disclosure</b>	<ul style="list-style-type: none"> <li>• Standardized items of information, including financial statements, are disclosed on ALIO web page.</li> </ul>
<b>Information system</b>	<ul style="list-style-type: none"> <li>• ALIO disclosure system.</li> </ul>
<b>Internal audit</b>	<ul style="list-style-type: none"> <li>• Audit Committee or auditor(s) within each PI.</li> </ul>
<b>External audit</b>	<ul style="list-style-type: none"> <li>• Line ministries, National Assembly, the Board of Audit and Inspection (Supreme Audit Institution), certified external auditor (private).</li> </ul>

Source: World Bank staff compilation.

**PIs generally follow International Financial Reporting Standards (IFRS).** All public corporations and quasi-governmental institutions have adopted IFRS, while nonclassified institutions may use IFRS or the Korean Generally Accepted Accounting Principles. The Act on Management of Public Institutions does not set accounting requirements for the nonclassified institutions, which are typically small entities.

**PI audit requirements are stipulated in the Act on the Management of PIs.** At the end of each fiscal year, financial statements must be subjected to external audit. Audited financial statements must be submitted to the MOSF (in the case of public corporations) or line ministers (in the case of quasi-governmental institutions) by the end of February, and should be reviewed by the end of March. Nonclassified public institutions are also

subjected to external audit,<sup>230</sup> as required by line ministries, although they are not legally required to do so.

**The Act requires PIs to be audited by the Board of Audit and Inspection.** In this respect, the MOSF and line ministers must submit PIs' externally audited financial statements and other relevant documents to the Board of Audit and Inspection by the month of May. The chair of the Board of Audit and Inspection must review the documents and submit an audit report to the Minister of Strategy and Finance by the end of July. Then, the Minister of Strategy and Finance reports audited financial statements, the audit report by the board, and other relevant documents at the Cabinet Meeting and submits them to the National Assembly in August.<sup>231</sup>

**Internal audit is managed by the internal auditor or audit committee of the PI board.** The Act states that any market-type public corporation and quasi-market-type public corporation, with assets of not less than KRW 2 trillion shall establish an audit committee under the board of directors. The internal auditor or audit committee may be standing or nonstanding. PIs also generally have an audit and inspection office as an internal organ under the internal auditor. This audit office is typically responsible for the inspection of internal irregularities and promotes integrity and transparency as a part of the organizational culture.

## Highlights and Good Practices

### Performance Monitoring of PIs

**A Management Performance Evaluation System for PIs has been firmly established in Korea since 2007.** The system is overseen by the MOSF, as provided by the Act on the Management of PIs, and is based on three pillars: (i) a Management Performance Evaluation Team, designated by the MOSF, in charge of developing performance indicators; (ii) the signing of annual bilateral performance agreements between individual PIs and corresponding line ministries; and (iii) the determination of performance evaluation grades, under the auspices of the MOSF and the Ownership Steering

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230 External audit is most often conducted by the "Big 4" Korean accounting firms, or in some cases by the remaining accounting firms and certified public accountants. The audit report is disclosed on the ALIO.

231 For further details, see Heo and Jang (2015), pp. 10–11.



Committee.<sup>232</sup> The system targets all public corporations and quasi-governmental institutions, and evaluates them in three areas: (i) the organizational performance of the institution; (ii) CEO performance; and (iii) auditor performance. The performance of nonclassified PIs is monitored by relevant line ministries, and the evaluation method follows a similar process.

**The MOSF publishes the manual for the Management Performance Evaluation at the beginning of each year.** The manual is for public corporations and quasi-governmental institutions and describes the target PIs, timeline of evaluation, performance indicators and weights, and measurement. Performance indicators are common for the business management area but are differentiated for the various core business areas across target PIs. The Management Performance Evaluation assesses the performance of PIs against preset indicators in the manual.

**A Management Performance Evaluation Team develops performance indicators for evaluating public corporations and quasi-governmental institutions.** The team, designated by the minister of

#### BOX 52

### Performance Monitoring of PIs in Korea

<b>Tools</b>	Management Performance Evaluation: <ul style="list-style-type: none"> <li>• Evaluation of public corporations and quasi-governmental institutions.</li> <li>• Evaluation of CEO performance.</li> <li>• Evaluation on auditors' performance.</li> </ul>
<b>Scope</b>	116 PIs in 2016.
<b>Timespan</b>	Annually.
<b>Indicators</b>	<ul style="list-style-type: none"> <li>• <b>Business Management:</b> management strategy, corporate social responsibility, business efficiency, financial management and performance.</li> <li>• <b>Core Business:</b> plan, resource allocation, and outcomes of major businesses.</li> </ul>
<b>Reporting</b>	Evaluation grades are released to the public.

Source: World Bank staff compilation.

<sup>232</sup> The system was first introduced by the Framework Act on Government Invested Institutions, which was replaced by the Act on the Management of PIs in 2007.

strategy and finance, consists of independent experts, including professors, certified public accountants, certified public labor attorneys, research fellows from government-funded research institutes, and other experts in related fields. The team is in charge of developing suitable performance indicators for each PI. In 2015, the Management Performance Evaluation Team consisted of 162 experts and helped evaluate 116 PIs—30 public corporations and 86 quasi-governmental institutions.

**MOSF and PIs review and update these indicators and associated targets before the beginning of the evaluation year.** Once an agreement has been reached on relevant indicators and targets for each PI, the CEO of the PI signs a performance contract with the relevant line minister. At the end of the year, the Management Performance Evaluation Team conducts the evaluation using both quantitative and qualitative measures, and translates resulting evaluation outputs into specific grades. The three areas of management performance evaluation are further discussed in Box 53.

#### BOX 53

### Three Areas of Management Performance Evaluation

#### Evaluation of the performance of public corporations/quasi-governmental institutions

This evaluation reviews management outcomes with the aim of increasing efficiency and improving public service. The performance indicators and weights differ among the institutions depending on the type of PI and whether they are required to submit mid-term and long-term Financial Management Plans. The evaluation has two components:

- **Business Management:** This is examined by the managerial aspects of the subject organizations, encompassing business strategy, social responsibility, business process efficiency, human resources management, financial management, remuneration, and employee benefits.
- **Core Business Performance:** This is assessed by comparing actual performance with preset performance indicators.

Evaluation outputs are graded using the average within the target group and standard deviations into six levels: S, A, B, C, D, and E, with S indicating the best and E the lowest level. In the 2015 performance

*(box continues on next page)*

**BOX 53** *continued*

evaluation, out of a total 116 PIs, 20 received an A, 53 received a B, 30 received a C, 9 received a D, and 4 received an E.

**Evaluation of CEO Performance**

This review assesses the performance agreement between the CEO and the line minister with a view to generating and promoting performance-oriented management and enhancing CEO accountability (KIPF 2015). Introduced in 2014, these performance agreements are signed by the line minister and the CEO at the beginning of his/her three-year term. The CEO becomes subject to evaluation after completing one-and-a-half years, and his/her performance is reviewed only once during the term. The evaluation is split into two categories:

- **Leadership and Management:** This is examined using performance indicators that measure the CEO's leadership and managerial accountability.
- **Performance and Achievement:** This is assessed using indicators on financial performance, remuneration, benefits, and the medium- and long-term strategic tasks of the institution.

Final evaluation scores are translated into three grades: “strong” (80 points or more out of 100 total points), “adequate” (60–79 points), and “weak” (under 60 points).

**Evaluation of Auditor Performance**

Standing auditors or audit committee members are subject to regular performance reviews in order to improve the accountability and integrity of audit functions. The standing auditors or audit committee members are evaluated only once during their term, and if they have served fewer than six months they are exempted from the performance review. The evaluation of auditors is composed of three parts:

- i. Propriety and performance of the auditor;
- ii. External audit-related evaluation; and
- iii. Management performance evaluation.

Final evaluation scores are transformed into three grades: “strong” (80 points or more out of 100 total points), “adequate” (60–79 points), and “weak” (under 60 points).

*Source:* MOSF (2016); KIPF (2015).

**BOX 54****Amount of Incentive Pay (% of base salary)**

Classification	Position	S	A	B	C	D-E
Public corporations (30)	Employees	250	200	150	100	0
	CEOs	120	96	72	48	0
	Standing directors	100	80	60	40	0
Quasi-governmental institutions (86)	Employees	100	80	60	40	0
	CEOs	60	48	36	24	0
	Standing directors	60	48	36	24	0

*Note:* The unit is the percentage of monthly salary (employees) and annual salary (CEOs and standing directors).

*Source:* MOSF (2015).

**Final grades from the performance monitoring exercise help to determine PI incentive payments.** The minister of strategy and finance decides the incentive payments for PI employees, CEOs, auditors, and audit committee members relative to the grades received in the evaluation of public corporations and quasi-governmental institutions and following the review of the Ownership Steering Committee. These grades are also used as references to decide on the renewal of positions for CEOs, auditors, and audit committee members.

**Low overall grades on the performance evaluation of public corporations and quasi-governmental institutions can have serious consequences, including CEO dismissal.** If a PI is given a D grade, the minister issues a performance warning. If a PI is given an E grade or receives two consecutive D grades, the Minister of Strategy and Finance can suggest the dismissal of the CEO, standing directors, and auditors or audit committee members to the Ownership Steering Committee. In 2015, the MOSF suggested dismissal of three CEOs whose PIs had received an E grade: Korea Resources Corporation, Korea Infrastructure Safety Corporation, and Korea Midland Power Co., Ltd. The ministry also warned three CEOs of PIs that had received a D grade: Korea National Oil Corporation, Korea Hydro and Nuclear Power Co., Ltd., and Korea Meteorological Industry Promotion Agency.

## **ALIO Management Information System for PIs**

**The ALIO system is an Internet-based disclosure system that allows public access to PIs' management information.** The purpose of ALIO is to provide real-time public information on the Internet about the financial and nonfinancial performance of SOEs. The website discloses a vast amount of information on SOEs, which not only serves the information needs of the media and the general public, but also helps hold SOEs to a high standard of probity. The system won the President's Award for innovation in 2007 and has been a benchmark for other disclosure systems, including the Local Public Enterprise Clean Eye,<sup>233</sup> through which local SOEs disclose their management information. The ALIO system is available in Korean.

**The ALIO system discloses 39 categories of management information, grouped into six sections: general status, operation of institution, core business and management performance, evaluation results, notification, and normalization policy progress.** The general status section provides the institution's establishment-related information, legal basis, mission, web page address, short history, and brief information on its functions, managerial goal and strategies, CEO's profile, and organizational chart. The operation of institution section discloses information on employment, remuneration, expenses, labor union, and others. The core business and management performance section opens financial statements and information on investment, borrowings, contributions, and others. The evaluation section gathers the feedback and results of evaluations targeting PIs. The notification section discloses announcements (such as job opening and bidding) and research papers. More recently, ALIO presents changes in PIs' debt and the operational statement of employee benefits.

**The quality and accuracy of the information provided on the ALIO is monitored closely.** The MOSF provides a set of guidelines regarding the type of information and form of disclosure. Under MOSF guidance, each PI uploads the data online. If the information is found incomplete or inaccurate, penalties are imposed. Penalties are ranked on a scale from one to five points and fed into the final score of the institution's performance evaluation. If a PI accumulates 40 penalty points or more in a given fiscal year, the PI is declared "negligent on disclosure" on the ALIO system for a period of three months.

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233 See [www.cleaneye.go.kr](http://www.cleaneye.go.kr).

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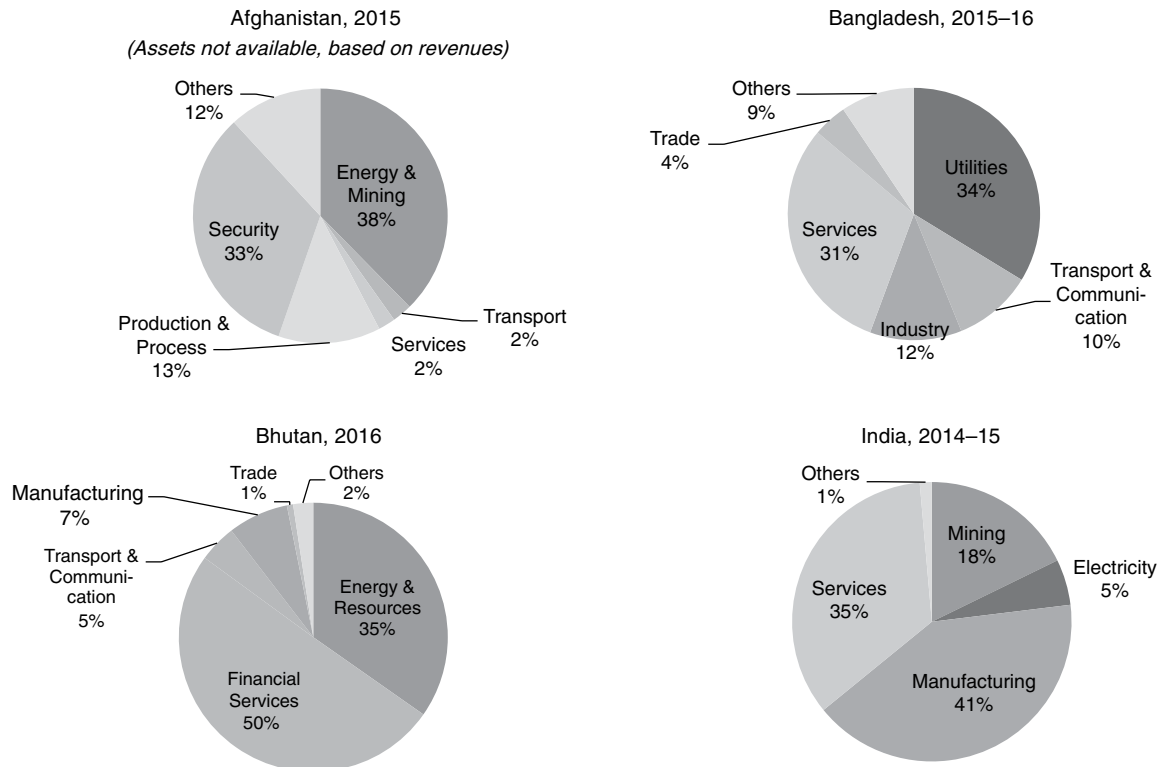
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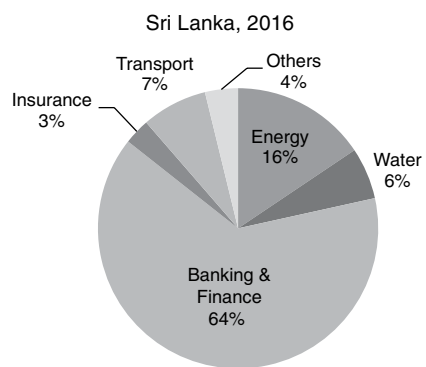
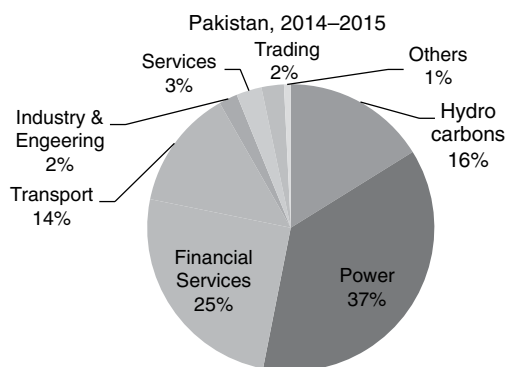
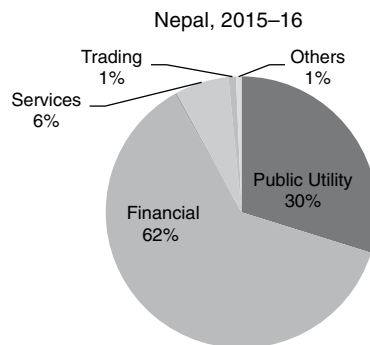
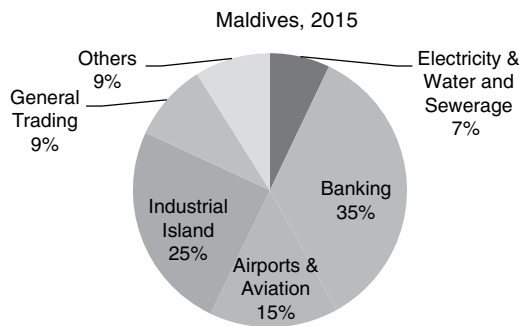
## **ANNEXES**



## ANNEX 1

# SOE Asset Distribution by Sector





Source: World Bank team estimation based on sources listed in Annex 2.

## ANNEX 2

# Data Sources and Notes

### Data on Revenues, Profits, Taxes, Dividends, and Subsidies

Country	Scope of SOEs	Source
<b>Afghanistan</b>	Chart based on revenues, SOEs only (SOCs excluded)	SOECs general Directorate, MOF
<b>Bangladesh</b>	Statutory corporations under the MOF (Joint-Stock Companies excluded)	Budget Summary, MOF; SOEs Audited Financial Statements
<b>Bhutan</b>	Both SOEs under MOF and DHI	National Budget, MOF
<b>India</b>	CPSEs	Public Enterprises survey, Ministry of Heavy Industry and Public Enterprises
<b>Maldives</b>	17 significant SOEs under the Privatization and Corporatization Board, MOF	Privatization and Corporatization Board, PCB, MOF
<b>Nepal</b>	Public enterprises	Annual Performance Review of Public Enterprises, Yellow Book, MOF

*(continues on next page)*



<b>Country</b>	<b>Scope of SOEs</b>	<b>Source</b>
<b>Pakistan</b>	Public sector companies, federal authorities and development finance institutions	SOEs Performance Review, MOF
<b>Sri Lanka</b>	State-Owned Business Enterprises	Performance report, Department of Public Enterprises, MOF

### **Data on GDP and Government Revenues**

- World Economic Outlook, IMF

## ANNEX 3

# Methodology

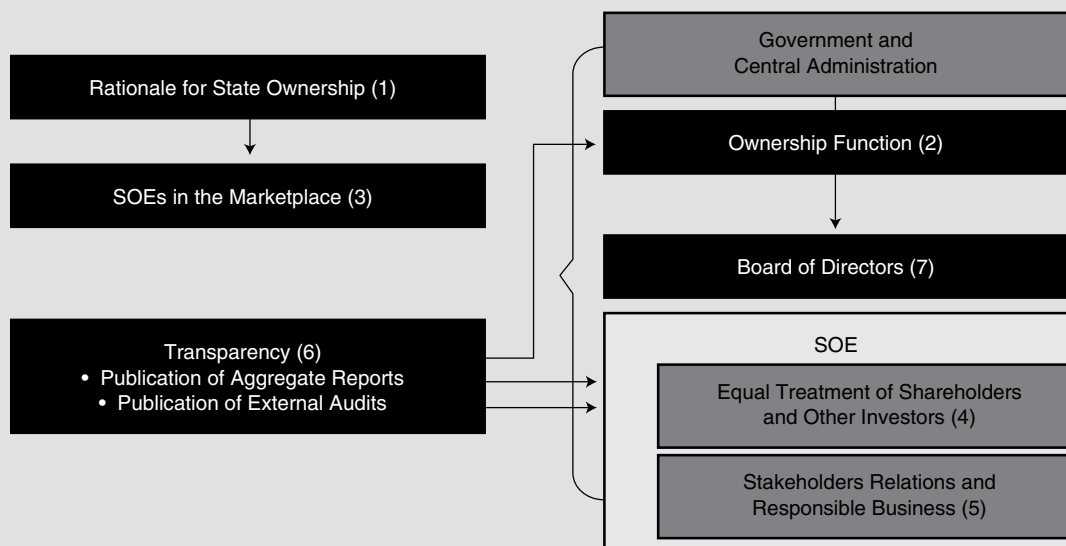
**The OECD and the World Bank have produced conceptual guidelines to analyze SOE Corporate Governance.** The aim is to guide policy makers interested in pursuing reforms to strengthen governance. An updated edition of *OECD Guidelines on Corporate Governance of State-Owned Enterprises* (the *Guidelines*) was published in 2015. The *Guidelines* constitute an “internationally agreed standard for how governments should exercise the state ownership function to avoid the pitfalls of both passive ownership and excessive state intervention.”<sup>234</sup> The World Bank published *Corporate Governance of State-Owned Enterprises: A Toolkit* in 2014. The two publications fundamentally agree on the key requirements of sound SOE corporate governance: a clear regulatory framework ensuring a level playing field and competition with the private sector, equitable treatment of all shareholders, ample disclosure and transparency, and clear SOE Board authority combined with accountability (Box 55).

**The regional stocktaking is based on the OECD Guidelines and the World Bank Toolkit and describes the existing corporate governance framework and practices in the SOE sector.** The stocktaking aims to

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234 OECD Guidelines on Corporate Governance of State-Owned Enterprises (2015), p. 3.

## Governance Dimensions of the OECD SOE Guidelines



Source: OECD Guidelines, 2015 Edition.

assess the existing institutional arrangements, laws and regulations in the selected countries, as well as an understanding of *de facto* practices drawn from discussions with stakeholders. The following key dimensions of SOE corporate governance have been covered (Box 56): legal and regulatory framework, state oversight and ownership arrangements, performance monitoring, boards of directors, transparency and disclosure. The stocktaking is based on the structure of the World Bank Toolkit on Corporate Governance of SOEs.

**The stocktaking has been coordinated and jointly prepared with governments through desk research and field missions.** The stocktaking is based on public information and data collected from available online resources from the Ministry of Finance, line ministries, SOEs, Supreme Audit Institution, General Auditor, and others. This has been complemented by field missions and interviews with SOE oversight entities and SOE sector stakeholders in consultation with the governments. Interviews have been based on a questionnaire developed as support tool, based on the OECD *Guidelines* and the World Bank *Toolkit*.

## Key Corporate Governance Elements—Extracted from the World Bank Toolkit

<b>Legal and regulatory framework</b>	<ul style="list-style-type: none"> <li>• Bringing SOEs under company law and applying other laws and regulations to SOEs to create a level playing field.</li> <li>• Listing them on the stock markets to create capital market discipline.</li> <li>• Developing modern SOE laws and regulations.</li> <li>• Uniting SOEs under a national code of corporate governance or creating a specific SOE code to codify good practices.</li> </ul>
<b>State oversight and ownership arrangements</b>	<ul style="list-style-type: none"> <li>• Identifying and separating the state's ownership functions from its policy making and regulatory functions.</li> <li>• Developing appropriate arrangements for carrying out ownership functions.</li> <li>• Creating safeguards against government interventions.</li> <li>• Centralizing the state's ownership functions to bring focus, consistency, and good practices to the SOE sector.</li> </ul>
<b>Performance monitoring</b>	<ul style="list-style-type: none"> <li>• Defining SOE mandates, strategies, and objectives.</li> <li>• Developing key performance indicators and targets, both financial and nonfinancial.</li> <li>• Establishing performance agreements between SOE owners and SOE boards.</li> <li>• Measuring and evaluating performance with the goal of holding SOEs accountable for results and ensuring good performance.</li> </ul>
<b>Financial and fiscal discipline</b>	<ul style="list-style-type: none"> <li>• Reducing preferential access to direct and indirect public financing.</li> <li>• Identifying, computing, and financing the true cost of public service obligations.</li> <li>• Monitoring and managing the fiscal burden and potential fiscal risk of SOEs.</li> </ul>
<b>Board of Directors</b>	<ul style="list-style-type: none"> <li>• Developing a structured and transparent process for board nominations.</li> <li>• Defining the respective roles of the state, as owner, of boards, and of management and empowering boards with core responsibilities such as strategy setting, choosing and overseeing the chief executive officer (CEO), and managing risks.</li> <li>• Enhancing board professionalism through the separation of chair and CEO, development of board committees, and the like.</li> <li>• Putting in place board remuneration and evaluation policies and practices.</li> <li>• Providing training to members of boards of directors.</li> </ul>
<b>Transparency and disclosure</b>	<ul style="list-style-type: none"> <li>• Applying private sector principles and international standards to SOEs.</li> <li>• Improving SOE reporting and disclosure.</li> <li>• Strengthening the control environment.</li> <li>• Carrying out independent external audits.</li> </ul>

Source: World Bank SOE Toolkit.

State-owned enterprises (SOE) remain a strong pillar of the economy in South Asian countries across large and small economies — even after successive waves of privatization starting in the 1980s. As SOEs often play a vital role in delivering basic services such as water and energy, their performance is critical for citizens and the broader development agenda. SOEs also operate in strategic sectors that are associated with national security and the development of public infrastructure and can be critical for a country’s fiscal space, competitiveness, and governance. Recognizing the continued importance of SOEs while considering the challenges of limited fiscal space and competitiveness, many countries have undertaken significant SOE reforms over the past two decades. Many of these reform efforts have focused on strengthening SOE corporate governance to improve SOE performance. Prepared with contributions from SOE ownership entities, this Regional Stocktaking summarizes current SOE corporate governance practices in each of the eight South Asian countries regarding the legal framework for SOEs, ownership arrangements, performance monitoring, boards of directors, and transparency and disclosure, drawing out regional commonalities and distinct features. This experience is complemented by a review of interesting lessons from selected countries in East Asia –China, Malaysia, Singapore, and the Republic of Korea (South Korea)– opening additional perspectives on the potential that SOE corporate governance reforms can have for performance and economic growth.