

Republic of Azerbaijan: Corporate Governance and Ownership of State Owned Enterprises



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Technical Note, November 2017

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Abbreviations

CAERC	Center for Analysis of Economic Reforms and Communication
CFRR	The World Bank Centre for Financial Reporting Reform
CJSC	Closed Joint Stock Company
EBRD	European Bank for Reconstruction and Development
ECA	Europe and Central Asia Region
EU	European Union
FIG	Financial Institutions Group
GLC	Government Linked Company
IFC	International Finance Corporation
IFRS	International Financial Reporting Standards
ISA	International Standards on Auditing
JSC	Joint-Stock Company
KPIs	Key Performance Indicators
LLC	Limited Liability Company
MOE	Ministry of Economy
MOF	Ministry of Finance
NAS	National Accounting Standards
OECD	Organization for Economic Cooperation and Development
OJSC	Open Joint Stock Company
PIE	Public Interest Entity
SAI	Supreme Audit Institution
SCPI	State Committee on Property Issues
SE	State Enterprise
SOE	State Owned Enterprise
WB	World Bank

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¹ The World Bank Centre for Financial Reporting Reform: www.worldbank.org/cfr

Executive Summary

This Technical Note assesses the corporate governance of state-owned enterprises (SOEs) in Azerbaijan with a view to supporting the government's efforts to bolster economic development. Mutually reinforcing recommendations are closely linked and aim to increase accountability across the whole ownership structure of SOEs, from their ultimate owners, the citizens, to their employees.

The Note outlines international good practice, summarizes current practices in Azerbaijan, and indicates areas for consideration to improve SOE corporate governance in Azerbaijan. The Note was prepared by a World Bank Group team, based on research and consultations during January - October 2017, to (i) analyze current SOE governance frameworks and practices in Azerbaijan and identify main deviations from international good practices; and (ii) develop a series of policy recommendations for further reforms in strengthening SOEs governance and improving their effectiveness. This work may serve as a basis for further collaboration between the World Bank and the Government of Azerbaijan towards SOE reform and related policy considerations. Given the significance of SOEs and a range of important socio-economic and political-economy related factors, improving SOEs governance in Azerbaijan is a significant challenge. Implementation of any of the recommendations contained in this Note should form part of a broader strategy for SOEs linked to economic and sector strategies in Azerbaijan.

Recommendations draw on a range of internationally recognized standards, guidelines, and practices, and the latest available research produced by the World Bank and others. OECD Guidelines on the Corporate Governance of State Owned Enterprises² (the OECD Guidelines) are the leading benchmark aspired to by OECD member-states. These outline a set of policies aimed at improving SOEs state ownership function while raising efficiency and generating benefits for society in a more transparent and accountable way. The Note is not a comprehensive diagnostic comparing standards and practices in the Republic of Azerbaijan with relevant international benchmarks, but uses the experience of OECD countries and other leading economies of the world to summarize good international experience of governance arrangements for SOEs, and compares these to current practices in Azerbaijan.

This Note aims to build on the priorities outlined by the Strategic Roadmaps for the national economy and main economic sectors of Azerbaijan for 2016-2020, signed by the President of Azerbaijan on December 6, 2016. The Roadmaps re-affirm Azerbaijan's priorities in diversification of its oil-dominant economy, reduce the State's participation in the existing state-owned enterprises, and enable more private sector led growth.

² OECD Guidelines for Corporate Governance of SOEs (revised edition, 2015).

Key Findings

SOEs play a major role in the national economy of Azerbaijan, as significant contributors to national wealth, providers of essential goods and services, and employers in key sectors. SOEs generate more than 45% of national GDP. The largest 20 SOEs are engaged in activities of national importance, including extraction of natural resources (oil & gas), infrastructure, transport, communications, water, and energy.

The Government has initiated reforms to improve the corporate governance and accountability of SOEs, which is a positive development. These ambitious reforms put SOEs corporate governance at the top of State reform priorities, targeting improved corporate governance practices, incentives to improve performance and accountability of SOEs senior management to ensure more efficient operations of SOEs.

The existing statutory framework for SOE ownership, oversight and operation in the Republic of Azerbaijan needs to be improved. Azerbaijan has already made initial steps to modernize SOE governance and management, such as corporatization of many state-owned enterprises as joint stock companies, however, the existing corporate governance framework and practices deviate from internationally accepted good practice. The current division of roles and responsibilities of the various stakeholders involved in corporate management and oversight of SOEs remains incomplete. This generates two effects: it dilutes stakeholder accountability and negatively impacts SOE performance.

In 2011 the Government adopted Corporate Governance Standards, which can be used by all types of entities on a voluntary basis. These CG Standards provide a good basis for SOEs to start introducing basic principles of corporate governance into their operations. However, these CG Standards are not mandatory, and are implemented by only a few companies in the country.

Azerbaijan does not have a fully elaborated SOE ownership policy. SOE ownership policy helps to formulate the objectives of state ownership, identify strategic ownership sectors or entities, establish clear frameworks for operation and management of SOEs and eventually contribute to improved accountability of SOEs. SOE ownership policy also assists the Government to clearly indicate the positive objectives and outcomes it pursues through state ownership and to develop a systematic approach on objectives and functions of ownership, governance principles, and requirements toward SOEs.

Financial information on SOEs, including the largest ones, is generally not publicly available. High quality, reliable information is essential for the Government to lead reforms and take informed decisions. Under existing legislation, SOEs designated as public-interest entities (PIEs) are required

to prepare their financial statements based on IFRS and to publish them. In practice, however, information on SOEs is not largely available and only very few of the largest SOEs comply with existing reporting and disclosure requirements. This is out of step with market expectations on transparency and disclosure.

Lack of financial information and data flow between SOEs and the Government impacts decision-making by the Government and weak monitoring of SOEs' financial performance. Reliable and timely financial information and its disclosure are vital to holding SOEs accountable for their performance. The Government of Azerbaijan may not be able to process and analyze performance of its respective SOEs, unless the respective mechanism is in place. Such mechanism should establish the financial information flow, its verification by an independent audit, analysis and benchmarking against agreed key performance indicators (KPIs).

Azerbaijan has decentralized and fragmented SOE ownership mechanisms which are not conducive to an effective ownership function. The country's decentralized model is typical in the ECA region, where many countries share similar economic past. The decentralized model gives most ownership functions to the line ministries, including setting policies and objectives, as well as appointment of board member and CEOs. The line ministries act simultaneously as owners, policy makers, and regulators of the SOEs under their respective portfolios. These dual responsibilities dilute the ownership function and create potential conflicts of interest in competitive sectors. In markets where SOEs have private competitors, this can create disadvantages for private sector companies or lead to allegations of bias in regulatory or enforcement decisions in favor of SOEs.

SOE monitoring and supervision functions are scattered across different Government agencies, undermining SOE accountability. Line ministries have the greatest responsibility for exercising the state's ownership rights but other agencies, including the Cabinet of Ministers, the State Committee on Property Issues, Ministry of Finance, and Ministry of Economy, may also control shares in SOEs and exercise their ownership rights. These bodies carry different functions and do not have established communication channels that would allow them to streamline their supervision mandate, which weakens SOE accountability. A gradual transition to an advisory or centralized model would allow for greater focus and professionalism in the state's ownership role.

Azerbaijan SOEs are in progress of establishing boards of directors, which form a key foundation of corporate governance³. Boards play a central role providing strategic advice while ensuring that management discharge their responsibility in the best interests of the state as owner and of the enterprise itself. An important aspect of professionalizing boards is to ensure that Directors have appropriate financial competencies and/or industry expertise. To that end, the Government can help build better boards, providing existing and future Directors with targeted training and establishing clear qualification criteria to serve on SOE boards.

³ Civil Code requires state owned JSCs with more than fifty shareholders and public interest entities to establish a supervisory board.

While important reform steps have been taken by all government agencies to improve effectiveness and monitoring of SOEs in Azerbaijan, their results are yet to be demonstrated. Practical measures introduced by the Decree of the President of the Republic of Azerbaijan “On Additional Measures with Regards to Increasing Efficiency of Activities of Legal Entities with Controlling Block of Shares Owned by the State”⁴, and respective Regulations of the Cabinet of Ministers of the Azerbaijan Republic on “Approving Action Plan to Improve Financial and Economic Performance Transparency and to increase the Efficiency of Large State Owned Enterprises”⁵ and “On Revenues and Expenses of Large State Companies”⁶, are aimed at increasing accountability and operating efficiency of SOEs, reducing their fiscal burden on the State budget. The details of these measures are highlighted in this Note. These reform steps are key to improve SOEs’ performance, but their enforcement will be critical in producing benefits for Azerbaijan’s economy and demonstrating their effectiveness to the public.

Areas for Consideration

SOE reforms completed to date have established a good ground for making SOEs accountable. For example, corporatization of SOEs has been progressing well, with 16 out of the 20 largest SOEs converted into corporate entities since 1996. Fully corporatized SOEs, i.e. joint stock entities, have become subject to general legislation requirements established in the Civil Code, which legislates that entities with more than 50 shareholders must establish supervisory boards. More recent reform measures included implementation of International Financial Reporting Standards (IFRS) for eight large SOEs and publication of IFRS-based financial statements on SOEs internet pages.

As the country’s largest SOE, the State Oil Company of Azerbaijan Republic (SOCAR), requires a specific approach and its governance should be assessed separately. SOCAR is one of the few SOEs that publicly disclose its financial and non-financial information on their corporate website. This Note does not cover the assessment of SOCAR corporate governance practices or its performance evaluation. However, given its significance to the economy of Azerbaijan, the Government may consider it beneficial to carry out individual corporate governance assessment of SOCAR to identify specific needs in the short- to medium-term. In case such an assessment is performed, SOCAR would benefit greatly from incorporating the requirements of the Extractive Industries Transparency Initiative⁷ into their operations and reporting structure.

The impact of SOE reforms could be stronger if relevant legislation on SOE ownership, oversight, corporate governance and operations is consolidated under a unified legislation, which builds on international experience. This step would help to focus the reform framework and implementation

⁴ Dated September 5, 2016.

⁵ #636s, dated December 1, 2016.

⁶ #534, dated December 30, 2016.

⁷ EITI Requirements: <https://eiti.org/eiti-requirements>

path for SOEs in the short- and medium-term. The same would be advisable in terms of establishing direction in the oversight of SOEs, including appointments of their supervisory board and management, clarifying SOEs' reporting lines, financial and social obligations. In the medium and long-term, this strategic approach will help to create a coherent and clear path for implementation and monitoring of SOE governance reforms, improving their accountability, streamlining oversight and decision-making processes on the part of the Government.

Moving toward a more centralized model would help to professionalize the SOE ownership function and make it more effective. Several SOE ownership models are discussed in more detail in this Technical Note. The Government of Azerbaijan may consider these SOE ownership models (or combinations of options), evaluating risks and benefits, with the aim of moving towards a more centralized SOE ownership function. This would be a gradual process and the chosen model could be adjusted and revisited over the medium or longer term as the Government gains momentum and experience with ownership reforms, and SOEs become more efficient and independent with exposure to capital market discipline and oversight.

Clear distinction of the state's roles as an owner, policy maker and regulator will need to be established and formalized. The aim should be for the state to separate decision-making from ownership responsibilities and act as an engaged and professional owner of its assets, while giving SOEs operational independence. This step will enable SOEs to focus on achieving their objectives agreed with government, but shield them from political influence or inappropriate intervention into their operations.

The role of SOE supervisory boards needs to be strengthened to provide more authority and decision-making power. Presently, SOE boards have limited decision-making power with most strategic decisions taken by line ministries and/ or by SOE directors, exercising direct control over strategic and operational decision making, giving priority to the state's policy goals at the cost of efficiency, commercial and financial viability.

SOE boards should be legislatively empowered with the authority and autonomy to determine SOE performance strategic objectives and monitor SOE performance. There is a need to develop clear requirements for SOE boards, defining and authorizing them with any necessary legislative authority, and establishing competence and objectivity requirements to facilitate strategic guidance and monitoring of SOE management.

SOE supervisory boards will need to be professionalized and strengthened with independent board members in the short to medium-term. The Government and SOEs would benefit from balancing the skills set and industry expertise at SOE supervisory boards, gradually reducing presence of civil servants and introducing respective industry experts and independent board members to supervisory boards of the largest SOEs. Such experts and independent board members may be drawn from various private sector entities in Azerbaijan or abroad, including but not limited

to commercial banks, leading accounting and audit firms, privately owned or joint ventures industry leaders.

It will be important to build capacity and skills set of existing and potential State representative to the SOE boards, providing necessary training, peer exchange and learning opportunities. A key aspect of professionalizing boards is to ensure that board members have appropriate financial competencies and / or industry expertise. To that effect, the Government will need to invest into capacity of existing and future Directors providing them with respective training and establishing clear qualification criteria to serve on SOE Boards. This step will help to build human capacity to professionally act in the best interest of the State as owner and the enterprise itself. Special training programs may be developed and updated to include good corporate governance practices, reference to strategy and SOE oversight, and include larger number of board members.

The Government of Azerbaijan should evaluate a good international practice of establishing specialized board committees (i.e. Audit, Remuneration, Risk Management). Modern corporate governance sees a clear role for the Board Chairman, in organizing the work of the board and providing clear leadership, and the introduction of specialized board committees to delegate and oversee specific issues related to audit process and communication with the external auditors, setting and implementing proper remuneration policies, and managing risks at SOEs.

To ensure that SOE reforms achieve their ultimate objective in maximizing SOE value for society, SOEs require tools and remuneration policies that appropriately incentivize senior executives. SOE supervisory boards should have power and authority to design remuneration policies that are competitive with the private sector and contain incentives to achieve financial targets such as an agreed return on equity or profit (or in some cases a loss reduction target in enterprises where significant restructuring may be required). The level of remuneration and incentives for senior executives and the chief executive should be transparent and fully disclosed in the nonfinancial information in the SOEs annual reports.

SOE performance monitoring systems need to be introduced, connecting SOE management remuneration to growth in shareholder value of SOEs, stimulating improvement in SOEs performance. All SOEs, regardless of legal form, should aim to maximize value for the state and the public, and as such, should be evaluated on a uniform basis. An effective system of performance monitoring should be considered and developed to discourage poor performance by SOE management through clear definition and enforcement of rewards and consequences for SOE managers and line ministries.

The Government and public would significantly benefit from improved disclosure and reporting of SOEs financial statements. The existing legislation requires SOEs to report under IFRS and make their financial statements publicly available. In practice, only limited number of SOEs comply with this requirement. Strengthened enforcement of reporting and disclosure of audit and un-audited

interim financial information would enable the Government to analyze and evaluate SOEs performance on a timely basis, providing reliable information for decision making.

Capacity building will be required among all Government agencies involved in SOE management and oversight to develop an understanding and ability to evaluate the change in SOE ownership, and to make timely and informed decisions. Insufficient capacity may hinder SOE reforms in many countries, and will need to be addressed at all levels: individual SOEs, line ministries, Ministry of Finance, Ministry of Economy, State Committee on Property Issues. Skills and capacity building will need to be geared towards providing knowledge, tools and mechanisms, which would enable analysts, managers and decision makers to understand the effects of the reform process and empower them to properly react and adjust the reforms as they are being implemented. This step will help to build human capacity and expertise among a critical group of SOE executives and officers in charge of policy making as to SOE ownership and oversight.

Effective implementation of the planned reforms will be key in improving SOE corporate governance and accountability. The complex of SOE reform measures will require both significant investment in capacity of the government agencies in charge of the ownership function, and close supervision of the reform process in SOEs and their respective line ministries. This process takes time and should therefore be initiated as soon as feasible. Incentives mechanisms should be considered to encourage and support the change in SOE governance and reporting. Clear definition and assigned ownership roles and functions will empower the Government's to strategically oversee and analyze a holistic picture of SOEs' performance and risks.

The Government of Azerbaijan is taking steps to address gaps in governance and accountability of SOEs, but critical legislation still needs to be approved and enacted. Important progress in legislation must be secured via approval and implementation of several important legal instruments, including drafts of: (i) Corporate Governance Guidelines and Standards; (ii) Procedures for Issuance of Bonus Payments for Members of Management Bodies of Legal Entities with Controlling Block of Shares Owned by the State; and (iii) Procedures for an Efficiency Assessment of the Legal Entities with Controlling Block of Shares Owned by the State. These documents will pave the clear path towards further implementation of the SOE reforms and build on the steps already taken by the Cabinet of Ministers in line with the Strategic Roadmaps.

CHAPTER 1: CONTEXT AND OVERVIEW

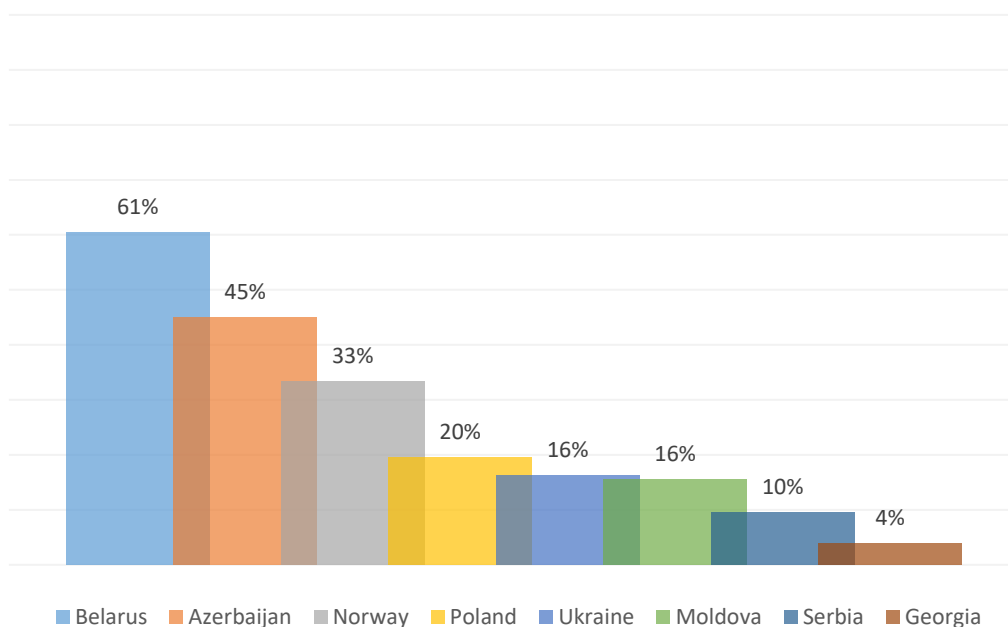
Objectives and Scope of the Technical Note

- 1. This technical note was prepared by the World Bank Group team based on the findings of research and consultations performed between the main counterparts during January - May 2017.** The document focuses on the areas of research requested by the Government of Azerbaijan, which include: (i) the rationale for state ownership; (ii) state's role and responsibilities as an owner; (iii) role of SOE boards; (iv) accountability and performance monitoring; (v) SOEs financial accountability, disclosure and transparency, including audit arrangements; (vi) financial discipline and fiscal risks stemming from SOEs operations.
- 2. The document uses OECD Guidelines on Corporate Governance of State Owned Enterprises as the leading benchmark aspired by the OECD member-states.** These Guidelines outline the set of policies aimed at improving SOEs ownership function by the state while raising their efficiency and generating benefits for society in a more transparent and accountable way. The analysis also draws on wider range of internationally recognized standards, guidelines and practices, and the latest available research produced by the World Bank and others. Using the experience of OECD countries and other leading economies of the world, this note summarizes good international experience of governance arrangements for SOEs, and compares these good practices to those employed by the Republic of Azerbaijan.
- 3. The Note does not attempt to provide a comprehensive diagnostic comparing standards and practices in Republic of Azerbaijan with relevant international benchmarks.** The Note is limited to the analysis of current practices in Azerbaijan and indicates areas for further consideration by policy makers which may help improve the structure of public ownership in the Republic.
- 4. The objective of this Technical Note is to support the Government of Azerbaijan on the reform path to improve policies and practices in the governance of SOEs, improving incentives and ultimately contributing to better performance.** This addressed this main objective through: (i) analyzing current SOE governance frameworks and practices in Azerbaijan and identifying main deviations from international good practices; and (ii) developing a series of policy recommendations for further reforms in strengthening SOEs governance and improving their effectiveness.
- 5. This work may serve as a basis for further collaboration between the World Bank and the Government of Azerbaijan to further SOE reforms and related policy considerations.**

Role and Economic Importance of State Owned Enterprises in Azerbaijan

- 6. Today, SOEs are significant players in many countries, including in the Europe and Central Asia Region.** While most countries have undergone efforts to privatize SOEs, the SOE sector remains significant according to many metrics, including revenues as a share of GDP, share of overall employment, share of total investments, as demonstrated in Figure A below. SOEs are responsible for significant share of employment in the region and delivering essential services in many sectors, important to citizens, such as utilities, health, transportation, education and others.

Figure A: SOEs Contribution to GDP in Selected Countries in Europe (%)



Source: SOE FACT Study, WB staff analysis (2014-2016)

- 7. In Azerbaijan SOEs continue to have important economic and social roles.** They are important players across many industries, including major export sectors - oil and gas, power generation and distribution, but also essential public services, such as water supply, railway, air passenger and communications. Ensuring that these services are available to citizens and monitoring their quality are among the key responsibilities of the state, as an owner.
- 8. Low oil prices environment, in which the Government of Azerbaijan operates since 2014,** has put substantial strain on public balance sheets narrowing the Government's

possibilities to continue supporting SOEs out of state budget. In this regard SOE reform becomes even more important as the Government expects its existing SOEs to strengthen their corporate governance, eventually improving their financial performance and enabling the Government to downsize the subsidies to SOEs and redirect those spending to more productive areas.

- 9. Over the past years, the Government of Azerbaijan has initiated significant SOE reforms, including privatization and corporatization of entities owned by the state.** The implementation of these reforms has been partially successful in terms of privatization of smaller and medium-sized SOEs and with initial steps taken to improve governance and operations of large-scale enterprises. The Government of Azerbaijan is currently looking to improve its ownership and oversight of SOEs, raising their effectiveness and contribution to the state budget.
- 10. Existing and publicly available data on the number and size of SOEs in Azerbaijan is limited and scattered.** State Statistical Committee of Azerbaijan accounts for 2,846 public entities, state institutions and state-owned enterprises. These entities, comprising public sector and SOEs, employ approximately 1.2 million people, accounting for 25% of total employment in the country⁸.
- 11. The Government regulates and monitors TOP 20 SOEs in the country through general legislation and special regulations.** At the same time, information on these entities, including largest SOEs in Azerbaijan, is fragmented and generally not publicly available. This practice does not allow the Government to assess the performance of SOEs and is out of step with market expectations on transparency and disclosure. As demonstrated by Figure A, out of 15 significant SOEs in Azerbaijan, only six SOEs make their financial information publicly available, and only four are fully compliant with national transparency and disclosure legislation and market expectations.
- 12. Information about Azerbaijani SOEs management, governance, financial status, etc., is hard to find and generally not publicly available.** The larger SOE are classified as public interest entities (PIEs) and, according to the Law on Accounting, must prepare and publish their IFRS based financial statements. However, despite their importance to the state economy, some SOEs still do not produce consolidated financial statements, and are not independently audited. Table 1 below provides a summary of data available from open sources and demonstrating the lack of sufficient information availability and flow between SOEs, Government and public.

⁸ 2015 Data from the State Statistical Committee of Azerbaijan: <http://www.stat.gov.az/source/labour/indexen.php>

Table 1: Summary of Publicly Available Information on TOP 15 SOEs in Azerbaijan

#	SOE	Industry/sector	Number of employees	Annual turnover in million US\$ (2015)	Net Profit/ (Loss) in million US\$ (2015)
1	SOCAR	Natural Resources	52,000	21,236	(1,145)
2	Azerenergy	Energy generation and transmission	7,000	471	(558)
3	Azerbaijan Airlines (AZAL)	Infrastructure (Air Transport)	8,450	No Data	No Data
4	Azerbaijan Railways	Infrastructure (Railways)	11,784	177	(453)
5	Azersu	Utilities (Water)	12,800	89	(347)
6	Azerishig	Utilities (Energy Transmission)	No Data	No Data	No Data
7	Azeristiliktechizat	Utilities (Heating)	No Data	No Data	No Data
8	Azerbaijan Irrigation and Water Operations	Agrosector	No Data	No Data	No Data
9	Azerbaijan Caspian Shipping Company	Infrastructure (Maritime Transport)	9,000	213	44
10	Azerbaijan Motor Roads State Agency	Infrastructure (Roads Administration)	No Data	No Data	No Data
11	Baku Metropolitan	Infrastructure (Metro Transport)	6,500	58	(18)
12	Baku International Sea Trade Port	Infrastructure (Port)	600	No Data	No Data
13	Azerkosmos	Aerospace	100	No Data	No Data
14	Aztelekom	Communications	No Data	No Data	No Data
15	Baku Telefon Rabitesi	Communications	No Data	No Data	No Data

Source: SOEs website, National Statistics, WB staff calculations

13. The State Oil Company of Azerbaijan Republic (SOCAR), is the largest SOE and main revenue generator for the country, contributing approximately 40% of GDP. SOCAR is a full cycle oil & gas producer involved in extraction, refining, transportation, and sale of gas, oil, and their end-products. It is by far the largest SOE in Azerbaijan, employing 52,000 people, and is among the biggest SOEs in the region. It has a vital national role, including SOCAR's tax contributions and distributions to the Government, as its sole owner.

14. Other SOEs among TOP 15 contribute to the critical infrastructure of the country, providing important services to citizens and businesses. The Government of Azerbaijan regulates and monitors TOP 20 SOEs in the country through general and special legislation, which is analyzed further in this document. Five out of TOP 20 SOEs belong to financial sector (banks,

insurance and leasing companies), and, therefore, are not included in the scope of this Technical Note. The information on these TOP 15 SOEs is only partially available, as demonstrated in Table 1 and Figure B below.

Figure B, TOP 5 SOEs in Azerbaijan

2015 Revenues, US\$ million



Source: SOEs website, National Statistics, WB staff calculations

- 15. The Government undertakes significant quasi-fiscal operations through large SOEs, which potentially understate the fiscal deficit and overall debt.** Exact costs per company or per sector are not available but the Government provides subsidized utilities to the population (gas, electricity, transport) through its fifteen largest SOEs, for which they are not compensated. Overall subsidies provided by the Government through public sector agencies and SOEs are presented in Table 2. In addition, these SOEs undertake investment projects on behalf of the government. Additional costs could surface from SOEs for which data is not currently available.

Table 2: Subsidies and Transfers from the State Budget

Subsidies and Transfers from the State Budget	2014	2015	2016
In million Azerbaijani Manat	683	805	738
In million US Dollars	870	1,027	476
Exchange Rate (End of Year)	0.78	0.78	1.55

Source: Azerbaijan Chamber of Accounts

- 16. The information flow and availability is critical for analysis of SOEs performance and managing fiscal risks stemming from their operations.** Presently, the Government does not have a complete picture of SOE performance and lacks tools to hold SOE management accountable for their performance. Moreover, lack of financial and operational information, hinders decision making process in terms of public investments by the SOEs, as well as evaluation of quality of critical services delivery to citizens.
- 17. Although considerably more progress is needed, there are some good starting points toward building good governance in SOEs.** Over the past years, the Government has made some progress in terms of raising transparency and improving corporate governance of SOEs. For instance, in 2011, Azerbaijan adopted Corporate Governance Standards, which are voluntary for application by private- and state-owned entities. At the same time, these Standards are not widely implemented in practice due to their recommended nature. During the same period, several of the largest SOEs in Azerbaijan, including SOCAR, Azerenergy, Azerbaijan Caspian Shipping Company, Azerbaijan Railways and Azersu, transitioned to International Financial Reporting Standards (IFRS), which is a good practice and is a welcome step.
- 18. The Government is moving ahead with implementation of the Strategic Roadmaps and other legislation⁹, which set the target for improved performance of SOEs:** (i) the Ministry of Economy has developed a draft Regulation on SOE Monitoring, which included key performance indicators (KPIs) critical for the Government of Azerbaijan; (ii) special SOE Commission was established under the Cabinet of Ministers, which reviews and approves SOEs annual budgets; and (iii) the State Committee on Property Issues initiated the development of a single SOE database. These are important initial steps towards coordinated oversight of SOEs, which will take time and require proper implementation to demonstrate effect in raising transparency and accountability of Azerbaijani SOEs.

⁹ President Decree #1003 “About measures related to accelerating the privatization of the state property and increasing the efficiency of its management” (d.d. July 19, 2016).

Overview of Legislative Framework

- 19. The existing statutory framework for SOE ownership, oversight, and operation in Azerbaijan is fragmented, with various levels of laws, regulations, and resolutions, sometimes conflicting.** This fragmentation in guidance and requirements may cause conflict between different legislative acts and lead to “double readings” by the regulators, SOEs, their managers, and counterparts. Depending on the legal form of the SOEs, various legislation would apply.
- 20. There are three types of SOEs in Azerbaijan: joint stock companies, limited liability companies, and a special legal form.** Most SOEs were corporatized and turned into joint stock companies over the past twenty years but some, organized in a special legal form, still exist. These include: several Production Associations (remnants of the Soviet System) and one state enterprise - the State Oil Company of Azerbaijan Republic (SOCAR), which represents a quasi-governmental company wholly owned and governed by the state. Some SOEs, including Azersu (Water Company), Aztelekom and Baku Telephone Communications¹⁰ enjoy quasi-governmental or near-monopoly status in their respective sectors.
- 21. All Azerbaijan SOEs operate under general legislation, the Civil Code of the Republic of Azerbaijan, however, several special regulations and resolutions exist, applicable only to specific SOEs.** For example, high-level requirements are set in the Civil Code, with various aspects and details provided by the Law on Accounting and the Law on Internal Audit. Strategic guidance on additional measures to promote the efficiency of SOEs is provided by the Decree of the President of Azerbaijan, and comprehensive guidance is provided in Azerbaijan Corporate Governance Standards, voluntary for implementation by all entities in the country, regardless of the ownership or legal form. Details of the existing legislation affecting SOEs are outlined in Annex I.
- 22. The existing legislative frameworks on corporate governance and financial reporting for SOEs are also fragmented.** SOEs are required to prepare and submit numerous reports to various governmental authorities, including the Ministry of Finance, the Ministry of Economy, Tax Authorities, the State Statistics Committee, as well as their respective line ministries and social funds. SOEs functions, practices, and corporate governance arrangements are contained in a range of legislation (see Annex I for more detail). Key legislation includes the Constitution of Azerbaijan; the Civil Code; the Law on Approving

¹⁰ The Resolution of the State Property Committee on Property Issues approved the change in legal status of “Baku Telephone Communications” to LLC “Baku Telephone Communications” (#105, May 3, 2017).

Rules on Transforming the State Property into Joint Stock Company; the Law on Accounting; and the Law on Internal Audit. SOEs are also subject to general provisions of other laws, including the Tax Code; the Labor Code; the Law on Public Procurement; Decrees and Orders of the President of Azerbaijan; and others.

- 23. Variety and multitude of legislation hinders the strategic reform objective and dilutes accountability for change among SOEs and respective Government agencies.** Responsibility over the SOE reform implementation and enforcement of respective legislation is spread among several Government agencies. For reform implementation to be effective, communication channels and accountability mechanisms between main stakeholders need to be strengthened.
- 24. Over the past ten years, the President of Azerbaijan has initiated important reforms to integrate the country more fully into the global economic marketplace, making the improvements in SOEs corporate governance a top reform priority.** The reform program aims to increase foreign investment, diversify the economy, and maintain growth despite the global financial crisis and volatile oil prices. SOE reform has been prioritized through several policy documents and regulations, targeted at improving corporate governance of SOEs, implementing performance based incentives at SOEs, and promoting their efficiency¹¹. The Center for Analysis of Economic Reforms and Communication (CAERC) was established to analyze the existing frameworks, advise on implementation of SOE reforms, and coordinate between the Government agencies.
- 25. The impact of SOE reforms could be stronger if relevant legislation on SOE oversight, financial reporting and corporate governance is consolidated under a single set of Guidelines or Rules.** This step would help focusing the reform framework and implementation path for SOEs in short- and medium-term. The same would be advisable in terms of establishing direction in oversight of SOEs, including appointments of their supervisory board and management, clarifying SOEs reporting lines, financial and social obligations. In medium- and long-term perspective, this strategic approach will help creating a coherent and clear path for implementation and monitoring of SOE governance reforms, improving their accountability, streamlining oversight and decision-making process on the part of the Government.
- 26. If implemented, this consolidated set of Guidelines or Rules can ensure that requirements are harmonized and meet a minimum standard, and will also avoid requirements that are incomplete, inconsistent or conflicting.** These rules should set clear boundaries and define the roles and responsibilities of government as shareholders, and of SOE boards and

¹¹ For example, Presidential Decree dated September 5, 2016.

management, as relationship between the government as shareholder and SOE boards and management. Such a framework would thus provide a clear guidance on the reform expectations and accountability mechanisms on the part of SOEs to ensure that reform steps are implemented and enforced.

27. Many countries have transitioned SOEs to general company legislation, while other countries are increasingly moving in that direction. Equal application of broader laws and regulations helps create a level playing field and achieve competitive neutrality between state and non-state companies so that no business entity is advantaged (or disadvantaged) solely because of its ownership. It also aims to ensure that the participation of SOEs in all kinds of economic activities does not distort competition in the market. Experience suggests that corporatizing SOEs and bringing them under company law achieves little without parallel corporate governance reforms. Hence, the importance of SOE corporate governance reforms among many leading economies in the world, led by the OECD member-states.

28. Demand for better performance among SOEs have provided the impetus for adopting more modern legislation in Azerbaijan and globally. Countries are revising their existing SOE legislation or developing new modern laws and regulations to provide strength and legitimacy to the government shareholder; to codify relations among the shareholder, board, and management; and to outline reporting functions. The aim is typically to recast the state's role as owner, separating this function from policy making, based on several key principles:

- separation of the state's ownership functions from its policy-making and regulatory functions to minimize conflicts of interest, real or perceived;
- professionalization of corporate governance bodies, including boards;
- transition to SOEs operating on a commercial basis, resembling the private sector;
- raising transparency and accountability of the SOEs.

CHAPTER 2: FUNCTION AND FORM OF STATE OWNERSHIP

Rationale for State Ownership

- 29. The OECD Guidelines are the internationally agreed standard for governments to exercise state ownership,** avoiding the pitfalls of both passive ownership and excessive state intervention. They were first adopted in 2005 and updated in 2015 to reflect a decade of experience of the member-states with their implementation and address new issues concerning SOEs in the domestic and international context. This Note uses the OECD Guidelines as the main aspirational benchmark, as well as experience of other countries, which are widely accepted as good practices in the global move for better corporate governance systems.
- 30. The OECD Guidelines recommend that the ultimate purpose of state ownership should be to maximize value for society, through an efficient allocation of the resources.** Each country determines its own SOE ownership policy based on governmental priorities, economic needs, and SOEs profile. There is no universal, globally recognized model or set of objectives for SOEs, but some common good practice elements exist. Key principles to address include: corporate governance; segregation between commercial and non-commercial activities; policy objectives; funding mechanisms; and transparency and accountability requirements. If strategic sectors, industries, or individual SOEs, are to be owned by the state, the rationale for this should be clearly defined and publicly disclosed.
- 31. Many countries have defined the rationale for state ownership in a public policy document.** Increasingly OECD countries explicitly set out a clear vision of the reasons for state ownership, types of ownership, objectives of ownership in particular areas/sectors, political accountability, and arrangements for periodic revision of the ownership policy (see examples at Annex II). Table 3 below summarizes forms and legal status of SOE ownership rationale across various jurisdictions.

Table 3. Examples of countries with explicit state ownership rationale¹²

Explicit ownership rationale	Country
Legislation	Estonia, Germany, Hungary, Lithuania, Poland
Government Decree	Chile, Finland, Norway, Sweden, Switzerland
Government Policy Statement	Ireland, Netherlands
Legislation and Government Decree	Czech Republic
Legislation, Government Decree and Cabinet Decision	Portugal
Without explicit ownership rationale	Country
SOE-specific Statutory Legislation, Articles of Association	Canada, Italy, Japan
Government's Legislation and Policies	Mexico, Slovak Republic, Slovenia, Turkey
No Formal Ownership Criteria	Israel, New Zealand, United Kingdom

Source: OECD (2005, adapted 2015)

32. Many governments choose to retain control over certain sectors and industries, often referred to as strategic sectors. The extent of state participation varies from country to country, but the tendency is towards strengthening state ownership in those industries where consumers need to be protected from potential natural monopoly abuses, or governments have strategic interests. The rationale behind maintaining state participation may be grouped into the following categories: (i) keeping control over natural monopolies; (ii) establishing sector specific regulations; (iii) dealing with political sensitivities or

¹² Source: OECD, 2015

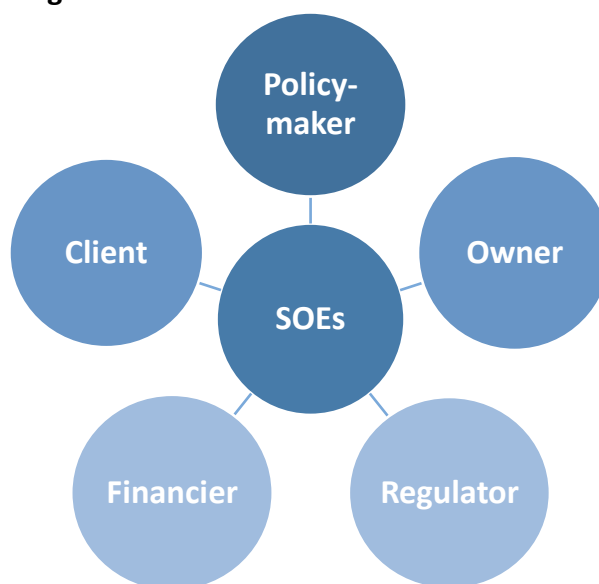
institutional constraints; (iv) maintaining infrastructure, such as railways and telecommunications; (v) producing strategic goods and services (mail, weapons); (vi) extracting natural resources; (vii) providing access to energy; (viii) controlling other essential and social areas, i.e. broadcasting, healthcare, demerit goods (alcohol) etc. With recent technology developments, some countries are also classifying high-tech industries as strategic sectors, establishing SOEs as vehicles for accelerated development and international expansion. Annex III provides an overview of strategic sectors in some selected economies.

33. A clearly defined legal and regulatory framework for SOEs ownership rationale establishes key expectations to all stakeholders, including shareholders, boards, management, and the public. This helps improve SOE governance and performance; strengthens the state's ownership function; and improves the efficiency of resource allocation¹³. The process requires a comprehensive approach and can bring significant gains in increasing efficiency and attractiveness of SOEs, while optimizing the use of public resources.

State's Role as an Owner

34. The state often plays multiple roles in relation to SOEs. These may include owner, policy-maker, client, financier or regulator, as illustrated below.

Figure C: State's Roles in relations to SOEs



Source : Cour des Comptes (France) 2016

¹³ Some examples of SOE Ownership Policies are: Germany's "Holdings in private-law enterprises" (Section 65) of the Federal Budget Code 1969; Norwegian Government's Ownership Policy; Sweden's State Ownership Policy; Poland's Principles of Corporate Supervision over Companies with State Treasury Shareholding.

35. The OECD Guidelines recommend that the state should act as an informed and active owner, ensuring that the governance of SOEs is carried out in a transparent and accountable manner, with a high degree of professionalism and effectiveness. The most recent trend internationally is towards less state interference in SOE operations, instead creating a strong and centralized ownership function and giving SOE management operational autonomy but placing them under the oversight of a board of directors and making them accountable.

36. Reflecting on the State's role as an owner, the Government may need to concentrate on the key ownership functions. The OECD Guidelines assign the following seven broad responsibilities to the state as an owner:

Table 4: Ownership responsibilities and activities

SOE ownership responsibilities	Key related ownership entity activities
1. Exercise its voting rights as shareholder	<ul style="list-style-type: none"> a. Approving annual accounts b. Appointing or renewing directors c. Appointing or renewing appointment or renewal of independent auditors d. Approving dividend distribution e. Subscribing to share issues f. Approving management compensation ("say on pay")
2. Define board nomination processes and be actively involved in the nomination of SOE directors	<ul style="list-style-type: none"> a. Establishing guidelines on the profile of individuals to be considered and criteria in terms of diversity and independence of board members b. Developing and maintaining a pool of individuals who meet the basic qualifications for the role of director c. Providing training courses to SOE directors and on-boarding support to new board members d. Putting in place evaluation processes for board members, which also serve as inputs for implementation remuneration policies (see 7. below) and renewal of incumbent directors
3. Set and monitor broad SOE objectives	<ul style="list-style-type: none"> a. Establishing a performance monitoring system (dashboards, KPIs, balanced scorecards, etc.). An interesting development in this area is PwC's TIMM (proprietary tool) b. Structuring performance agreements—noting that these have had mixed success since they were introduced in the 1980s
4. Set up reporting systems	<ul style="list-style-type: none"> a. Requiring SOEs to meet high standards of reporting (e.g., IFRS) b. Monitoring the quality of the SOE's financial reporting c. Setting guidelines for the selection of the SOEs' independent auditors

	d. Setting guidelines for SOE audit committees, and providing technical support/training to audit committee members
5. Establish a disclosure policy	Setting out recommended disclosures on financial information (beyond what the applicable financial reporting standard requires) and nonfinancial information including “material information”
6. Maintain continuous dialogue with the external auditors	This dialogue should not in any way “bypass” the board of directors (or creating such perception)
7. Establish remuneration policies for boards	a. Analyzing national (private-sector) and international (SOE and private-sector) practices in board remuneration (form, levels, conditions), to ensure that directors are appropriately compensated/incentivized for fulfilling their role effectively b. Setting guidelines on the determination of directors’ remuneration and possibly specific amounts for such remuneration

Source: adapted from OECD 2015

37. State ownership should protect the state’s interest as an owner of valuable assets while ensuring that SOEs meet their economic or policy objectives. Achieving these twin goals demands competence and accountability. This can be undermined by an ownership form that is opaque, complex, or contains inherent conflicts of interest. The most recent trend internationally is towards less state interference in SOE operations, instead creating a strong and centralized ownership function and giving SOE management operational autonomy but placing them under the oversight of a board of directors and making them accountable.

Models of SOE Ownership

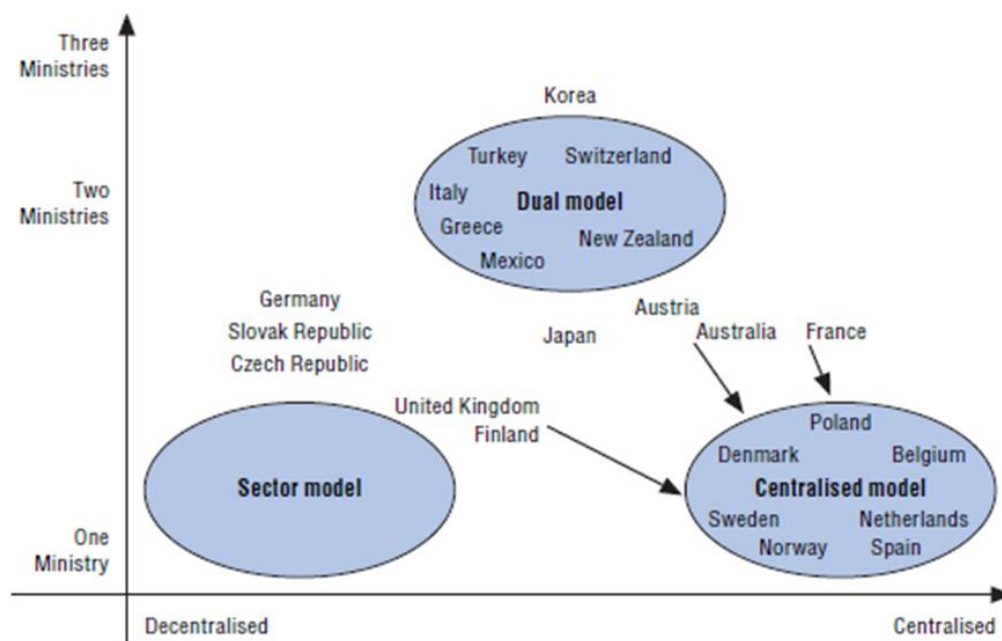
38. State ownership arrangements in many countries have evolved over time as SOEs have changed in form and as governments have sought to improve their productive capacity. Although countries’ legal frameworks vary substantially, ownership models today fall broadly into four models: decentralized, dual, advisory, or centralized (see Annex II, Figure 2.3 for country examples). There are no bold lines separating ownership models, in fact, many countries may be categorized under one type of ownership model but may also retain aspects of other models for some or all SOEs:

- **Decentralized model:** SOE ownership responsibilities are dispersed among different line ministries;
- **Dual model:** ownership responsibilities are shared, for example, by line ministries and the Ministry of Finance/ Economy;

- **Advisory model:** ownership remains dispersed but an advisory or coordinating body provides high-level input into SOE governance and ownership matters.
- **Centralized model:** SOE ownership is centralized in a single ownership entity, which may be independent or a part of government.

39. The decentralized and dual models are typical in the ECA region, as many countries share a similar economic past. Historically, governments organized their activities under the respective line ministries, which were responsible for all aspects of SOE management and oversight. The decentralized model still exists in many countries, including Azerbaijan. But in many others, it has evolved to dual, advisory, or centralized models, as evidenced by the recent studies by OECD and the World Bank (Figure D).

Figure D: Evolution of SOE Ownership Models



Source: OECD (2005, adapted 2015)

40. National reform of SOE ownership arrangements often involves the introduction of checks and balances and promotion of both technical and financial oversight over SOEs. The dual model, for example, enables financial oversight of individual SOEs and the SOE aggregate analysis. In this respect, the dual model balances the interests and objectives of line ministries - ensuring that the policy and service delivery roles of the SOE are being met, and the financial performance objectives of the government at the aggregate level.

41. There is no ideal state ownership model of SOEs, but the OECD notes a trend towards advisory and centralized models to bring focus and professionalism to the state's ownership role. This transition takes place gradually, typically developing an advisory model from either a de-centralized or dual ownership model. In an advisory model the SOE

ownership may remain dispersed among several governmental agencies, which are advised by a coordinating body providing centralized guidance to ministries/ agencies as to the ownership matters. Several examples of SOE ownership models employed by different countries are presented in the Figure E.

Figure E. Country examples of SOE ownership models

<p style="text-align: center;">Dual SOE Ownership Model:</p> <p>For example, in the Czech Republic, line ministries vote the State's shares, while the Ministry of Finance oversees the financial and operational performance of the SOEs. Or in Morocco, the Department of Public Enterprises in the Ministry of Economy and Finance oversees the budget and performance of SOEs.</p> <p style="text-align: center;">Advisory SOE Ownership Model: Lithuania</p> <p>Lithuania's ownership model may be classified as advisory, with Governance Coordination Centre (GCC) being responsible for SOEs' coordination, collection of relevant information, monitoring and analysis of the State's policy toward SOEs. The GCC is part of Turto Bankas, Lithuania Centralized Public Property Management. The <i>Ownership Guidelines</i> define GCC's functions: (i) analysis of financial and non-financial information disclosed by SOEs and the trends of activities of these enterprises; (ii) preparing and publication of aggregate SOE reports; (iii) advice on and coordination on the good practice of strategic planning in SOEs; (iv) assessment of strategic objectives set by SOEs; (v) monitoring of strategy implementation indicators. GCC also takes part in the process of nominating board members via providing technical advice to the institutions representing the state in their search and selection of SOE board members. Finally, the GCC evaluates compliance with the <i>Ownership Guidelines</i> and the <i>Transparency Guidelines</i> and submits its opinion and recommendations to the Government.</p> <p style="text-align: center;">Centralized SOE Ownership Model: Hungary</p> <p>In response to the financial crisis, The Hungarian government established the Hungarian National Asset Management Company (MNV Zrt) as the State asset manager. The primary goal of this change was to preserve and increase the value of SOEs that remain in permanent State ownership. The Ministry of National Development exercises the State's rights and obligations as the owner, largely through MNV Zrt. The entity was established by merging three organizations that had been involved with SOEs before the reform, allowing the State to consolidate its functions into single-ownership approach for all national assets, including SOEs. MNV Zrt. is a single-shareholder joint-stock company. Board of directors may include up to seven members, who are appointed by the Minister. The management of MNV Zrt. is nominated by the Minister and the Board.</p>

42. A centralized SOE ownership model is often employed by the more developed economies.

Ownership arrangements have been steadily evolving toward greater centralization to strengthen the focus on ownership issues and help resolve many of the problems associated with SOE governance. The state becomes an active and professional owner of its assets, while giving SOEs operational independence. This seeks to ensure that SOEs are insulated from political influence, day-to-day intervention into their operations, and can keep an arm's length relationship with the state. Centralized ownership arrangements can take the form of government ownership entities in ministries or within ministerial departments; in agencies; or in company-type structures (see examples in Annex IV).

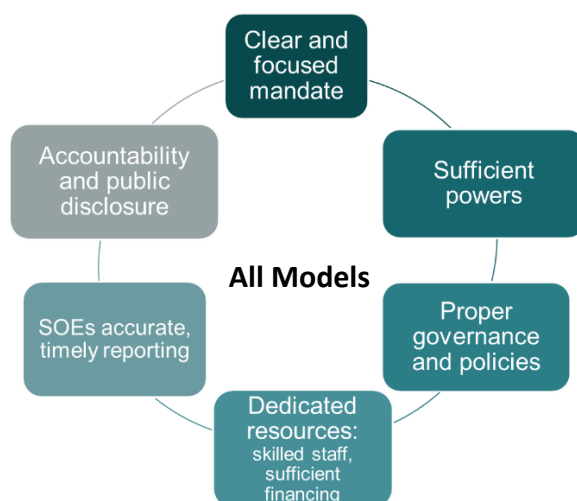
43. Change to either advisory or centralized SOE ownership will help to clarify and implement the state's ownership policy and to develop and promote sound corporate governance frameworks and practices in SOEs. The broad objective in doing so is to bring greater clarity and professionalism to the state's ownership role while reducing the scope for political involvement. More specifically, centralization of SOE ownership aims to:

- Separate the State's ownership functions from its policy-making and regulatory or supervisory functions to avoid or minimize potential conflicts of interest;
- Manage state assets in a way that protects and grows shareholder value;
- Minimize the scope for political interference and professionalize the state's role by building specialized capabilities and concentrating scarce resources;
- Promote greater coherence and consistency in improving corporate governance standards and in exercising the state's ownership role across SOEs;
- Achieve greater transparency and accountability in SOE operations through better oversight and performance monitoring.

44. State ownership, regardless of form, requires protecting the state's interest as an owner of valuable assets while ensuring that SOEs carry out their economic or policy objectives. Achieving these twin goals demands competence and accountability that can be undermined by an ownership form that is opaque, complex, or contains inherent conflicts of interest. Clearly, the role of directors is crucial: in the absence of adequate external pressures, effective management of an SOE relies almost exclusively on the behavior of its board of directors and on compliance with its own fiduciary duties.

45. Under all SOE ownership models, the main ownership entity should have the capacity and competencies to effectively carry out its duties. As illustrated in Figure F below, these capacity and authority must be supported by formal regulations and procedures consistent with those applicable to the companies in which it exercises the state's ownership rights.

Figure F. Formal Authorities and Capacity of SOE Ownership Entity



46. Establishing a completely new SOE ownership model with a large degree of independence is complicated, and requires significant legislative changes and capacity building at all levels. International experience suggests that countries that choose this approach should implement the following measures:

- Put in place safeguards against political interference in commercial decision-making;
- Empower SOE boards to take on greater role and responsibilities;
- Strengthen SOE corporate governance tools and guidelines;
- Encourage better public oversight by enhanced disclosure of information;
- Develop performance benchmarks and monitor progress; and
- Enhance the capacity and role of the advisory or coordinating body.

SOE Institutional Arrangements in Azerbaijan

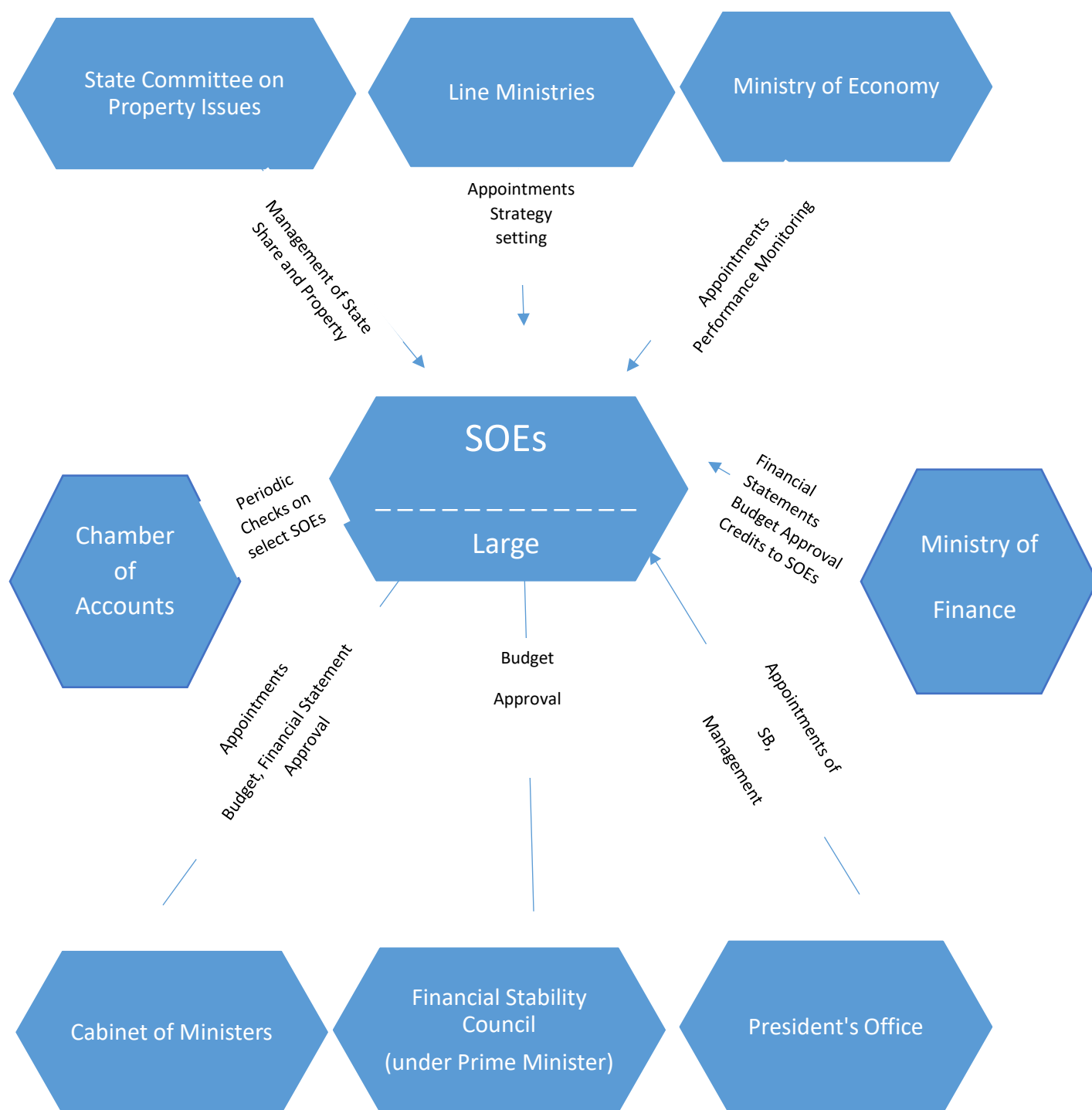
47. Azerbaijan has no publicly defined objectives of state ownership. Many medium and small size SOEs were privatized over the last twenty years, but most large SOEs remain in state ownership. Legislation allows authorities to use economic, social, and legal reviews to assess SOEs and advise SCPI of the reasons to retain state ownership or privatize. Some SOEs remain in sole or partial state ownership for commercial reasons, some for social reasons, or for a combination of both. Statements by public officials and evidence from the first two rounds of the State Property Privatization Program signal that the Government's rationale for privatizing or holding ownership of SOEs was also impacted by inefficient management of SOEs, losses generated, insufficiency of funds to recapitalize them, or state budget constraints. Certain natural monopolies, utilities, and infrastructure companies remain in state ownership, while others were privatized or handed to private management.

48. A new ownership policy needed to improve operation and management of SOEs and eventually contribute to improved accountability of SOEs. It may be useful for the state to clearly indicate the positive objectives and outcomes it pursues through state ownership and to develop a systematic approach on objectives and functions of ownership, governance principles, and requirements toward SOEs. This policy document could determine and formulate an overall ownership policy, stating why it owns enterprises and how it maximizes the benefit for society. The ownership rationale policy could explicitly address the trade-offs in respect of the governance of SOEs, for example:

- whether SOEs pursue economic activities for returns, or whether they also serve as policies instruments for industrial, social or other purposes;
- whether SOEs should aim at generating short-term profits, or at maximizing long-term growth and quality of service delivery;
- whether profits should be re-invested or distributed as dividends etc.

- 49. SOE ownership in Azerbaijan is de-centralized and scattered across different agencies, including the President's Office, Cabinet of Ministers, line ministries, SCPI, MOE, and MOF** (see figure G). SCPI acts as the ownership entity of small and medium SOEs that are mostly joint stock companies intended for privatization. Ownership responsibilities for larger SOEs are divided among the President's Office, Cabinet of Ministers, line ministries, and SCPI by presidential decrees on a case by case basis.
- 50. Line ministries, the Cabinet of Ministers, or SOE boards are responsible for different aspects of SOEs decisions and management responsibilities**, as outlined in Figure H below. The ownership function of these bodies seems to be mainly to appoint their representatives to SOE boards, and the chief executive is appointed by the founding institution based on the SOE board's proposal. The President appoints Chief Executive Officers and their deputies in most of the largest SOEs, giving them relatively higher authority and influence in making key SOE decisions compared to any other governmental agency. The Ministry of Economy and Ministry of Finance set performance objectives for SOEs, and the special SOE Commission established under the Cabinet of Ministers reviews and approves annual budgets of SOEs. Subordinate regulations do not provide any further guidance, and therefore, ministers and heads of agencies have significant discretionary powers on SOE management and supervision.

Figure G: Main Roles of Government Agencies in the SOE Governance in Azerbaijan



Source: Various pieces of relevant legislation, interviews with state officials

- 51. Existing legislation in Azerbaijan addresses how SOEs should operate, but not why SOEs should be owned by the state.** The current legislative framework defines SOEs legal status, the responsibilities of governmental agencies and SOEs, respective reporting lines, and the reasons for SOEs not to be privatized (i.e., a safeguard for strategic enterprises of national importance). Line ministries are individually empowered to determine SOEs strategic plans with no overall Government rationale and very little coordination between the various governmental agencies involved in SOEs management, supervision and oversight. Individual SOEs' regulations outline the basic objectives of state ownership but there is no clear overall rationale.
- 52. Azerbaijan continues to operate a decentralized SOE ownership model which leads to SOE ownership functions being scattered across different line ministries and agencies.** Line ministries control the key ownership functions over SOEs, and have the greatest responsibility for exercising the state's ownership rights, including setting policies and objectives, and appointing board members and CEOs. Other agencies, including the Cabinet of Ministers, the State Committee on Property Issues, Ministry of Finance, and Ministry of Economy, may also control shares in SOEs and exercise their ownership rights. Line ministries receive recommendations and advice from the President's office and the Cabinet of Ministers with respect to the largest SOEs in the country. This decentralized model leads to SOE ownership functions being scattered across different line ministries and agencies carrying different functions and lacking clear coordination channels that would allow them to streamline their supervision mandate. Such fragmentation does not allow for competent oversight and monitoring of performance for the complete SOE portfolio, reducing their accountability and diluting the existing expertise levels.
- 53. SCPI is the legal owner of SOEs on behalf of the state, but its powers are limited.** Under all SOE ownership models, the main ownership entity should have the capacity and competencies to effectively carry out its duties. As illustrated in Figure H below, this capacity and authority must be supported by formal regulations and procedures consistent with those applicable to the companies in which it exercises the state's ownership rights. SCPI has only limited powers, its responsibilities include mainly changes to the SOEs charter documents, approval of changes to SOEs capital structure, representation at SOE boards, processing of SOEs privatization, restructuring or post-privatization monitoring. The Ministry of Finance and Ministry of Economy are involved in SOE oversight and provide their input in approval of major decisions and performance monitoring of SOEs.
- 54. The Government of Azerbaijan has increased its efforts to strengthen SOEs operations and governance practices but with limited results so far.** For corporatized SOEs (JSCs), the governance arrangements comprise of: (i) AGM: general meeting of shareholders, where the state appoints a state representative to act on its behalf; (ii) board of directors; (iii) executive

body / management board, and (iv) revision committee. SOEs are not obliged to establish audit committees, however, Corporate Governance Regulations for SOEs, recommend establishing various committees, including audit, remuneration, and risk management committees. The Azerbaijan Corporate Governance Standards were adopted in 2011, providing a good basis for SOEs to start introducing basic principles of corporate governance into their operations. However, the CG Standards are not mandatory, applying on a “Comply or Explain” principle, and are being implemented by only a few companies in the country. It was observed, for example, that only Azerbaijan Investment Company (AIC) applies these CG Standards to both its own operations and its portfolio investment companies. Some companies, such as the Azerbaijan Caspian Shipping Company, choose to apply their own Corporate Governance Code. Coordination and enforcement by the many governmental agencies involved in the SOE reform could be improved. The Ministry of Economy is in the process of developing Corporate Governance Guidelines and Standards for SOEs (SOE CG Guidelines), including a performance-based bonus payment system and rules on efficiency assessments of SOEs.

55. In 2016 the President of Azerbaijan initiated a series of measures aimed at improving efficiency in largest SOEs. The measures include enhancing SOE performance, putting in place performance-based remuneration system for their governing bodies and improving corporate governance in JSCs with control state ownership. Some of the measures only encompass TOP 20 SOEs and still involve distributing ownership responsibilities among Ministry of Economy, SCPI and line ministries. Among major changes measures being introduced are: establishing SOE boards, creating a single database of large SOEs, and improving their transparency and accountability through quality financial reporting and public disclosure. The implementation of these important reforms and its effects are yet to be demonstrated in practice.

56. Reform is challenging and takes time but will be key to improving SOE corporate governance. Implementation will not be fast or easy, and will require close monitoring and enforcement by the state as an owner of SOEs. Existing legislation is not yet fully implemented by the largest SOEs, even if required by Government Resolutions. The establishment of boards in the top 20 SOEs, for example, is not yet complete. It is also important to note that effective reform implementation requires significant capacity strengthening within the government agencies in charge of the ownership function, as well as at the SOE level. This process takes time and should therefore be initiated as soon as is feasible.

57. The development of a publicly available SOE Ownership Policy should be a priority. This can assist the Government to clarify the objectives, rationale, and scope of SOE reforms in Azerbaijan. The World Bank, through reviewing practices from several countries around the

world, particularly advises on strengthening SOE corporate governance, including through clarification of ownership objectives by the state. Developing this policy in an inclusive and open manner will allow the Government to identify priority sectors and individual SOEs for strategic ownership, and rationalize further steps with respect to other SOEs. The resulting policy should be openly available and be subject to potential revisions overtime.

58. Azerbaijan may benefit from evaluating different models in the region and in the world to identify an option that could enhance their SOE ownership function. Establishing a centralized SOE ownership entity operating on a commercial basis, as was done by some countries in the region such as Kazakhstan (through Samruk-Kazyna), is an option for consideration. Another, more gradual approach may be to introduce advisory model, such as in Lithuania (Figure E).

59. Adoption of either advisory or centralized SOE ownership would help clarify and implement the state's ownership policy, and develop and promote sound corporate governance frameworks and practices in SOEs. The broad objective is to bring greater clarity and professionalism to the state's ownership role while reducing the scope for political involvement. More specifically, a more centralized of SOE ownership aims to:

- Separate the state's ownership functions from its policy-making and regulatory or supervisory functions to avoid or minimize potential conflicts of interest;
- Manage state assets in a way that protects and grows shareholder value;
- Minimize the scope for political interference and professionalize the state's role by building specialized capabilities and concentrating scarce resources;
- Promote greater coherence and consistency in improving corporate governance standards and in exercising the state's ownership role across SOEs;
- Achieve greater transparency and accountability in SOE operations through better oversight and performance monitoring.


Figure H: Potential Options for SOE Ownership Models

Model	Strengths	Constraints
Centralized ownership model within the Government: consolidating SOE ownership functions under one of the Ministries or SCPI	SCPI already holds title rights to SOEs No need to create a new institution Separation of ownership and regulatory functions	Low/ near absent capacity to carry out SOE ownership functions. The SCPI's resources need to be substantially reinforced Need to follow civil service pay guidelines; difficult to attract professional managers
Establish a State-Owned Asset Management Company and hire professional asset managers	State becomes an active shareholder Ability to hire, properly compensate qualified asset managers	Complex establishment process with no guarantee of successful implementation

	<p>Apply private sector incentives / good corporate governance practices, while remaining in state property</p> <p>Relative insulation from political interference</p>	<p>Difficult to identify and hire people with proper skills level, even from private sector</p> <p>Requires strong political support</p>
<p>Advisory ownership model: consolidating SOE oversight under one agency within the Government, or a separate institution, for example CAERC</p>	<p>Legal structures already exist</p> <p>Builds on existing infrastructure of line ministries</p> <p>Strong intermediary to collect, process and analyze SOE information</p> <p>Requires minimal legislative changes</p> <p>Works across various sectors</p> <p>Builds foundation for further centralization in longer-term perspective</p>	<p>Must be able to hire and properly compensate qualified asset managers</p> <p>Limited ability to apply private sector compensation / incentives / good corporate governance practices</p> <p>This approach is gradual and will not achieve quick improvements in SOE reform objectives</p> <p>Requires strong political support</p>

60. Progress towards a new form of SOE ownership takes time and should be undertaken cautiously. Any transition should take place gradually. Modifications to legal frameworks would be required, as well as significant investment in human resources and capacity building at all levels. In an advisory model the SOE ownership may remain dispersed among several governmental agencies, advised by a coordinating body providing centralized guidance to ministries/ agencies on ownership matters. Creating a centralized ownership entity may be more complicated, as it involves a radical change that may be infeasible in the short run because of the political situation or lack of institutional capacity.

Areas for Consideration: State Ownership

 **Development of a publicly available SOE Ownership Policy should be a priority.** It would clarify the objectives, rationale, and scope of SOE reforms in Azerbaijan. Developing this policy in an inclusive and open manner will allow the Government to identify priority sectors and individual SOEs for strategic ownership, and rationalize further steps with respect to other SOEs. The resulting policy should be openly available and be subject to potential revisions overtime.

- ✚ **Consolidating existing relevant legislation on SOE objectives, ownership, oversight, and corporate governance over SOEs** under a single set of Guidelines or Rules would help establish a clear framework and path for implementation of SOE governance reforms in the medium-term. This set of Guidelines may also include for example appointments of SOEs supervisory board members and management board, setting remuneration, and SOEs reporting lines and obligations.
- ✚ **Moving toward a more centralized model would help professionalize the SOE ownership function and make it more effective.** The options (or combinations of the options) should be assessed and the risks and benefits carefully evaluated by the Government, with the aim of moving towards a centralized SOE ownership function. This would be gradual process and the chosen model could be adjusted and revisited over the medium or longer term as the Government gains momentum and experience with ownership reforms, and SOEs become more efficient and independent with exposure to capital market discipline and oversight.

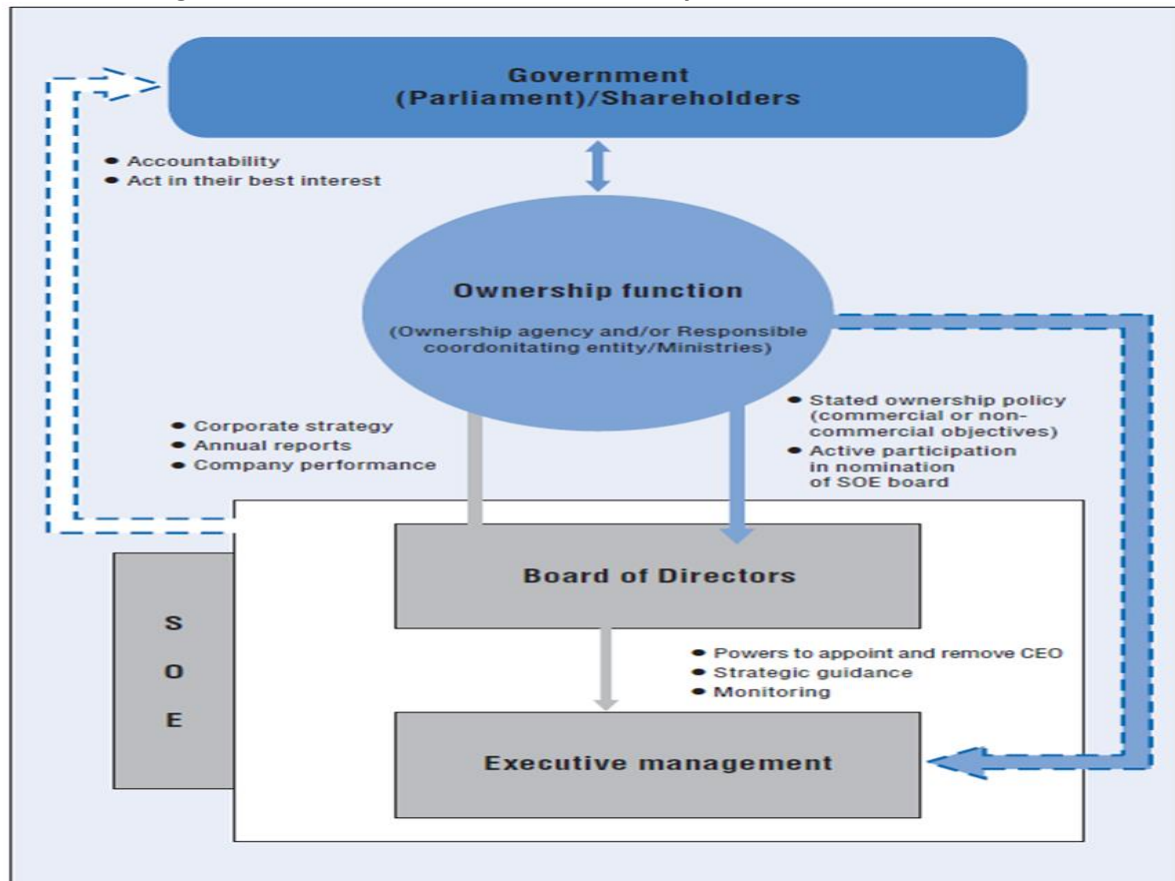
CHAPTER 3: ROLE OF BOARDS AT STATE-OWNED ENTERPRISES

Relationship of the State with SOE Boards and Management

- 61. OECD Guidelines recommend a clear distinction of roles between the state, ownership entities, boards, and management.** The aim is to separate decision-making from ownership responsibilities to avoid conflicts of interest and disincentives. Clarifying these roles ensures that decision-making is made on a rational and informed basis, and in line with stated objectives.
- The state as owner should be responsible for defining and communicating SOE ownership policy and objectives, including any entity-specific objectives for individual SOEs.
 - Boards should be charged by the state with overseeing the development of a strategy to achieve the objectives, and to monitor progress. Boards should be ultimately responsible for the entity's performance to its shareholders - state or non-state.

- Executive management is accountable to the board for implementing corporate strategy. Strategy is normally developed by the executive management and proposed to the board for approval, though in a minority of cases strategies may be imposed top-down.

Figure I: The Role of the Board in a Three-layer Governance Structure



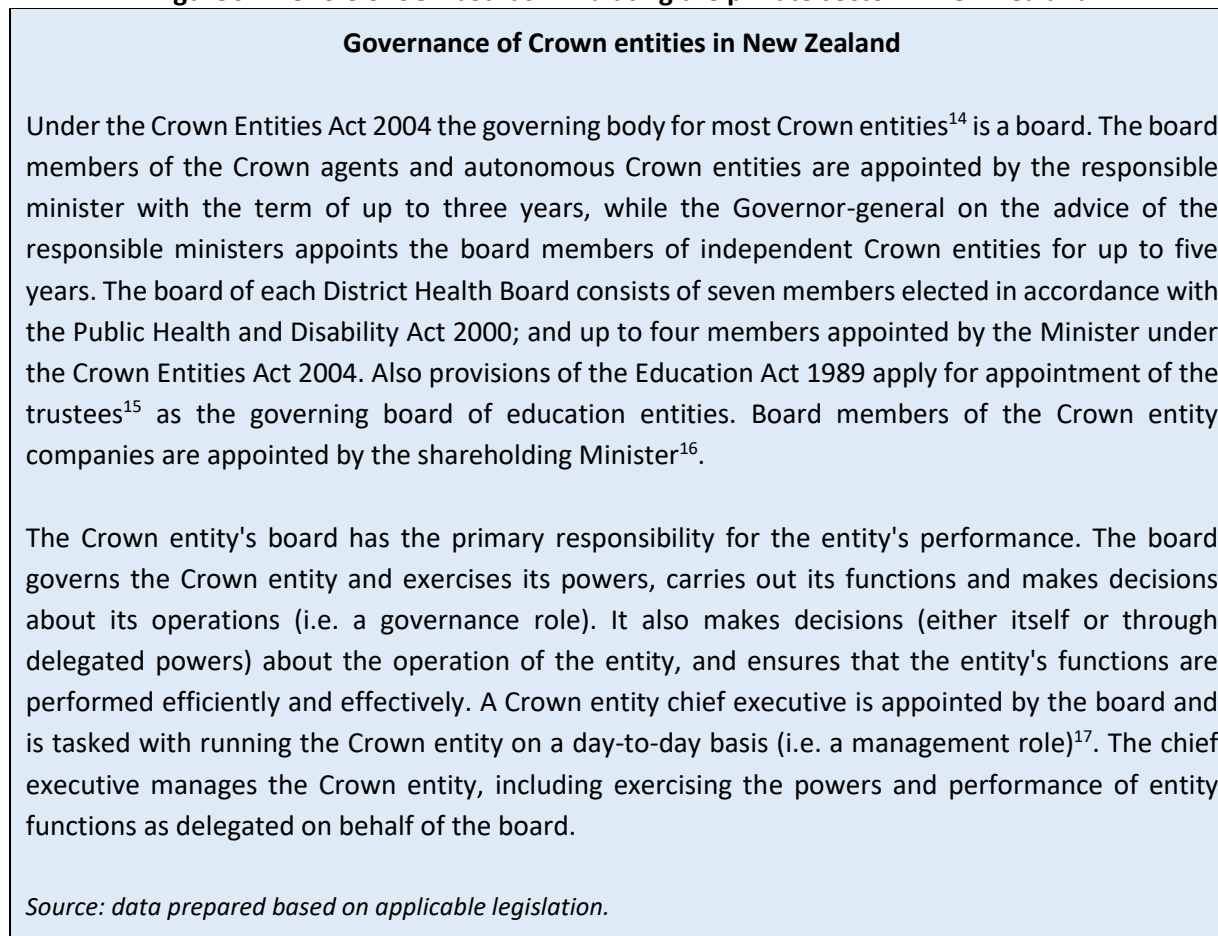
Source: Boards of Directors of State-Owned Enterprises – an Overview of National Practices, OECD (2013)

62. In most OECD countries there is a trend to emulate private sector practices when it comes to SOEs governance. Boards play an increasing role in the governance of public service providers. A properly constituted and managed board of directors can “add value” by working in a structured manner with the ownership entity and helping executive management make better decisions. The characteristics of a value-adding board are:

- responsiveness to management’s need for direction;
- bringing skills and perspectives that management may be lacking;
- encouraging the development and examination of a range of options, bearing in mind risks;
- being objective;
- encouraging and listening to in-house expertise;
- looking forward to the future, and taking the long-term view; and
- thinking strategically.

63. Boards typically bear ultimate responsibility for the stewardship and performance of a company. Their composition and functioning therefore have a significant impact on the governance of SOE, and their operational and financial performance. This is the case in countries including Australia, Belgium, Czech Republic, Estonia, Norway, Netherlands, New Zealand and the United Kingdom. New Zealand is often cited as a country that has gone far in emulating private sector practices, as outlined in Figure J below. The board should be fully accountable to the owners, act in the best interest of the enterprise, and treat all shareholders equitably.

Figure J. The role of SOE boards: Emulating the private sector in New Zealand



¹⁴ The Crown Entities Act 2004 indicates the following five categories of the crown entities:

- statutory entities (Crown Agents, Autonomous Crown Entities and Independent Crown Entities) - bodies corporate that are established by or under an Act;
- Crown entity companies - companies incorporated under the Companies Act 1993 that are wholly owned by the Crown;
- Crown entity subsidiaries - companies incorporated under the Companies Act 1993 that are controlled by Crown entities;
- school boards of trustees established under the Education Act 1989;
- tertiary education institutions bodies corporate established under the Education Act 1989.

¹⁵ A mixture of appointed and elected members.

¹⁶ Provisions on board and CEO appointments of the Companies Act 1993 also apply; however, they are much the same as the Crown Entities Act 2004.

¹⁷ In most cases, corporations sole (a Crown entity with one office holder, e.g. the Privacy Commissioner) do not appoint a full time chief executive.

Board Role and Responsibilities

- 64. Generally, depending on legislative requirements, governments exercise their ownership rights in SOEs by application of either one-tier or two-tier governance systems.** In a *one-tier system*, a single board of directors provides strategy and oversight of the company. Its board may be composed either entirely of *nonexecutive members* (that is, members who are not part of the senior management), of a combination of *executive* and *nonexecutive members*, or, in rare cases, of *executive members* only. In jurisdictions with a *two-tier system*, the SOE has both a *supervisory board* and a *management board*. The supervisory board, usually composed entirely of *nonexecutive directors*, oversees the management board, which consists of the enterprise's senior management team. For companies with a two-tier system, the board of directors is usually called the supervisory board. A good example is the Netherlands governance model, where public sector entities have either one or two-tier systems of governance (see Annex V).
- 65. The nature and duties of boards of directors vary by jurisdiction, but the overarching principle is that the boards of SOEs should be assigned a clear mandate and have ultimate responsibility for the entity's performance.** The OECD Guidelines state that “the boards of SOEs should have the necessary authority, competencies and objectivity to carry out their functions of strategic guidance and monitoring of management. They should act with integrity and be held accountable for their actions”.¹⁸ The role of SOE boards should be clearly defined in legislation, preferably according to company law. The role of directors is crucial: in the absence of adequate external pressures, effective management of an SOE relies almost exclusively on the behavior of its board of directors and on compliance with its own fiduciary duties - a duty of care and a duty of loyalty (see Figure K below).

Figure K: Director's Duties of Care and Loyalty

Boards of directors have two principal fiduciary duties toward the company: the duty of care and the duty of loyalty. These duties have implications that can pose challenges for SOE board members:

- The *duty of care* is an obligation to exercise reasonable diligence and care in performing acts that could potentially harm shareholder interests. This duty requires board members to inform themselves on all issues that could affect the SOE and to make fully informed decisions. One practical implication is that board members need to satisfy themselves that control systems are functioning properly and providing good information. The duty of care

¹⁸ VII. Responsibilities of the Boards of State-Owned Enterprises, OECD Guidelines on Corporate Governance for State-owned Enterprises, 2015 Edition

also requires that board members act professionally, avoid serving on too many other boards, and receive adequate training and other support.

- The *duty of loyalty* is generally defined as a duty of allegiance to the SOE and its interests. A common interpretation is that this duty requires board members to raise the value of the enterprise for its owners. In addition, it requires board members to prevent their personal interests from prevailing over the interests of the SOE or its shareholders. Nor should board members allow the interests of others—including managers, other board members, and prominent government or political officials—to prevail over those of the SOE.

Source: Corporate Governance of State Owned Enterprises, The World Bank Group (2014)

66. SOE boards are expected to carry out their functions of setting strategy and supervising management effectively. To do so SOE boards should:

- formulate or approve, monitor and review corporate strategy, within the framework of the overall corporate objectives;
- establish appropriate performance indicators and identify key risks;
- develop and oversee effective risk management policies and procedures with respect to financial and operational risks, but also with respect to human rights, labor, environmental and tax-related issues;
- monitor disclosure and communication processes, ensuring that the financial statements fairly present the affairs of the SOE and reflect the risks incurred;
- assess and monitor management performance; and
- decide on CEO remuneration and develop effective succession plans for key executives¹⁹.

67. An empowered board should appoint and, subject to clear terms, remove the CEO. This reinforces the key function of the board in overseeing management and ensures that the CEO is accountable to the board rather than to the government. It also reduces the scope for government interference in operational decision making. For these reasons, some countries have made changes to explicitly strengthen the power of the board (See Annex V for examples).

¹⁹ Ibid, Annotations to the Chapter VII, Para B.

Professional Board: Structure, Composition and Nomination

68. Many countries are taking steps to improve board composition by designing a robust policy framework and clear processes for board nominations and appointments. They are seeking to depoliticize the process, make it more professional and transparent, and ensure that boards have the competencies and objectivity needed to carry out their duties. Such a framework usually includes several critical elements:

- Creation of balanced boards
- Adoption of professional criteria for the selection, and removal, of board members
- Development of a structured nomination process
- Timely appointment and public disclosure of the results.

69. Countries that chose to pursue these strategies report a better quality of board discourse, more professional boards, and ultimately improved SOE performance. Furthermore, better boards seem to protect governments from operational missteps, political fallout, and allow them to better gauge and manage the risks of operating an enterprise in a commercial environment.

70. In practice, SOE boards often include civil servants, political, and stakeholder representatives with limited commercial or financial knowledge. Often these representatives possess limited experience or may lack understanding of SOE sector matters, reducing their ability to monitor management or provide strategic guidance. Staffing a board with unsuited directors can also compromise the board's objectivity and independence, leaving it beholden to individual politicians and government officials and unable to act in the SOE's best interests.

71. One way towards a balanced board is to gradually reduce government representation at SOE boards. When government representatives are appointed they should meet the necessary qualifications and have the same obligations and roles as other board members. To maximize a board's value and increase its strategic role, the following safeguards should be considered:

- Appointment should be made to a board where no conflict of interest arises.
- Appointment should be made based on relevant skills.
- Appointment should be made in the person's own right, and the delegation of the role to other officials should be prohibited.
- Appointee should be subject to the same performance evaluation as other directors, including removal (if deemed necessary).

- Appointee should share the same liabilities and reputational risks as other directors.
- Appointee should be responsible for maintaining the same skills and governance competencies as other directors.
- Appointee should be subject to the same terms of appointment as other directors.
- Appointee should not be made chair or deputy chair.²⁰

72. Increased private sector representation on SOE boards, particularly independent board members, helps achieve balanced boards. Many countries are taking steps to increase the share of *independent board members* on the boards of listed and unlisted SOEs (see Annex V examples). The goal is to bring objective viewpoints and better governance skills to boards, to expand board willingness and ability to represent other stakeholders' interests, and to bring fresh views to strategic directions and market approaches. The presence of independent members helps shield boards from ad hoc political or politicized intervention, increases independence in decision-making, and builds confidence that a board's deliberations are free from obvious bias and have involved a degree of debate, challenge and pushback. They add value by:

- Bringing an outside perspective on strategy and control;
- Adding new skills and knowledge that may not be available within the company;
- Bringing an independent and objective view from that of the owner;
- Making hiring and promotion decisions independent of personal (family, friendship, politics or government) considerations;
- Bringing an independent view whenever there may be conflicts of interest within the board;
- Acting as a balancing element between the different shareholders and, in some cases, serving as objective judges of disagreements amongst owners or managers; and
- Benefiting from their business connections and other contacts.

73. Independent board members are non-executive directors who meet the independence criteria of a company, industry standards or the national legislation. Independent board members should be objective, unbiased professionals with no significant company ties or relationships that could interfere with their judgment. As a rule, after serving more than 5 years as an independent board member, the person could not be considered independent of a company. Some accepted definitions of independence are presented in Figure L below.

²⁰ Hamilton and Berg, 2008

Figure L: Definition of an Independent Board Member (Independent Director)

An independent director means a person who:

- ✓ Has not been employed by a company or its related parties, including its major shareholders, in the past five years.
- ✓ Is not an adviser or consultant to a company or its related parties and is not affiliated with a company that is an adviser or consultant to a company or its related parties.
- ✓ Is not affiliated with a significant customer or supplier of a company or its related parties, including banks or other financial institutions owned by any of the major shareholders.
- ✓ Has no personal service contracts with a company, its related parties, or its senior management.
- ✓ Is not affiliated with a nonprofit organization that receives significant funding from a company or its related parties.
- ✓ Is not employed as an executive of another company where any of a company's executives serve on that company's board of directors.
- ✓ Is not a member of the immediate family of an individual who is, or has been during the past five years, employed by a company or its related parties as an executive officer.
- ✓ Is not, nor in the past five years has been, affiliated with or employed by a present or former auditor of the company or of a related party.
- ✓ Is not a controlling person of a company (or member of a group of individuals or entities that collectively exercise effective control over a company) or such a person's close relative, widow, in-law, heir, legatee, and successor of any of the foregoing or the executor.

Related party means, with respect to the company and its major shareholders, any person or entity that controls, is controlled by, or is under common control of the company and its major shareholders.

Source: IFC

74. The ability to establish professional boards, with independent judgment and a range of talent and perspectives, is essential for SOEs. While specific skills required will vary from board to board, governments are identifying the set of competencies, skills, and experience needed to exercise independent judgment and successfully lead SOEs—including industry-specific knowledge, financial, legal, corporate governance skills—and striving to appoint directors who match those profiles. Apart from the technical skills, soft skills such as integrity, ability to add value, and critical faculty are also important. Annex V provides examples of recent reforms in EU countries related to board composition and nominations in SOEs.

75. Transparent nomination and appointment of board members is one of the primary responsibilities of the state as an owner²¹. By establishing and enforcing a well-structured and transparent board nomination processes in fully or majority owned SOEs, the state enables its active participation in SOEs' decision making process. Under the decentralized model of SOE ownership, line ministries typically lead the nomination process for board directors. This lack of transparency can lead to or be perceived as political influence. Many countries have therefore introduced processes delegating parts or entire nomination process to an advisory body, expert panel, centralized ownership entity, or the SOEs themselves. Annex VI outlines several international examples of SOE board nomination models.

76. Timely appointment and public disclosure of the results is an important area of board functioning. Final appointment of selected candidates is usually authorized by the government and made by the shareholding minister responsible for the SOE. This can be another moment of vulnerability for a merit-based appointment process. However, a government persuaded of the importance of sound SOE governance will resist the urge to interfere with a professionally based selection. In many countries, company law and good practice require that appointments be made through the general shareholders' meeting. This procedure increases transparency and is particularly important when the company has non-state shareholders.

77. Greater public disclosure of information on the nomination process and the final appointments can improve SOE boards professionalism and transparency. Increasingly the nomination procedure and relevant information about selected candidates is included in the annual report or in the notice of the annual shareholders' meeting, allowing the public and shareholders to assess the suitability and, if need be, the independence of each candidate.

²¹ II. The State's Role as an Owner, F2, OECD Guidelines on Corporate Governance for State-owned Enterprises, 2015 Edition

Board Committees

78. Specialized committees play an important role supporting the board, for example in the areas of audit, risk management, remuneration, and appointments. The OECD Guidelines state that “SOE boards should consider setting up specialized committees, composed of independent and qualified members, to support the full board in performing its functions, particularly in respect to audit, risk management and remuneration. The establishment of specialized committees should improve boardroom efficiency and should not detract from the responsibility of the full board”²².

79. Board committees support SOE boards in taking well-informed and considered decisions and manage much of the workload. As a rule, decisions are not made by the committees, but rather by the board as a whole - nonetheless committees manage much of the workload in the decision-making process in relation to their specific mandates (analyzing specific problems, establishing facts, finding alternative solutions, etc.). Independent board members must be actively involved in the activities of the committees. Annex V provides an outline of the main responsibilities of the board committees and their composition according to the UK Corporate Governance Code.

80. SOEs establish various board committees depending on the needs of specific entity. It is typical for any company to establish the following committees:

- *Audit committee:* is set up by the board of directors to assist it in performing oversight of financial reporting, internal control and risk management systems, internal and external auditors, as well as compliance of a company.
- *Risk management committee:* is mainly recommended for financial institutions, such as banks, insurance companies, other financial institutions. This committee is responsible for advising the board of directors on overall current and future risk appetite, overseeing senior management’s implementation of the risk appetite statement, reporting on the state of risk culture, and interacting with and overseeing the Chief Risk Officer”²³.
- *Remuneration committee:* assists the board of directors in establishing remuneration levels for the board of directors and the management board.
- *Nomination committee:* advises the board of directors on board members and senior management appointments, as well as on succession planning arrangements.

²² VII. Responsibilities of the Boards of State-Owned Enterprises, OECD Guidelines on Corporate Governance for State-owned Enterprises, 2015 Edition.

²³ Corporate Governance Principles for Banks, para 72, Basel Committee on Banking Supervision (2015).

81. Some examples can also be drawn from different countries, where board committees already exist²⁴:

- **France:** the ownership agency has actively encouraged government-invested companies to establish audit, strategy and remuneration committees.
- **Finland:** the country does not formally require committees, but it has since 2007 encouraged the establishment of remuneration committees, with the purpose of ensuring competitive and incentive consistent remunerations in SOEs.
- **Baltic States:** Baltic Institute for Corporate Governance recommends SOEs to establish several committees (audit, remuneration, risk, reserves and governance) that are responsible for company specific matters.
- **Mauritius:** Guidance Notes for SOEs on the Corporate Governance Code recommend establishment of Audit/Risk, and Corporate Governance/Remuneration/Nomination Committees.
- **Poland:** The National Owners Supervision Scheme – New Corporate Governance in the State-owned Companies established the appointment of a Nomination Committee, to recommend the Treasury nominees to the supervisory boards of certain “key” state-owned entities and on their dismissal when such a situation arises.
- **Korea:** board audit committees are required by law for commercial SOEs.

SOE Boards in Azerbaijan

82. There is a poor track record of supervisory boards in Azerbaijan. According to the Civil Code, establishment of a supervisory board is mandatory only for joint stock companies with more than 50 shareholders²⁵. Limited liability companies may establish a supervisory board if this provision is envisaged by the company chapter²⁶. Management board members cannot be elected to the supervisory board, which means that only nonexecutives can be members of the supervisory board²⁷.

83. In practice, among the twenty largest SOEs, mainly those in the financial sector have established supervisory boards:

- Agrarkredit Closed Joint-Stock Non-Bank Credit Institution
- International Bank of Azerbaijan OJSC
- Azer-Turk Bank OJSC
- Agrolizing OJSC

²⁴ Source: Board of Directors of State-Owned Enterprises: An Overview of National Practices, OECD (2012)

²⁵ The Civil Code of the Azerbaijan Republic, art. 107-7.

²⁶ Ibid, art. 91.3.5.

²⁷ Ibid. art. 107-7.5.

- Supervisory boards have also been established at Baku Telephone Communications LLC, Aztelecom LLC, Azerpost LLC²⁸ and Azerbaijan Investment Company OJSC.

84. SOE supervisory boards in Azerbaijan are not active in terms of strategy-setting, appointing and removing management, deciding on remuneration, or assuming overall responsibility over the efficiency of internal controls system. The main expectations from the SOE supervisory boards are only related to exercise of control over SOEs management. The exercise of this control function is weak as the supervisory board members often are high-ranking officials, who do not have enough time to devote to their board duties and often exercise their authority through their subordinates.

85. The Civil Code of the Republic of Azerbaijan addresses fiduciary duties of the supervisory board and requires its members to act in good faith and in the best interests of the company and shareholders²⁹. However, apart from detailing the procedures of the supervisory board and number of mandatory meeting per year, the Civil Code does not address the main functions to be performed by this body and leaves it company charters to define the competence of the supervisory board³⁰. In practice this leads little or no influence by supervisory boards on the appointment or removal of the management board. This function is assigned to the AGM, and can be transferred to the supervisory board if defined by the company charter³¹. In practice, however, this rarely happens, especially among SOEs.

86. In 2011 the Government has adopted Corporate Governance Standards, which can be used by all types of entities on a voluntary basis. These CG Standards address fiduciary duties of supervisory board members and contain specific provisions on the responsibilities of supervisory board, including those related to strategy setting and monitoring management's performance. The Standards require that supervisory boards should focus on oversight of the work of executive bodies, strategic guidance and direction to the management team, especially in the areas of internal control, risk management, strategic planning, regulatory compliance, major transactions and acquisitions, as well as oversight of transactions with related parties³². However, mainly due to their voluntary nature, these CG Standards are not widely applied in Azerbaijan, including by SOEs.

²⁸ SPCI Regulations № 105 dated May 3, 2017, and №161 dated July 17, 2017, respectively.

²⁹ The Civil Code of the Azerbaijan Republic, art. 49.3.

³⁰ Ibid, art. 107.3.

³¹ The Civil Code of the Azerbaijan Republic, art. 107.1.3.

³² The Azerbaijan Corporate Governance Standards, Chapter 3, art. 3.1.

87. The State has taken initial steps to strengthen the role of SOE supervisory boards. An Action Plan to Improve Financial and Business Performance Transparency and Efficiency of Large State-Owned Enterprises has been approved by the Cabinet of Ministers³³. It identifies the twenty largest SOEs and aims to support their establishment and operation of supervisory boards, including their role in development of strategies. The Government of Azerbaijan has also initiated the development of SOE CG Guidelines, which will become mandatory for implementation by SOEs. Areas under consideration include approval of key company policies, provisions, and significant transactions by supervisory boards, responsibility for the efficiency of risk management systems and independence of internal audit³⁴. The draft Guidelines also address matters related to the appointment of the management board and assessment of their performance by SOEs supervisory boards.

88. SOE supervisory boards are currently staffed with civil servants, including in senior positions. The rules and procedures for nomination of state representatives for supervisory board members in SOEs are contained in the Resolution of the Cabinet of Ministers on approving Guidelines for Managing State's Shares in Joint Enterprises and Joint-Stock Companies³⁵. These requirements are also supported by individual Decrees establishing several largest SOEs. For instance, in Azerbaijan Investment Company, members of the Supervisory Board include: Minister of Economy (Chair of the Supervisory Board), Executive Director of the State Oil Fund (Deputy Chairman), First Deputy Minister of Finance, Deputy Chairman of the State Committee for Management of State Property and Deputy Governor of the Central Bank of Azerbaijan³⁶.

89. The selection and nomination of SOE board members is not transparent or well defined. The only general selection criteria contained in the Resolution for supervisory board members in SOEs requires candidates to have higher education and two or more years of management experience³⁷. There are no other professional selection criteria, such as industry expertise, strategy or risk management experience, financial literacy, etc. The voluntary CG Standards recommend that the supervisory board should comprise of competent individuals with adequate experience and qualifications in the areas of law, finance, audit and accounting as well as other individuals who could contribute to the achievement of companies' objectives³⁸. There are no other provisions in the local legislation

³³ The Resolution of the Cabinet of Ministers of the Azerbaijan Republic on Approving Action Plan to Improve Financial and Business Performance Transparency and Efficiency of Large State-Owned Enterprises (#636s, December 1, 2016).

³⁴ Draft Corporate Governance Guidelines and Standards for State Controlled Joint Stock Companies.

³⁵ Decree of the Cabinet of Ministers of the Azerbaijan Republic on "Approving Rules of Managing State-owned Stakes (Shares) in Joint Enterprises and Joint Stock Companies, art.6 (# 136, dated on July 14, 2005).

³⁶ Decree of the President of the Republic of Azerbaijan "on Additional Measures to Promote Investment Activity", art. 3, (#1395, March 30, 2006).

³⁷ The Resolution of the Cabinet of Ministers of the Azerbaijan Republic "on Approving Guidelines for Managing State-owned Shares in Joint Enterprises and Joint Stock Companies", art. 4 (# 136, dated on July 14, 2005).

³⁸ Corporate Governance in Transition Economies, Azerbaijan Country Report (EBRD, 2016).

that would help ensuring transparent nomination and appointment process of the board members.




- 90. The draft SOE Corporate Governance Guidelines introduce selection criteria for SOE supervisory board members though do not address the nomination and appointment process.** The draft Guidelines outline requirements for supervisory board members having higher economic or legal qualification appropriate to the activities of a joint-stock company, introducing a minimum five years of working experience in the relevant area. They will also require a presence of at least one supervisory board member with financial background to understand the entities financial statements. At the same time, draft SOE Corporate Governance Guidelines are silent about procedures or timeframe for the nomination and appointment process of supervisory board members.
- 91. There are no requirements for independent board members in SOEs in Azerbaijan.** The 2011 voluntary CG Standards promulgate that supervisory boards should have independent members, with the chairperson be elected of independent members of the board. The same CG Standards require that at least half of supervisory board members at SOEs are to be independent, however, as these standards are not applied by Azerbaijani SOEs, their boards do not have independent members.
- 92. Board committees are rare among SOEs in Azerbaijan.** Board committees are not required under the Civil Code. At the same time, the legislation provides for an establishment of a revision commission, mandatory for entities with more than fifty shareholders. This commission exercises control over financial and operational activities of a company, and is elected at the AGM. Members of this Commission cannot be company's shareholders or members of the supervisory board or management³⁹.
- 93. Revision commissions differ from typical audit committee of a supervisory board.** These bodies serve different purposes, including approval of financial statements, advising on tax issues etc. They are usually staffed with SOE employees that report to the CEO and management board. Such commissions have been typical in the planned economies and are remnants of the Soviet system. In most countries of Eastern and Central Europe, these bodies have been reformed or removed. Respective recommendation was proposed in Azerbaijan by 2009 Corporate Governance ROSC report.
- 94. Existing legislation cannot assure effective composition of the Audit Committee and efficiency of its operations.** The Law on Internal Audit requires entities to establish Audit Committees, without specifying committee membership requirements, which leads to

³⁹ The Civil Code of the Azerbaijan Republic, art.107-11. In LLCs, establishment of a revision commission is regulated by the art. 91-3 of the Civil Code of the Azerbaijan Republic. In LLCs, members of the supervisory or management board cannot be members of a revision commission.

companies having an audit committee without having a supervisory board. The Law on Internal Audit makes no reference to the make up or level of the committee nor does it establish any independence requirement criteria for its members. In April 2017, amendments were introduced to the Civil Code introducing mandatory establishment of audit committee in the JSCs with more than 50 shareholders and those meeting the criteria of the PIEs. However, the wording of the relevant provisions prevents presence of the supervisory board members on the audit committee.⁴⁰ This step introduces the change, but does not assure competence and independence of an audit committee, which should comprise only of the board members, with majority of independent board members.

Areas for Consideration: SOE Supervisory Boards

95. Changing the way state ownership is exercised will improve corporate governance arrangements at the Government and SOE level. Below are areas for consideration to address major risks and gaps in SOE corporate governance practices in Azerbaijan, with a few accompanying suggestions:

-  **Legislatively empower SOE boards with the authority and autonomy to determine SOE performance strategic objectives and monitor SOE performance.** Eventually, SOE boards should possess autonomy and authority to guide the strategic direction of SOEs. There is a need to develop clear requirements for SOE boards, defining and authorizing them with any necessary legislative authority, and establishing competence and objectivity requirements to facilitate strategic guidance and monitoring of SOE management. The reform process could be complemented by relevant awareness raising among SOE supervisory board members and relevant stakeholders.
-  **Nomination and appointment process of state representatives to SOE supervisory boards must clear and transparent.** The mechanisms and procedures for selection, nomination and appointment of SOE board members needs to be streamlined, clearly defining qualification, procedures of selection, nomination, appointment and dismissal of state representatives, and disclosure of relevant information about appointments.
-  **Introducing more balanced supervisory boards in SOEs by gradually reducing the presence of civil servants and increasing the number of qualified independent board members.** The Government may consider appointing skilled and experienced independent board members to the leading SOEs. Independent board members may be drawn from various private sector entities, including but not limited to commercial banks, leading accounting and audit firms, privately owned or joint ventures industry leaders.

⁴⁰ The Civil Code of the Azerbaijan Republic, art. 107-12.

- ✚ **The Government will need to establish clearly defined selection criteria for potential supervisory board members at SOEs.** The preference should be given to candidates with relevant industry expertise, knowledge and understanding of financial statements, strategy setting, risk management and internal controls, and with a proven ability to exercise independent and objective judgement.
- ✚ **Establishing effective supervisory board committees is advised to support SOEs supervisory boards in taking well-informed and considered decisions.** A priority would be for audit committees to assist supervisory boards in performing oversight of financial reporting, internal control and risk management systems, internal and external auditors, as well as compliance. Other committees could be established depending on the needs of individual SOEs.
- ✚ **Board committees should comprise only supervisory board members with appropriate skills and experience, including the sufficient presence and participation of independent board members.** The committees could seek specialized advice from external advisors or consultants as necessary. Issues related to the composition, authority and working procedures of the Committees should be reflected in the relevant internal documents of the SOEs (Charter, By-Laws on the Supervisory Board or even a separate Regulation of the relevant Committee).
- ✚ **Enhance capacity and build skills set of existing and potential state representative to the SOE boards, providing necessary training, peer exchange and learning opportunities.** This step will help to build human capacity and expertise building on the existing training programs and mechanisms of the State Representatives to SOE boards. These training programs will need to include good corporate governance practices, reference to strategy and SOE oversight, as well as information on the importance of the supervisory board and its role and responsibilities, benefits and values that properly functioning supervisory boards can bring to SOEs.
- ✚ **Before or during the reform process, the largest Azerbaijani SOEs may be requested to follow the 2011 Corporate Governance Standards.** This step would allow for gradual implementation of the SOE reform and establish initial procedures and practices in good corporate governance among SOEs.

CHAPTER 4: PERFORMANCE MONITORING

Key Objectives of Performance Monitoring

- 96. Historically, SOEs in most countries perform worse than their private sector peers.** This trend is similar across different jurisdictions and sectors of the economy. The reasons vary from country to country, but are summarized in three main weaknesses of a state as the owner: (1) setting unclear or conflicting goals for SOEs; (2) appointing directors that lack commercial or industry expertise to SOE boards; and (3) lack of strong monitoring of SOE performance and adherence to the financial and non-financial objectives set by the owner.
- 97. Countries use various forms of performance-monitoring systems to monitor the financial and non-financial performance of SOEs.** Addressing a trend of historically weak performance of SOEs, many governments have initiated reforms aimed at raising accountability. These measures are particularly aimed at clarification of SOEs' financial and non-financial objectives, measuring performance against quantifiable targets and publishing this information for open access by all interested stakeholders. A performance monitoring system usually involves three key elements: (i) setting mandates, strategies, and objectives for SOE; (ii) structuring reporting framework or performance agreements between SOE and government to monitor each SOE performance; and (iii) developing key performance indicators and targets. The purpose of the performance monitoring framework is to ensure management's accountability in meeting financial and nonfinancial benchmarks. Assessing SOE performance is central to determining their effectiveness in meeting set objectives. While retaining SOE ownership may be beneficial to budgets, it could also lead to significant costs, if entities are loss making and are run inefficiently.
- 98. OECD Guidelines summarize the aspirational practices in SOE performance monitoring and management.** These include the state's responsibilities as an owner to:
- Set and monitor the implementation of broad mandates and objectives for SOEs, including financial targets, capital structure objectives and risk tolerance levels;
 - Establish reporting systems that allow the ownership entity to regularly monitor, audit and assess SOE performance, and oversee and monitor their compliance with applicable corporate governance standards.
 - Support proper incentives for SOE boards through a clear remuneration policy that fosters the long- and medium-term interest of the enterprise and can attract and motivate qualified professionals.

99. Effective and timely performance monitoring is a key ownership function of a business owner. Strong performance monitoring practices establish clear objectives and financial targets for a company, and formalize owners' expectations. The practice of establishing and monitoring financial and non-financial indicators has long been employed by private businesses in all sectors of the economy. Transparency of operations and accountability of directors and managers of SOEs are especially important as their ultimate owners are the citizens of a state. To achieve good corporate governance and financial sustainability of SOEs, it is necessary not only to publish clear objectives for SOEs and their managers, but also periodically to assess progress towards these performance objectives and hold respective managers accountable.

100. The aim of performance monitoring is to ensure that SOEs are moving in the right direction and progressing towards the objectives set for them. As set out in Chapter II of the OECD Guidelines, *"the state should act as an informed and active owner, ensuring that the governance of SOEs is carried out in a transparent and accountable manner, with a high degree of professionalism and effectiveness"*. Whether performance evaluation amounts to performance management largely depends on the extent to which the results influence management incentives and sanctions (i.e. reappointment, dismissal and remuneration of the top executives).

Management's Role and Accountability

101. A solid performance monitoring system sets clear objectives and targets that spell out government's expectations to the SOE boards and management. The government, as a shareholder, is obliged to manage its investments in SOEs efficiently and is accountable before taxpayers of the country. Hence, the government must ensure that boards are properly staffed with able professionals and given broad mandates to oversee and incentivize management, but must also ensure their performance is rigorously and effectively monitored. Without this, management and boards may take SOEs in directions that are not in their best interest or outside the agreed core business.

102. To increase incentives for SOEs to stay on track with the objectives, many governments integrate the results of performance management into performance-based contracts for SOE executives. In most countries with a performance evaluation framework, the results have some influence on executive remuneration. The OECD Guidelines underline the board's role in overseeing SOE performance monitoring, *"the boards of SOEs should be assigned a clear mandate and ultimate responsibility for the enterprise's performance."* Specific performance contracts established by governments and SOEs have different names

in different countries, sometimes reflecting their different form or legal status. Examples include statements of corporate intent, performance contracts, memorandums of understanding (MOUs), statements of expectations, shareholders' letters, letters of agreement, and business plans (see Annex VII for an example from New Zealand). However, the performance contracts are recommended for countries with strong boards and ownership entities and are less recommended in the initial stages of institutionalizing performance management, especially in countries with weak or developing boards.

103. Many countries still do not have formalized performance contracts, but have some form of performance evaluation system for SOEs undertaken by the ownership or coordinating agency on a yearly basis. It is essential that the system is robust, streamlined, based on proper data collection and benchmarking process resulting in setting right indicators and their proper monitoring (see Annex VII an example from Malaysia).

104. One well-established performance management framework is the “balanced scorecard”. Created by Drs. Robert Kaplan (Harvard Business School) and David Norton it is essentially a list of key performance indicators useful for monitoring company performance. The balanced scorecard adds strategic non-financial performance measures to traditional financial metrics and gives managers a better overview of organizational performance. The balance scorecard approach has evolved to a full strategic planning and measurement system. The “new” balance scorecard transforms a company’s strategic plan from a passive document into an operational tool. Balanced scorecards have been successfully used by the Development Bank of South Africa and Canada’s Business Development Bank. Indonesia and Philippines also apply a “balanced scorecard performance measurement” approach.

105. Management remuneration in many countries includes a fixed payment and a variable payment. Remuneration of board members of listed companies is typically composed of three elements: base salary and two types of variable compensation (annual bonus and long-term incentive premiums). A proportion of annual bonuses are increasingly paid as shares, and long-term incentive premiums are almost always in the form of shares. Variable payments are based on the performance of a company, preferably related to key performance indicators. In Australia, the UK, and the US, the variable share may account for 60% or more of total remuneration. In Finland, guidelines on remuneration in SOEs establish that bonuses and other variable payments “should be based on measurable profitability” and that “good performance of executives should be for a long term”, so “the minimum length for determining long-term incentive payments is three years”. Remuneration instructions in Sweden state that SOEs should avoid over-payments but be “wage-leading”. Some countries expressly provide that the amount of wages in SOEs cannot be higher than the market level, although it should be competitive. It also is good practice to introduce

greater transparency to the state's policy by formalizing performance-based pay systems through explicit, published pay scales⁴¹.

- 106. A challenge in creating sound performance frameworks is that SOEs often have commercial and non-commercial objectives** (the reason they are kept in state ownership). The non-financial objectives, mostly of a social or policy character, are associated with certain costs and create competing priorities. They can also be used by managers to obscure poor performance. Therefore, a sound performance monitoring framework should identify financial and non-financial objectives of SOEs, reflected in appropriate targets.⁴²

Developing and Enforcing Performance Indicators and Targets

- 107. The first step in setting up an SOE performance monitoring system is to formulate and document each SOE's mandate and strategy.** Clear definition of the mandate and objectives of each SOE is necessary to establish the basis for the company's accountability, determining the scope of public services or other special obligations, and formulating more specific targets for company's operations.
- 108. Non-commercial objectives of SOEs, should be clearly documented in the SOE's mandate, properly disclosing costs associated with such social commitments or public obligations, and indicating respective funding sources.** A prerequisite for successfully implementing performance monitoring is clarity on the commercial and non-commercial goals of SOEs. For this it is essential to take explicit account of the costs of the non-economic objectives, such as the delivery of certain public services or fulfilling social responsibilities. This separation of objectives will provide the state and the public with an understanding of the cost of meeting social objectives.
- 109. A high degree of transparency is separate reporting on commercial and non-commercial objectives and related costs of SOEs financing public obligations.** This analysis and presentation allow the owner to assess SOE progress in meeting its commercial objectives in a clear way. Failure to set the strategies and objectives for each SOE in a clear manner may lead to ambiguities in subsequent monitoring of SOE performance.

⁴¹ Overview of SOE Performance Evaluation and Management in Asia, 2016

⁴² Corporate Governance of State-Owned Enterprises, a Toolkit, World Bank Group 2014

110. It is important to strike a balance on the number and importance of performance indicators. They should be tailored to capture the main dimensions of SOE performance and be tied to SOE strategy and objectives reflecting the nature of business, as well as government’s priorities. Keeping to a manageable number of trackable indicators (around 15 is good practice) allows SOEs to focus on key areas and minimize administrative resources needed for collecting and processing data. Requiring too many performance indicators places a burden on both the SOE to produce them and on the SOE ownership entity, which may have limited capacity to analyze them. Figure M below has several examples of KPIs.

Figure M: Examples of performance evaluation indicators used in Asia

	Quantitative	Qualitative
Financial	<ul style="list-style-type: none"> • Net interest margin (Bhutan) • Economic value added (China) • Net profit (India) • Financial ratios (Indonesia) • Labor productivity (Korea) • Return on investment (Philippines) 	<ul style="list-style-type: none"> • “Policy directed activities” (Bhutan) • Quality of risk management (Indonesia) • Transparency of budgetary practices (Korea)
Non-financial	<ul style="list-style-type: none"> • Customer satisfaction index (Bhutan) • Number of new products (China) • Project cost overrun (India) • Number of corporate events (India) • Achievement of “core business targets” (Korea) • Percentage of beneficiaries served (Philippines) 	<ul style="list-style-type: none"> • Quality of corporate governance (Bhutan) • Commitment to corporate social responsibility (India) • Timely submission of reports to regulators (Indonesia) • Development of a gender equality policy (Korea) • Certifications indicating compliance with international standards (Philippines)

Source: State-Owned Enterprises in Asia: National Practices for Performance Evaluation and Management 2016

111. Performance indicators should also include non-financial indicators to evaluate various aspects of SOEs operations and provide a broader perspective on SOE’s performance. For instance, these may include: customer satisfaction, service quality, market share, service availability (in electricity or other utilities), environmental compliance, research & development, employee safety etc.

112. An important element of performance monitoring is sector/ industry benchmarking. KPIs comparison and benchmarking allows to identify respective gaps and areas for improvement for a company. Ownership entities should strive to benchmark SOE performance with appropriate peers, domestic or foreign.

Managing Performance of State Owned Enterprises

- 113. Performance monitoring is usually carried out by SOE ownership entities and/ or by SOE boards.** In Singapore, for example, performance evaluations of individual companies are conducted by their respective boards, whereas in Indonesia, the Ministry of State-Owned Enterprises develops an evaluation manual with clear quantitative indicators against which to conduct SOE performance evaluation. These evaluations are undertaken by assessors from SOE boards before being ultimately submitted to the Ministry of State-Owned Enterprises.
- 114. Preparation of a business plan is an important element of good management and governance.** A business plan helps the board clarify an entity's business objectives; identify potential problems; set out the performance expectations by period; and measure the actual progress of SOEs. It supports the effective management of an entity and is a source of key information for the owner. It is important that the boards, when established in large SOEs and the ownership agency, when and if established are involved in the preparation of SOE business plans and can provide input or comments to these documents on an ongoing basis.
- 115. SOEs performance against the agreed objectives and targets as set out in the performance agreement or business plans should be regularly monitored.** Monitoring of SOE performance against the agreed objectives and targets set out in the performance agreement is typically undertaken on an annual basis, but more frequent monitoring may be established for important or strategic SOEs. The monitoring process can be streamlined by requiring SOEs to provide standard-form financial and non-financial data. More sophisticated systems can facilitate data analysis by identifying trends, producing cross-sector or intertemporal analysis, and generating aggregate reports.
- 116. To review performance effectively, the ownership entity must ensure that it has access to timely and relevant information regularly.** Timely reporting reduces a risk of unpleasant surprises and allows the ownership entity more time to take necessary measures to ensure that they not only achieve their stated objectives in an efficient, effective and socially responsible way, but that they deliver on wider societal outcomes that create value for the public. The ownership entity should monitor the SOE performance not only annually, but also on an ongoing basis,⁴³ analyzing results and introducing necessary adjustments over time as experience and capacity increase (see Figure N).

⁴³ Accountability and Transparency, A guide for State Ownership, OECD 2010

Figure N: SOE Performance Monitoring Cycle



SOE Performance Monitoring in Azerbaijan

- 117. Azerbaijan should consider developing SOE performance monitoring system.** SOE ownership functions, supervision, and monitoring of SOE performance are dispersed across several agencies and line ministries. Currently, SOEs prepare and agree their business plans with the Ministry of Economy and the Ministry of Finance. Other agencies involved in the governance of SOEs, including line ministries and SCPI are not currently involved in this important process.
- 118. The recent introduction of several institutional and legislative changes can, if implemented and enforced properly, produce tangible results for SOE governance and their improved accountability.** In September 2016, the President of Azerbaijan issued an order “On Additional Measures with Regards to Increasing Efficiency of Activities of Legal Entities with Controlling Block of Shares Owned by the State”, requesting concerned governmental agencies to take necessary steps in increasing efficiency of SOEs. One of the measures is a Procedure for Efficiency Assessment of the Legal Entities with Controlling Block of Shares Owned by the State. While not yet adopted, and although it is not a comprehensive tool for performance monitoring, it can be regarded as the first step towards improvement of SOE efficiency. Another measure instituted by the Cabinet of Ministers Resolution #534, is establishing a commission to review and evaluate projects of upcoming year’s income and




expenditure estimates of 14 largest SOEs and monitor their annual execution. The commission mainly comprises of ministers of economic sector ministries and is chaired by the Deputy Prime Minister⁴⁴. Review of SOE performance at such a high level will improve their accountability, however a system where estimates are based on clear mandates, strategies, and objectives set for each SOE would be better.

119. Remuneration of SOE management in Azerbaijan is not linked to performance.

Linking executive remuneration to actual performance provides a strong incentive for strong performance. The President of Azerbaijan's order "On Additional Measures with Regards to Increasing Efficiency of Activities of Legal Entities with Controlling Block of Shares Owned by the State" also introduces a bonus system for the governing bodies of SOEs. This does not, however, differentiate between remuneration of management and of the supervisory board and is not presented in a holistic manner dealing with both base wages and bonuses, and would therefore benefit from streamlining. Linking compensation of the supervisory board to company performance may create a potential conflict of interest vis-a-vis company's management so good international practice is to compensate the supervisory board in a fixed manner against clear objectives.

Areas for Consideration: SOEs Performance Monitoring

120. The Government of Azerbaijan may consider implementing SOE performance monitoring systems, which should connect SOE management remuneration to growth in shareholder value of SOEs. All SOEs, regardless of legal form, should aim to maximize value for the state and the public, and as such, should be evaluated on a uniform basis. An effective system of performance monitoring should be considered and developed to discourage poor performance by SOE management through clear definition and enforcement of rewards and consequences for SOE managers and line ministries.

-  Azerbaijan has taken first steps in developing SOE performance monitoring framework. It is important, however, to introduce centralized SOEs performance monitoring under a single Government agency or body.
-  The SOE ownership entity/ agency should be involved and directly responsible for performance monitoring of SOEs together with the SOE supervisory board.
-  The ownership unit should perform periodic (at least yearly) review of each SOE's performance.

⁴⁴ Resolution of the Cabinet of Ministers of the Republic of Azerbaijan #534 of on December 30, 2016

- ✚ Key financial and non-financial performance indicators and targets should be linked to the entity's strategy and objectives to measure and evaluate results.
- ✚ A transparent system of incentives for the executive management of the SOEs could be created linking company performance with remuneration; and potential sanctioning could be considered (i.e. dismissal, reappointment).
- ✚ Linking compensation of the supervisory board to company performance may create a potential conflict of interest vis-a-vis company's management, good international practice suggests compensating the supervisory board in a fixed manner against clear objectives.
- ✚ Performance results and evaluations for individual SOE's, and aggregate reports on overall performance of the SOE sector, could be compiled and published in public domains to offer better accountability of SOE boards and management.
- ✚ Performance agreements in Azerbaijan could be implemented at a later stage, considering the critical contextual factors. In the long term, Azerbaijan may consider entering into individual performance agreements with large SOEs, but international experience suggests that their effective implementation is a complex process that takes time and strong support from various stakeholders. It is therefore recommended to first set up a sound but simple performance monitoring framework and only later consider switching to performance agreements.

CHAPTER 5: FINANCIAL ACCOUNTABILITY, CONTROLS AND TRANSPARENCY

SOE Financial Reporting

- 121. The OECD Guidelines recommend that SOEs should observe high standards of transparency and be subject to the same high-quality accounting, disclosure, compliance, and auditing standards as listed companies.** Each country may choose to apply their own tailor-made standards on transparency, disclosure, and controls to reflect local needs. However, this can involve significant costs in their initial design, updates in response to changes in the business environment, and educating those responsible for implementing and using them.
- 122. Adopting international standards allows comparability of financial information across countries and sectors, as well as reduces adoption costs.** It also prevents lack of local capacity from leading to lower-quality national standards. The main international standards include International Financial Reporting Standards/IFRS for SMEs; International Standards for the Professional Practice of Internal Auditing; International Standards on Auditing; International Standards for Supreme Audit Institutions; Principles of Corporate Governance; SOE Corporate Governance Guidelines; and the Sustainability Reporting Guidelines.

Figure O: OECD Guidelines on Disclosures

State-owned enterprises should disclose material information on all matters described in the OECD's Principles of Corporate Governance, focusing on areas of significant concern for the state as owner and the public, namely:

- A clear statement to the public of the company's objectives and their fulfillment;
- Costs and funding arrangements pertaining public policy objectives, where relevant;
- The ownership and voting structure of the company;
- Board member qualifications, selection and remuneration, including remuneration of key executives;
- Any material risk factors and measures taken to manage such risks;
- Any financial assistance, including guarantees, received from the state and commitments made on behalf of the SOE;
- Any material transactions with related entities.

Source: OECD Guidelines 2015

Audit Committees and External Auditors

123. Effective audit committees are essential for transparent operations by SOEs. The OECD Guidelines encourage the formation of audit committees and suggest that large SOEs should be required to have an audit committee or equivalent body with powers to meet with any officer of the enterprise. To ensure efficiency, board committees should include qualified and competent financially literate members with adequate technical expertise. Good practice suggests audit committee members should be independent. The establishment of an audit committee by PIEs is compulsory in EU countries.

124. In OECD countries, SOEs' financial statements are audited by an external independent audit firm. It is critical that financial information and respective key performance indicators are regularly audited to ensure quality and reliability. SOEs financial performance and respective key performance indicators must be based on sound audited financial information. In some cases, the independent audit is conducted by the country's Supreme Audit Institution, but more often SAls audit parastatals and budget institutions. Governments may also implement external control procedures in addition to the independent external audit. In the case of parastatals, Supreme Audit Institutions normally have the authority to carry out performance audits in addition to the audit of the financial statements.

125. It is good practice for external auditors to be recommended by an audit committee of the board, and to be appointed either by that committee or by shareholders directly. This ensures that management is not significantly involved in decision making for the appointment or dismissal of auditors. In addition to qualification and competence, one essential consideration is independence of auditors. Independence refers to the way the external auditors are appointed and to whom they report. Auditors should be accountable to the shareholders via boards and not to the management with whom they work⁴⁵.

⁴⁵ Transparency and Accountability, A Guide for State Ownership, OECD, 2010

Public Availability of Financial Statements and Aggregated Data on SOEs

126. Financial transparency is enhanced through regular, open aggregate reporting. The OECD Guidelines provide several recommendations concerning transparency including the publication of aggregate reports by the ownership entity via web-based communications to facilitate access by the public. The aggregate reporting should be the key disclosure tool directed to the public. Aggregate reports serve a few objectives some of which are internal and some external. As recommended by the OECD Guidelines, the best way to foster public transparency and communicate aggregate reporting is through development of a robust website and ensuring continuous renewal of its content⁴⁶. Web based communication can also be used to provide interim updates to the public between publication of annual aggregated reports. Reports should provide at least an indication of the total value of the state's portfolio and include a general statement on the state's ownership policy and its implementation methods. Aggregate reporting should not duplicate the existing reporting requirements, and could include individual reporting on the most significant SOEs. Development of aggregate reporting requires a certain capacity of analysis from the governmental body in charge, ideally the ownership entity.

127. Aggregate reporting on Azerbaijan's SOE sector is not available. The Government does not publish SOEs aggregate information, nor was there sufficient available information on industries in which SOEs operate and their approximate contribution to total revenues in that industry.

Financial accountability, Controls and Transparency in Azerbaijan

128. Financial reporting and accounting requirements for all entities in Azerbaijan, including SOEs, are primarily regulated by the Accounting Law⁴⁷. The law specifies how entities should maintain their accounting books and records, the financial reporting standards applicable for preparation of financial statements, as well as related governance and transparency arrangements.

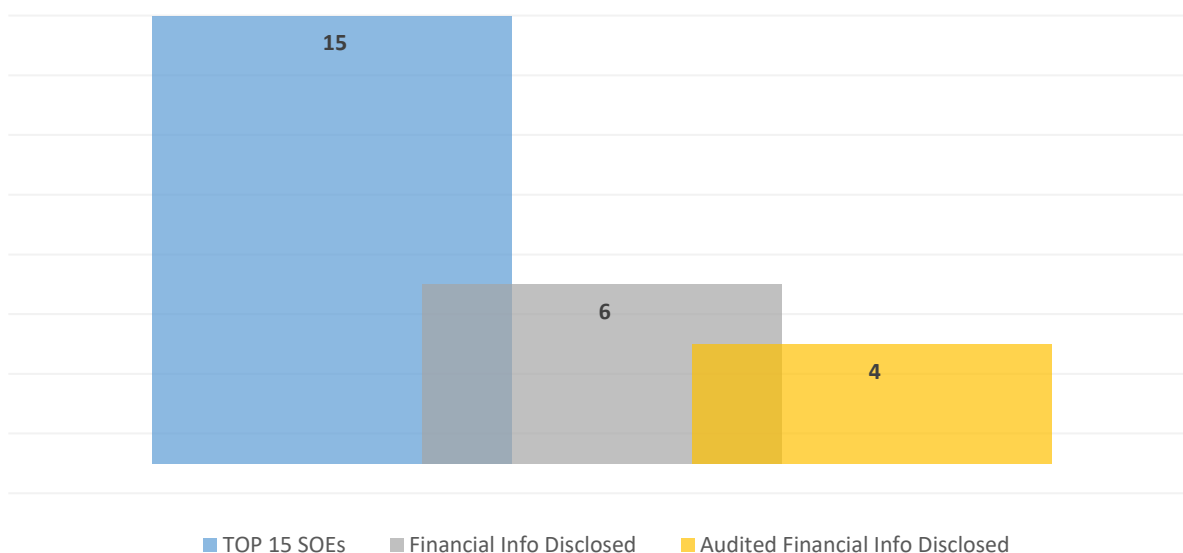
⁴⁶ Transparency and Accountability, A Guide for State Ownership, OECD, 2010

⁴⁷ Accounting Law, 2004

129. Fourteen large SOEs in Azerbaijan are classified as PIEs⁴⁸, and are therefore subject to International Financial Reporting Standards (IFRS). PIEs in Azerbaijan are defined as “credit organizations, insurance companies, investment funds, non-state (private) social funds, legal entities with securities traded on the stock exchange, and commercial organizations that on the date the financial statements are prepared, exceed two of the thresholds (for annual revenue, average number of employees during the financial year and total balance sheet)”⁴⁹. Simplified Accounting Rules for Subjects of Small Entrepreneurship are required for small enterprises, and National Accounting Standards (NAS) apply to all other SOEs. NAS are based on IFRS but the level of disclosures required under NAS is less demanding than under IFRS.

130. Requirements for the consolidated financial statements of corporate entities, including SOEs, are clearly stated but practices vary. The legal basis for transparency of financial information and its availability to users, including rules for their submission and publication, is in place⁵⁰. Figure P below illustrates the transparency of 15 significant SOEs in Azerbaijan⁵¹. It shows that only six largest SOEs make their financial information publicly available, and only four out of 15 significant SOEs are fully compliant with national transparency and disclosure legislation and market expectations.

Figure P: Azerbaijan’s Top 15 SOEs Transparency Illustration



Source: WB staff analysis

⁴⁸ Resolution #321 of Cabinet of Ministers of Azerbaijan, 2014

⁴⁹ Accounting Law, 2004

⁵⁰ Civil Code of Azerbaijan, Article 99.2 and 100.3; the Law of the Republic of Azerbaijan "On Audit Activity", the Law of the Republic of Azerbaijan "On Accounting".

⁵¹ Azerbaijan monitors TOP 20 SOEs for various purposes, as disclosed in the Annex I of the Technical Note. Out of TOP 20 – 5 belong to financial sector: banks, insurance and leasing companies, and are not included in Figure A.

131. Information on SOEs financial reporting is not publicly available. 18 out of 20 largest SOEs are required to prepare IFRS based financial statements and some non-PIE SOEs prepare IFRS based financial statements at the request of investors and/or creditors. It seems, however, that in practice day-to-day accounting is widely based on NAS, and IFRS-based financial statements for SOEs are often prepared by auditors, which represents a threat to their independence. Such financial statements are not always published.

132. Azerbaijan has not fully adopted a legal framework on high-quality international standards used by many countries. The government of Azerbaijan seems to be aware of discrepancies in the SOE accounting and disclosure practices. An action plan was developed⁵² as part of implementation of the Presidential Decree⁵³ on Improving Efficiency of State Enterprises, with the aim to, inter alia, align accounting practices of large SOEs with international standards (summarized in figure Q below) and foster public disclosure of audited annual and consolidated financial statements.

Figure Q: Main International Standards on Transparency, Disclosure, and Controls

Topic	International Standard	Standard setter	Current status in Azerbaijan
Financial reporting	International Financial Reporting Standards (IFRS); the IFRS for SMEs	International Accounting Standards Board	IFRS are mandatory only for PIEs The IFRS for SMEs not adopted in Azerbaijan
Internal audit	International Standards for the Professional Practice of Internal Auditing	Institute of Internal Auditors	The Internal Audit Standards adopted in Azerbaijan
Internal control and risk management	COSO Internal Control–Integrated Framework	Committee of Sponsoring Organizations of the Treadway Commission	Not required in Azerbaijan
External audit	International Standards on Auditing	International Auditing and Assurance Standards Board	ISAs are mandatory for all audits
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⁵² Cabinet of Minister's Decree No. 636 of December 1, 2016

⁵³ Presidential Decree No. 1003 of July 19, 2016

	International Standards for Supreme Audit Institutions (INTOSAI)	International Organization of Supreme Audit Institutions	Not adopted in Azerbaijan
Corporate governance	Principles of Corporate Governance SOE Corporate Governance Guidelines	OECD	Partially transposed in the voluntary Corporate Governance Standards (2011) ⁵⁴

133. The Law on Accounting requires the financial statements of PIEs and commercial entities receiving public funds to be audited. This requirement seems to cover most SOEs. International Auditing Standards became mandatory in 2010 for all audits by decision of the Chamber of Auditors. The Civil Code requires that the published financial statements and annual report should be audited by independent external auditors. However, there is no legal restriction on receiving non-audit services from external auditors, nor there is any requirement on disclosing of any information on provision of such services. Auditors are currently selected by means of state tendering procedure with little or no involvement of the board, which do not exist in most of the SOEs.

134. Public availability of financial statements in Azerbaijan SOEs is lagging, which is out of line with legal requirements and market expectations on transparency and disclosure. Transparency is hampered by a lack of enforcement of the requirement for entities subject to statutory audit, including SOEs, to publish financial statements on corporate websites. Legislation requires JSCs to publish their financial statements, but this happens only rarely. Few of the major SOEs publish their audited financial statements and when they do, only limited financial information is disclosed. All SOEs are expected to provide an accurate picture of the enterprise's strategy and operations, but this information is limited and not disclosed by SOEs. Financial statements and management reports are not publicly available and difficult to obtain.

135. 16 out of top 20 SOEs in Azerbaijan are JSCs and are required to produce annual reports. The content of the annual report is not specified in the legislation, leading to limited disclosure of both, financial and non-financial information in Azerbaijan SOEs⁵⁵. Failure to publish financial reports is subject to fines, but this mechanism is not effective to deter




⁵⁴ Corporate Governance Guidelines for State-Owned Enterprises are currently being developed by the Ministry of Economy.

⁵⁵ Civil Code of Azerbaijan, Article 99.2 and 100.3, the Law of the Republic of Azerbaijan "On Audit Activity", the Law of the Republic of Azerbaijan "On Accounting".

breaches⁵⁶. The Law on Accounting is silent on a timeframe for publication of financial statements, increasing the potential for publication of outdated information and making enforcement problematic.

- 136. Non-financial sector SOEs do not have audit committees, even though large SOEs representing PIEs and OJSCs⁵⁷ are legally required to set up one.** 2017 changes introduced into the Civil Code require that audit committees are established, but they are not required to comprise of board members. JSCs with more than fifty shareholders are also required to establish revision commissions, a remnant of Soviet legislation. Absence of proper audit committees leads to insufficient review of SOEs financial statements, monitoring of internal controls effectiveness and risk management systems, as well as does not allow for a proper dialogue with independent auditors. The control environment is compromised by the absence of a direct reporting relationship between the internal auditor and independent board members. The internal auditors should work on behalf of, and report directly to, the board and the audit committee comprised by its members.




Areas for Consideration: Financial Accountability, Controls and Transparency

-  **The state-owned enterprises need to implement good corporate governance practices.** In addition to the continuous improvement of the statutory framework, existing legislation must be enforced and implemented by means of clear and coordinated measures for SOEs operating in the most strategic areas of Azerbaijani economy.
-  **The Government needs to perform a gap analysis and preparation of detailed accounting reform implementation plan for the top 20 SOEs.** The implementation plan should include a sequence of enforcement measures to improve financial reporting and disclosure by SOEs, supplemented by training and technical assistance, information system installation/upgrade, additional budget requirements, etc. SOEs' management and the Government should further act upon these plans, using internal and/or external resources as appropriate. Detailed plans for embedding IFRS in SOEs and enforcing its use should be part of the implementation plan.
-  **Detailed instructions for the application of accounting standards and preparation of specific disclosures to be included in SOEs financial statements need to be developed.**

⁵⁶ Corporate Governance in Transition Economies, Azerbaijan Country Report, May 2016, European Bank for Reconstruction and Development

⁵⁷ Since Civil Code amendments of May 2017.

Disclosures should be required to be comprehensive and transparent, providing sufficient information on the relationships between SOEs and the Government, including the amount of subsidies paid and received, profit remittance information, dividends declared and paid, reconciliation of payables, and receivables, etc.

-  **Enforcement of publication requirements is critical and should be pursued.** Audited financial statements, management reports, non-financial information must be publicly disclosed on corporate websites by SOEs.
-  **Improve the system for scrutinizing financial reporting by SOEs to ensure that audits are undertaken and audited financial information is used for aggregate reporting.** Considering the current opacity of the SOE sector in Azerbaijan, it is highly recommended that a state agency be designated to prepare and publish regular aggregate reports and enforce public availability of financial statements.
-  **Take initial steps to develop an SOE aggregate report.** This includes: (a) setting-up a database (see recommendation on performance monitoring) of SOE financial and non-financial information to be aggregated and consolidated, (b) benchmarking aggregate reporting on SOEs to good international comparators and identify missing quantitative and qualitative information, (c) compiling aggregate analysis of SOEs data in a comprehensive manner.

CHAPTER 6: AREAS FOR CONSIDERATION AND PRIORITY ACTIONS FOR SOE REFORM

Main Observations and Challenges of SOE Reform in Azerbaijan

- 137. State ownership is an integral element of many countries' economic strategies, including Azerbaijan.** Strategic and largest companies around the world will remain in state ownership for years to come. Given this reality it is important for governments to tackle problems associated with SOE governance, performance and management. The key challenges for Azerbaijan were identified in this Technical Note and are presented below.
- 138. Implementation of structural SOE reforms has become even more critical given the volatility of the oil price over the past years.** To expand the economy's potential, the Government of Azerbaijan will need to devote significant efforts to improve governance, reduce the costs of doing business, and remove barriers to competition, including establishing level-playing field for privately and state-owned companies.
- 139. SOE ownership is rooted in the history of Azerbaijan and its SOEs are important economically and socially.** They are active in many key sectors, deliver essential public services, and are significant employers. This Note aims to contribute to the Government of Azerbaijan's efforts to improve its ownership and corporate governance of the sector by highlighting areas not currently in line with OECD guidance or international good practice examples.
- 140. The ultimate purpose of state ownership is to maximize value for society through an efficient allocation of the resources, which is not formulated in the SOE Ownership Policy in Azerbaijan.** Each country should determine its own SOE ownership policy based on governmental priorities, economic needs, and SOEs profile. The objectives of state ownership are not clearly defined in Azerbaijani legislation, and information about SOEs management, governance, financial performance is hard to find and generally not publicly available.
- 141. The existing statutory framework for SOE ownership, oversight and operation is fragmented.** While Azerbaijan has made initial steps to modernize SOE governance and management, such as corporatization of many state-owned enterprises as joint stock companies, the existing corporate governance framework and practices deviate from internationally accepted good practice. The current division of roles and responsibilities of the various stakeholders involved in corporate management and oversight of SOEs remains

blurred and exposes enterprises to competing, and at times contradictory political, commercial and financial objectives. This generates two effects: it dilutes stakeholder accountability and negatively impacts SOE performance.

142. Azerbaijan relies on a decentralized SOE ownership model, which dilutes the ownership function and creates potential conflicts of interest in competitive sectors.

Decentralized model is a legacy of the Soviet system and is typical in the ECA region, where many countries share similar economic past. Decentralized model gives most ownership functions to the line ministries, including setting policies and objectives, as well as appointment of board member and CEOs. The line ministries act simultaneously as owners, policy makers, and regulators of the SOEs under their respective portfolios. These dual responsibilities dilute the ownership function and create potential conflicts of interest in competitive sectors. In markets where SOEs have private competitors, this can create disadvantages for private sector companies or lead to allegations of bias in regulatory or enforcement decisions in favor of SOEs.

143. SOE monitoring and supervision functions are scattered across different Government agencies undermining SOEs accountability.

Line ministries have the greatest responsibility for exercising the state's ownership rights but other agencies, including the Cabinet of Ministers, the State Committee on Property Issues, Ministry of Finance, and Ministry of Economy, may also control shares in SOEs and exercise their ownership rights. These bodies carry different functions and do not have established communication channels allowing them to streamline their supervision mandate, reducing SOE accountability. Gradual transition to an advisory or centralized model would allow for greater focus and professionalism in the state's ownership role.

144. SOE supervisory boards in Azerbaijan are not active in terms of strategy-setting, appointing and removing management, deciding on remuneration, or assuming overall responsibility over the efficiency of internal controls system.

The main expectations from the SOE supervisory boards are only related to exercise of control over SOEs management. The exercise of this control function is weak as the supervisory board members are high-ranking officials, who do not have enough time to devote to their board duties and often exercise their authority through their subordinates.

145. SOEs other than those in financial sector do not have supervisory boards.

Supervisory boards and respective board committees remain to be voluntary in Azerbaijan, thus, are not implemented by SOEs. Boards play a central role providing strategic advice while ensuring management discharge their responsibility in the best interests of the state as owner and the enterprise itself. An important aspect of professionalizing boards is to ensure that Directors have appropriate financial competencies and/or industry expertise.

- 146. SOE supervisory boards do not have independent directors.** SOE boards include civil servants, political, and stakeholder representatives with limited commercial or financial knowledge. Often these representatives possess limited experience or may lack understanding of SOE sector matters, reducing their ability to monitor management or provide strategic guidance. Staffing a board with unsuited directors can also compromise the board's objectivity and independence, leaving it beholden to individual politicians and government officials and unable to act in the SOE's best interests.
- 147. Board committees are rare at SOE supervisory boards in Azerbaijan.** Board committees are not required under the Civil Code. The Law on Internal Audit provides for an establishment of a revision commission, mandatory for entities with more than fifty shareholders. Largest SOEs have only a single 100% shareholder – the State – therefore, they are not subject to this requirement. Other committees are not required, though, recommended by the voluntary Corporate Governance Code of 2011.
- 148. Financial information on SOEs, including largest SOEs in Azerbaijan, is fragmented and generally not publicly available for all SOEs.** High quality, reliable information is essential for the Government to lead reforms and take informed decisions. Under existing legislation, SOEs that are also public interest entities (PIEs) are required to prepare their financial statements based on IFRS and publicly disclose such information. In practice, however, information on SOEs is not largely available for all SOEs and only very few of the largest SOEs comply with existing reporting and disclosure requirements. This is out of step with market expectations on transparency and disclosure.
- 149. There are clear financial reporting and accounting requirements for SOEs in Azerbaijan, but practices appear to vary.** Financial statements and management reports are difficult to obtain, undermining the exchange of vital financial data between SOEs and the Government as their owner.
- 150. The State Oil Company of Azerbaijan Republic (SOCAR) is one of the few SOEs that publicly disclose its financial and non-financial information on their corporate website.** This Note does not cover the assessment of SOCAR corporate governance practices or its performance evaluation. However, given its significance to the economy of Azerbaijan, the Government may consider it beneficial to carry out individual corporate governance assessment of SOCAR and identification of specific needs in short- to medium-term.
- 151. Lack of financial information and data flow between SOEs and the Government impacts decision-making by the Government, as an owner of these entities, making it impossible to evaluate SOEs performance and hold management accountable.** Reliable and timely financial information and its disclosure are vital to holding SOEs accountable for their

performance. The Government of Azerbaijan may not be able to process and analyze performance of its respective SOEs, unless the respective mechanism is in place. Such mechanism should establish the financial information flow, its verification by an independent audit, analysis and benchmarking against agreed key performance indicators (KPIs). This mechanism does not currently exist in Azerbaijan.

Suggested Areas for Improvement and Consideration

- 152. The goal of the SOE reform undertaken by the Republic of Azerbaijan should be the enhancement of corporate transparency.** This goal would only be achieved through helping private- and state-owned companies to improve corporate governance practices, building capacity of local institutions on corporate governance services, improving financial reporting and training of respective officer involved in decision making process of SOEs.
- 153. As the country's largest SOE, SOCAR requires a specific approach and its governance should be assessed separately.** Given its significance to the economy of Azerbaijan, the Government may consider it beneficial to carry out individual corporate governance assessment of SOCAR and identification of specific needs in short- to medium-term. In case such assessment is performed, SOCAR would benefit greatly from incorporating the requirements of the Extractive Industries Transparency Initiative⁵⁸ into their operations and reporting structure.
- 154. The impact of SOE reforms could be stronger if relevant legislation on SOE ownership, oversight, corporate governance and operations is consolidated under a single set of Guidelines or Rules.** This step would help focusing the reform framework and implementation path for SOEs in short- and medium-term. The same would be advisable in terms of establishing direction in oversight of SOEs, including appointments of their supervisory board and management, clarifying SOEs reporting lines, financial and social obligations. In medium- and long-term perspective, this strategic approach will help creating a coherent and clear path for implementation and monitoring of SOE governance reforms, improving their accountability, streamlining oversight and decision-making process on the part of the Government.
- 155. The key aim of the SOE corporate governance framework would be to establish the Government's policy directions clear for the public, and to strike the right balance between SOE autonomy and SOE accountability.** Improved corporate governance may significantly

⁵⁸ EITI Requirements: <https://eiti.org/eiti-requirements>

improve SOEs competitiveness, initiate more efficient resource allocation, and improve access to international financial markets, which in turn may increase SOEs contribution to the Azerbaijan economy and enable them to better serve the public's interest.

- 156. Defining the rationale for state ownership in Azerbaijan in a public policy document, as many countries have done, would set out a clear vision of the reasons for state ownership.** This ownership policy should address types of ownership, objectives of ownership in particular areas/ sectors, political accountability, and arrangements for the periodic revision of the ownership policy. The policy needs to communicate key expectations to all stakeholders, including shareholders, boards, management, and the public.
- 157. Clear distinction of the state's roles as an owner, policy maker and regulator needs to be established and formalized.** The aim should be for the state to separate decision-making from ownership responsibilities and act as an engaged and professional owner of its assets, while giving SOEs operational independence. This helps ensure that SOEs can focus on achieving the objectives agreed with government, but insulated from political influence or inappropriate intervention into their operations.
- 158. Ownership model may be re-considered toward a more centralized model professionalizing the SOE ownership function and making it more effective.** Several SOE ownership models may be considered by the Government of Azerbaijan, evaluating risks and benefits, with the aim of moving towards a more centralized SOE ownership function. This would be gradual process and the chosen model could be adjusted and revisited over the medium or longer term as the Government gains momentum and experience with ownership reforms, and SOEs become more efficient and independent with exposure to capital market discipline and oversight.
- 159. Legislatively empower SOE boards with the authority and autonomy to determine SOE performance strategic objectives and monitor SOE performance.** Eventually, SOE boards should possess autonomy and authority to guide the strategic direction of SOEs. There is a need to develop clear requirements for SOE boards, defining and authorizing them with any necessary legislative authority, and establishing competence and objectivity requirements to facilitate strategic guidance and monitoring of SOE management.
- 160. Professionalizing SOE supervisory boards and introducing independent board members should be considered in short- to medium-term.** The Government may evaluate the need to balance the skills set and industry expertise at SOE supervisory boards, gradually reducing presence of civil servants and introducing respective industry experts and independent board members to supervisory boards of the largest SOEs. Such experts and independent board members may be drawn from various private sector entities in

Azerbaijan or abroad, including but not limited to commercial banks, leading accounting and audit firms, privately owned or joint ventures industry leaders.

- 161. Build capacity and skills set of existing and potential State representative to the SOE boards, providing necessary training, peer exchange and learning opportunities.** A key aspect of professionalizing boards is to ensure that board members have appropriate financial competencies and / or industry expertise. To that effect, the Government will need to invest into capacity of existing and future Directors providing them with respective training and establishing clear qualification criteria to serve on SOE Boards. This step will help to build human capacity to professionally act in the best interest of the State as owner and the enterprise itself. Special training programs may be developed and updated to include good corporate governance practices, reference to strategy and SOE oversight, and include larger number of board members.
- 162. The Government of Azerbaijan should evaluate a good international practice of establishing specialized board committees (i.e. Audit, Remuneration, Risk Management).** Modern corporate governance sees a clear role for the Board Chairman, in organizing the work of the board and providing clear leadership, and the introduction of specialized board committees to delegate and oversee specific issues related to audit process and communication with the external auditors, setting and implementing proper remuneration policies, and managing risks at SOEs.
- 163. Assessing SOE performance is central to determining their effectiveness in meeting set objectives.** While SOE ownership generates budget revenues, it can also lead to significant costs if entities are run inefficiently. The planned introduction of several institutional and legislative changes in Azerbaijan can, if structured and enforced properly, produce tangible results for SOE governance and their improved accountability. The key will be to ensure accountability in meeting financial and nonfinancial objectives - measuring performance against quantifiable targets and publishing this information for open access by all interested stakeholders. It may be worth considering introducing some linkage between performance evaluation and executive remuneration.
- 164. To ensure that SOE reforms achieve their ultimate objective in maximizing SOE value for society, SOEs require tools and remuneration policies that appropriately incentivize senior executives.** SOE supervisory boards should have power and authority to design remuneration policies that are competitive with the private sector and contain incentives to achieve financial targets such as an agreed return on equity or profit (or in some cases a loss reduction target in enterprises where significant restructuring may be required). The level of remuneration and incentives for senior executives and the chief

executive should be transparent and fully disclosed in the nonfinancial information in the SOEs annual reports.

165. SOE performance monitoring systems, which connect SOE management remuneration to growth in shareholder value of SOEs, are an effective incentive to improve SOE performance. All SOEs, regardless of legal form, should aim to maximize value for the state and the public, and as such, should be evaluated on a uniform basis. An effective system of performance monitoring should be considered and developed to discourage poor performance by SOE management through clear definition and enforcement of rewards and consequences for SOE managers and line ministries.

166. The Government and public would significantly benefit from improved disclosure and reporting of SOEs financial statements. Even though the existing legislation requires SOEs to report under IFRS and make their financial statements publicly available, this requirement is not applicable to all SOEs and rarely enforced, with only limited number of SOEs complying. Strengthened enforcement of reporting and disclosure of audit and unaudited interim financial information would enable the Government to analyze and evaluate SOEs performance on a timely basis, providing reliable information for decision making.

167. An improved disclosure requirements and greater transparency bring significant benefits to SOEs and public, as their ultimate owners. The reporting of financial and non-financial information are the direct elements of disclosure practices, but equally important are the external audit practices, internal control environment, risk management and internal audit practices. Disclosure of timely, reliable and complete information can increase accountability of the SOEs towards their owners and public at large, and thus encourage improvement of the performance of SOEs through improved governance and enhanced external scrutiny.

168. The Government of Azerbaijan should continue efforts to ensure SOEs observe high standards of transparency and are subject to high quality accounting, disclosure, compliance, and auditing standards. Transparency, currently hampered by a lack of enforcement of the requirement for entities subject to statutory audit, including SOEs, to publish financial statements on corporate websites, needs to be enhanced through regular individual and aggregate reporting.

169. Capacity building will be required across the board to develop an understanding and ability to evaluate the change in SOE ownership, and to make timely and informed decisions. Insufficient capacity may hinder SOE reforms in many countries, and will need to be addressed at all levels: individual SOEs, line ministries, Ministry of Finance, Ministry of Economy, State Committee on Property Issues. Skills and capacity building will need to be

geared towards providing knowledge, tools and mechanisms, which would enable analysts, managers and decision makers to understand the effects of the reform process and empower them to properly react and adjust the reforms as they are being implemented. This step will help to build human capacity and expertise among a critical group of SOE executives and officers in charge of policy making as to SOE ownership and oversight.

170. Effective implementation of the planned reforms will be key in improving SOE corporate governance and accountability. The complex of SOE reform measures will require both significant investment in capacity of the government agencies in charge of the ownership function, and close supervision of the reform process in SOEs and their respective line ministries. This process takes time and should therefore be initiated as soon as feasible. Incentives mechanisms should be considered to encourage and support the change in SOE governance and reporting. Clear definition and assigned ownership roles and functions will empower the Government's to strategically oversee and analyze a holistic picture of SOEs' performance and risks.

171. Among the proposed areas for consideration and reform steps there are many specific recommendations, which deserve immediate attention others are more long term. Reforms in SOEs governance are challenging and it is often difficult to find suitable and feasible solutions. This Note outlines and summarizes the main areas for consideration, all of which contribute to one goal of improved governance and accountability of SOEs. A suggested prioritization of activities and actions for SOE reform is provided below:

Issue	Recommendation	Priority
<i>FUNCTION AND FORM OF STATE OWNERSHIP</i>		
Existing statutory framework for SOE ownership, oversight, and operation in Azerbaijan is incomplete and fragmented	Consider consolidating legislation on SOE ownership, oversight, corporate governance and operations under a single set of Guidelines or Rules.	Short term
Lack of a clear vision of the purpose and objectives of state ownership	Formulate comprehensive SOE Ownership Policy, including types of ownership, objectives of ownership in particular areas/sectors, and political accountability, and ensure periodic revision.	Short term
No public and transparent SOE ownership policy	Develop SOE Ownership Policy in an inclusive and open manner and make the final document public.	Short term

Decentralized ownership model makes coordination and supervision of SOEs fragmented and ineffective	Alternative models for SOE ownership should be considered. These may be further adjusted over the medium or longer term as reforms gain momentum.	Medium term
Human capacity is limited and scattered among various Government agencies involved in SOE oversight	Build capacity and skills set of existing and potential SOE board members and officials involved in SOE oversight, providing necessary training, peer exchange and learning opportunities.	Short- and Medium term
Lack of clear guidelines on management of SOEs	Consider creating harmonized guidance on SOE terms of establishment and operations, including supervisory board and management board appointments, and SOEs reporting lines and obligations.	Medium term
<i>ROLE OF BOARDS AT STATE-OWNED ENTERPRISES</i>		
Civil Code has insufficient detail on supervisory board role and functions. 2011 CG Standards are voluntary, thus, not widely applied by SOEs.	Prior to adoption of new CG guidelines or regulations, SOEs should be required to apply the CG Standards, amending entity charters as necessary.	Short-term
SOEs other than those in financial sector do not have functioning supervisory boards.	Require an establishment of supervisory boards among largest SOEs.	Short-term
Supervisory boards insufficiently active in strategy-setting, appointing, remunerating and removing management boards, or assuming responsibility for efficient internal controls.	Supervisory boards need to be empowered by legislation to properly exercise their functions and act as effective governance bodies.	Medium term
SOE supervisory boards do not have independent board members	Professionalizing SOE supervisory boards and introducing independent board members is needed to introduce proper skills set and industry expertise at SOE supervisory boards, gradually reducing presence of civil servants and introducing respective industry experts and independent board members to supervisory boards of the largest SOEs.	Short- and Medium term

Board committees are rare at SOE supervisory boards in Azerbaijan, as not required under the Civil Code.	<p>Envisage supervisory board committees to support SOEs supervisory boards in taking well-informed and considered decisions i.e. audit committee, compensation committee, other committees depending on the needs of specific SOEs.</p> <p>Consider staffing board committees with board members possessing appropriate skills and experience, preferably headed by independent board members</p>	Medium term
Lack of awareness of the benefits and values that properly functioning supervisory boards can bring to SOEs.	Increase capacity of SOE boards members and Government agencies involved in SOE governance through training and awareness raising activities	Medium term
PERFORMANCE MONITORING		
Lack of linkage of SOE strategy and objectives with performance indicators and targets.	Link key financial and non-financial performance indicators and targets to entity strategy and objectives to measure and evaluate results.	Medium term
Limited enforcement and insufficient monitoring of SOEs performance.	Structure the performance management framework to facilitate periodic (at least yearly) monitoring of SOEs performance by SOE ownership entity or oversight body.	Medium term
No responsibility for SOEs performance monitoring.	Task the ownership entity or oversight body with SOEs performance monitoring and keeping SOEs accountable for results, either directly or via the supervisory board.	Medium term
Management remuneration is insufficiently linked to performance and achievement of objectives.	Legislate transparent system of incentives for SOEs management, linking it to SOEs performance, considering potential sanctioning (dismissal, reappointment).	Medium term
FINANCIAL ACCOUNTABILITY, CONTROLS AND TRANSPARENCY		
Inconsistent compliance by SOEs with accounting and reporting requirements and market expectations on transparency and disclosure.	Enforce application of accounting standards and specify comprehensive and transparent disclosures to be included in SOEs financial statements.	Short-term

Discrepancies in SOE accounting and disclosure practices	Enforce SOE publication requirements ensuring audited financial statements and management reports are publicly disclosed by SOEs.	Short-term
Incomplete use or enforcement of IFRS application by SOEs.	Develop detailed plans to embed IFRS in SOEs, and enforce its use through appropriate measures.	Short-term
Insufficient public information available on SOE finances, governance and performance.	<p>Develop clear ownership policies, outlining main governance matters, reporting lines, and make them publicly available on SOEs websites.</p> <p>Develop aggregate reports on SOEs to improve SOEs transparency. Benchmark aggregate reporting to good international comparators. Identify missing quantitative and qualitative information.</p>	Medium term
Insufficient oversight of financial reporting requirements.	<p>Perform periodic (at least yearly) review of each SOE's performance.</p> <p>Improve scrutiny of financial reporting by requiring independent audits by reputable firms.</p> <p>Consider assigning a single state agency with centralized monitoring, analysis and oversight function over SOEs performance.</p>	Short-term

Annex I: Details of Legislation Framework as to SOE Corporate Governance

The main Legislation influencing corporate governance arrangements and practices of SOEs in Azerbaijan:

The Constitution of Azerbaijan

The foundation of the state ownership lies in the Constitution of Azerbaijan, which states that the property may be state, private and municipal⁵⁹. The Constitution of Azerbaijan is the supreme legislative act. The Constitution is followed in ranks by laws, decrees of the President and the resolutions of the Cabinet of Ministers.

Civil Code

Civil Code guides the legal forms of SOEs in Azerbaijan. According to this Code, majority of SOEs are JSCs (either Open JSC or Closed JSC), with varying degree of state ownership. Some SOEs may be established as limited liability companies (LLCs), and those are mainly established by state-owned JSCs.

Civil Code requires state owned JSCs with more than fifty shareholders establish a supervisory board. Supervisory Boards are not authorized to appoint or dismiss executives unless this function is granted to them by a company charter, and seem to have limited authority over companies' strategic direction⁶⁰. In fact, Civil Code contains very few provisions on authority of supervisory boards, which entailed a practice of weak supervisory boards in Azerbaijan. Moreover, not all SOEs establish boards, i.e. out of top twenty SOEs less than half have supervisory boards.

Civil Code requires Open JSCs to prepare and disclose their annual reports, including audited financial statements⁶¹. However, the Code is not clear on the requirements, leading to poor execution of this provision by entities. Related party transactions and conflicts of interests are also regulated by the Code. For instance, the Code requires mandatory approval of related party transactions exceeding 5% of total assets by the AGM, and is being required of target SOEs⁶².

⁵⁹ The Constitution of the Azerbaijan Republic, art. 13.2. (November 12, 1995)

⁶⁰ The Civil Code of the Azerbaijan Republic, art. 107 (December 28, 1999).

⁶¹ Ibid, art. 99 and 107.6.

⁶² Ibid, art. 49.3 and 49-1.2.

Law on Approving Rules on Transforming the State Property into Joint Stock Company

This Law was an important step in reforming SOE, as it set out general principles of transformation and corporatization of state property, including appointment of management of the newly established JSCs⁶³.

However, in addition to legal forms stipulated by this Law, different types of SOEs exist in Azerbaijan. For example, apart from state owned JSCs, there are other types of SOEs: the largest SOE, State Oil Company of Azerbaijan Republic (SOCAR), is State Enterprise – a special legal form; Baku Telephone Communications is established as Production Association⁶⁴. Both mentioned forms come from the historical background of planned economy, which are common to post-Soviet economies, and which have not been transformed or changed so far. Besides, some of the SOEs may be established as LLCs. These are typically subsidiaries of larger SOEs, although some large SOEs are in fact LLCs, i.e. Aztelecom and Azerpost.

Law on Accounting

The Law on Accounting introduces definition of Public Interest Entities (PIE), which include credit institutions, insurance companies, listed and large companies. These PIEs are required to prepare their financial statements in accordance with International Financial Reporting Standards (IFRS)⁶⁵ and publish in open sources⁶⁶. Largest SOEs are defined as PIEs in Azerbaijan⁶⁷, which is in line with good international practices and OECD Guidelines.

Law on Internal Audit

This law requires all companies, including SOEs, establishing internal audit function and for PIEs establishing an audit committee. The law is silent about composition of audit committees, minimizing incentives for SOEs to invite independent members, which is a good practice. Although required by the Law, some public interest SOEs have not established audit committees in practice. i.e. CJSC Azerbaijan Airlines, or CJSC Azerbaijan Caspian Shipping Company Closed Joint-Stock Company.

Independence of internal audit is not clearly defined by the Law, leading to blending internal audit functions with other, such as HR or legal departments. In practice, SOEs opt for establishing

⁶³ The Law of the Azerbaijan Republic on “Approving Rules on Transforming the State Property into Joint Stock Company”, art. 4, 7.6 and 7.7. (November 29, 1996).

⁶⁴ The Resolution of the State Property Committee on Property Issues approves the change in legal status of “Baku Telephone Communications” to LLC “Baku Telephone Communications” (#105, May 3, 2017).

⁶⁵ The Law of the Azerbaijan Republic on Accounting, art.2.1.9 and 8.1 (June 29, 2004).

⁶⁶ The Law of the Azerbaijan Republic on Accounting, art.12.3.1 (June 29, 2004).

⁶⁷ Annex I and Resolution of the Cabinet of Ministers #321, October 1, 2014 approves the list of Public Interest Entities (other than credit institutions, insurance companies, investment funds, non-public (private) social funds, listed companies) that must keep records and report in accordance with the IFRS.

Revision Commissions under the Civil Code. Revision commissions are different from audit committees, and come from planned economy times when all activities needed to be inspected. Revision commissions are somewhat outdated and ineffective mechanism, which is being gradually phased out.

Other Laws

SOEs are also subject to general provisions of other laws, i.e. Tax Code, Labor Code, and Law on Public Procurement.

Decrees and Orders of the President of Azerbaijan

Though being positioned below the laws in the hierarchy of legislative acts of Azerbaijan, Decrees of the President of Azerbaijan play a paramount role in matters related to establishment and operation of the SOEs.

Decree on Streamlining Measures to Preserve Administration of the State Property

This Decree establishes the State Committee on Property Issues as the shareholding body representing the state's interests in SOEs through appointment of state representatives – members of supervisory boards, except if defined differently by the President. SCPI is technically versed with decision making power with respect to SOEs through attending and voting at AGMs.

The Decree also empowers relevant state agencies, i.e. line ministries, with control over SOEs activities under their respective oversight, including: (i) appointment of senior management, defining their authorities and signing their contracts; (ii) approval of SOEs financial statements and annual reports; (iii) distribution of SOEs profits; (iv) defining development strategies, and (v) approval of SOEs structure⁶⁸.

In practice, this Decree vests main decision-making power with line ministries, leaving limited power with SOE boards. Ministries are responsible for most strategic decisions taken by SOEs, exercise direct control over strategic and operational decision making, and appointment of senior management, many of the functions that should be held by the owner of SOEs.

Decrees on establishment of individual SOEs

There were several Decrees issued by the President, establishing individual rules of inception, operations and reporting lines for individual SOEs. In fact, more than half of top twenty largest SOEs in Azerbaijan were established and currently operate under the individual Decrees of the President: SOCAR, OJSC Azerenergy, CJSC Azerbaijan Airlines (AZAL), CJSC Azerbaijan Railways, OJSC Azersu, OJSC Azerishiq, CJSC Azerbaijan Caspian Shipping Company, CJSC Baku International

⁶⁸ Ibid, art. 7.10 and 9.1.

Sea Trade Port, State Insurance Commercial Company of the Republic of Azerbaijan, the State Agency for Roads of Azerbaijan, OJSC Azeristiliktechizat, Baku Metropolitan CJSC, Baku Telephone Communication, OJSC Azercosmos, OJSC Azerbaijan Melioration and Water Operations Company.

For these SOEs, the President of Azerbaijan has a direct power of appointing General Director (CEO) and his deputies (for instance, this is the case in SOCAR, AZAL and Caspian Shipping Company). Sometimes, the President only appoints CEO, who in turn appoints other senior management (for instance, in Baku International Sea Trade Port). Sometimes, CEO appointment may be delegated to the board, where it exists, for example, in Azerbaijan Investment Company and International Bank of Azerbaijan.

These Decrees set out different reporting lines for respective SOEs, for example:

- SOCAR President reports directly to the President of Azerbaijan
- Baku International Sea Trade Port and Caspian Shipping Company CEOs report to the Cabinet of Ministers of Azerbaijan

President's Order on Additional Measures to Promote Efficiency of Legal Entities with Control Share in State Ownership (SOEs)

The Decree calls for wider efforts to improve SOEs governance and efficiency, including development of corporate governance standards and guidelines for joint stock SOEs, structuring incentives system of bonus payments for SOEs supervisory boards and senior management that is linked to SOEs performance, and setting the rules on efficiency monitoring and assessment of SOEs⁶⁹. The aim of these three areas of reform is achieve proper implementation of improved governance mechanisms in SOEs.

Azerbaijan economy would only win if these measures are taken, and moreover, they should become applicable not only to JSCs, but also to other legal forms of SOEs. In the spirit of promoting good corporate governance practices among all SOEs, these changes should become effective also for other forms of SOEs.

⁶⁹ Order of the President of the Azerbaijan Republic "on Additional Measures to Promote Efficiency of the work of the Legal Persons with Share Control Package in State Ownership" 1.1.1.-1.1.3. (September 5, 2016).

Cabinet of Ministers Resolutions

The Government of Azerbaijan from time to time issues Resolutions, which aim to be supporting or explaining the Laws or Presidential Decrees. The below referenced Resolutions have direct impact on SOE operations.

Resolution on Approving Guidelines for Managing State's Shares in Joint Enterprises and Joint-Stock Companies

This Resolution sets out procedures for appointment and involvement of state representatives in the governing bodies, i.e. boards, of joint enterprises and privatized JSCs with the state decides to retain controlling (51%+ shares) or blocking (25.5%+ shares) interest.

The Resolution mandates an appointment of delegates from: SCPI, MOF, relevant line ministries, state committees and executive authorities to nominate their executive officers to SOE boards. These candidates must possess higher education degree and two or more years of management experience⁷⁰. The application of this Resolution in practice is rather limited, as respective state representatives have been appointed to less than 10 SOE boards in Azerbaijan.

Resolution on Approving the List of Public Interest Entities (other than credit institutions, insurance companies, investment funds, non-public (private) social funds, listed companies) that Must Keep Records and Report in accordance with the IFRS

This Resolution lists public interest SOEs that must adhere to IFRS and report under these internationally recognized standards⁷¹:

1. SOCAR and its subsidiaries,
2. OJSC Azerenergy,
3. CJSC Azerbaijan Airlines (AZAL),
4. CJSC Azerbaijan Railways,
5. OJSC Azersu,
6. OJSC Azerishiq,
7. CJSC Azerbaijan Caspian Shipping Company,
8. CJSC Baku Metropolitan.

⁷⁰ The Resolution of the Cabinet of Ministers of the Azerbaijan Republic on approving Guidelines for Managing State's Shares in Joint Enterprises and Joint-Stock Companies, art. 2, 4, 6. (#136, July 14, 2005).

⁷¹ The Resolution of the Cabinet of Ministers of the Azerbaijan Republic on approving the List of Public Interest Entities (other than credit institutions, insurance companies, investment funds, non-public (private) social funds, listed companies) that Must Keep Records and Report in accordance with the International Financial Reporting Standards (#321, October 1, 2014).

**Resolution on Approving Action Plan to Improve Financial and Business Performance,
Transparency and Efficiency of Large State-Owned Enterprises⁷²**

One of the most recent Government initiatives introduced in 2016, this Resolution lists top 20 SOEs in Azerbaijan, mandating their corporatization, which would be the case for SOCAR, Baku Telephone Communications and Aztelecom.

As part of improving corporate governance practices at the defined SOEs, this Resolution seeks to introduce supervisory boards in identified SOEs, which would guide strategic development, oversee transition of accounting practices and reporting by these SOEs to IFRS (or improving NAS reporting for entities not mentioned by the Resolution #321, above), implement publication of SOEs audited financial statements. The Resolution also discusses establishing a single database of large SOEs, starting with the companies targeted by this Resolution:

1. SOCAR,
2. OJSC Azerenergy,
3. CJSC Azerbaijan Airlines (AZAL),
4. CJSC Azerbaijan Railways,
5. OJSC Azersu,
6. OJSC Azerishiq,
7. OJSC Azeristiliktechizat,
8. OJSC Azerbaijan Melioration and Water Management
9. CJSC Azerbaijan Caspian Shipping Company,
10. OJSC Azeravtoyol⁷³,
11. CJS Non-Bank Credit Institution Agrarkredit,
12. OJSC International Bank of Azerbaijan,
13. OJSC Azer-Turk Bank,
14. State Insurance Commercial Company of the Republic of Azerbaijan,
15. OJSC Agrolizing,
16. CJSC Baku International Sea Trade Port,
17. CJSC Baku Metropolitan,
18. OJSC Azercosmos,
19. Aztelekom Production Association (transformed into LLC by December 30, 2016)
20. Baku Telephone Communication Production Association (transformed into LLC on May 3, 2017).

⁷² The Resolution of the Cabinet of Ministers of the Azerbaijan Republic on Approving Action Plan to Improve Financial and Business Performance Transparency and Efficiency of Large State-Owned Enterprises (#636s, December 1, 2016).

⁷³ Azeravtoyol subsequently re-organized into public legal entity "Azerbaijan Motor Roads State Agency" by the Decree № 1638 of the President of the Republic of Azerbaijan (October 18, 2017).

Resolution on Estimates and Expenditures of Large State-Owned Enterprises⁷⁴

This Resolution introduces review and approval of estimates and expenditures at top 14 SOEs by a special purpose Commission. The Commission comprised of high ranking government officials, and includes: First Deputy Prime Minister, Ministers of Economic Development, Finance, Taxes, Chairs of the Central Bank and the Financial Market Supervision Authority. The following top 14 SOEs are subject to this Resolution expenditure review and approval:

1. SOCAR,
2. OJSC Azerenergy,
3. CJSC Azerbaijan Airlines (AZAL),
4. CJSC Azerbaijan Railways,
5. OJSC Azersu,
6. OJSC Azerishiq,
7. CJSC Azerbaijan Caspian Shipping Company,
8. CJSC Baku Metropolitan,
9. OJSC Azerbaijan Melioration and Water Management
10. CJSC Baku International Sea Trade Port,
11. OJSC Azercosmos,
12. Aztelekom Production Association (transformed into LLC on December 30, 2016),
13. LLC Azerpost,
14. Baku Telephone Communication Production Association (transformed into LLC on May 3, 2017).

⁷⁴ The Resolution of the Cabinet of Ministers of the Azerbaijan Republic on the Estimates and Expenditures of Large State-Owned Enterprises (#534, December 30, 2016).

Annex II: Rationale for state ownership – examples⁷⁵

France: The Guidelines for the State as Shareholder assign to the State Holdings Agency list the following four objectives for ownership of economic entities: (1) ensure a sufficient level of control (...) in sectors particularly sensitive for sovereignty; (2) ensure the existence of resilient operators to meet the country's fundamental needs; (3) support the development and strengthening of enterprises particularly in sectors playing a crucial role for national and European economic growth; (4) participate in the rescue of enterprises whose failure could have systemic consequences, in accordance with the European rules.

Hungary: The Privatization Act (Act XXXIX of 1995) states that assets may remain in long term state ownership in: (1) national public utility service providers; (2) companies of strategic significance in the national economy; (3) companies carrying out defense or other special duties or services; and (4) cases when company shares are needed to guarantee state ownership or voting rights.

In **Mexico** the strategic areas⁷⁶ for state ownership are defined in Art. 28 of the Constitution. These are postal delivery, telegraphs, and radio telegraphy; petroleum and other hydrocarbons; basic petrochemicals; radioactive minerals and the generation of nuclear energy; electric power, and activities expressly provided by the laws enacted by the Congress of the Union. The state must secure the interests of the nation in satellite communications, and railroads are a priority for national development.

Norway: The Government's objective is to maintain a diverse and value-creating ownership. In line with the pronouncements of the White Paper presented by the Government to the Parliament [Meld. St. 27 (2013-2014)], A Diverse and Value Creating Ownership, SOEs in Norway are classified into four groups with different objectives for state ownership: (1) companies with commercial objectives; (2) companies with commercial objectives and national anchoring of their head office functions (i.e. develop Norwegian markets in Norway); (3) companies with commercial and other specifically defined objectives; (4) companies with sectorial policy objectives (State Ownership Report 2014).

In **Slovenia** the 2015 Law on State Assets Management Strategy requires the state to maintain or obtain at least a 50% shareholding + 1 share in companies classified as strategic. It defines the following strategic assets:

- Enterprises carrying out key infrastructural duties, including: (i) network infrastructure of key electronic communications; (ii) transport infrastructure (roads, railways); (iii) natural monopolies (ports, etc.).
- Companies in economic activities which are important for the stable and safe supply of resources and energy and public grid operators: (i) energy industry; (ii) distribution of electricity and distribution and storage of other energy products (gas, oil); (iii) water supply and other environmental services; (iv) national operator of the port activity (Port of Koper).

⁷⁵ Data prepared based on applicable legislation in each jurisdiction.

⁷⁶ That should not constitute monopolies.

- Companies rendering important public obligations (services of general economic interest): (i) public passenger transport; (ii) maintenance and management of public infrastructure (roads, railways, distribution networks), (iii) companies increasing the competitiveness of the entire forest-wood value chain.

Other examples include **Germany's** "Holdings in private-law enterprises" (Section 65) of the Federal Budget Code 1969; **Norwegian** Government's Ownership Policy; **Sweden's** State Ownership Policy; and **Poland's** Principles of Corporate Supervision over Companies with State Treasury Shareholding.

Annex III: Overview of strategic SOEs and sectors of the economy among some of the world's economies⁷⁷

Australia	
Financial Services	-
Telecoms & Mass media	Telstra C.L.
Extractives	-
Electricity	Snowy Hydro L.
Railway	Australian Rail Track C. L.
Air & Transport	Airservices Australia
Post	Australian Postal C.
Austria	
Financial Services	Hypo Alpe-Adria-Bank International*
Telecoms & Mass media	Telekom Austria AG
Extractives	OMV AG
Electricity	Verbundgesellschaft
Railway	Österreichische Bundesbahnen
Air & Transport	Austrian Airlines AG
Post	Österreichische Post AG
Canada	
Financial Services	Business Development Bank of Canada; Canada Mortgage and Housing Corporation
Telecoms & Mass media	Canadian Broadcasting Corporation
Extractives	-
Electricity	-
Railway	VIA Rail Inc
Air & Transport	-
Post	Canada Post Corporation
France	
Financial Services	Banque Postale; BPI; Dexia
Telecoms & Mass media	France Televisions; Radio France; AFP
Extractives	Charbonnage de France; EMC (<i>Note. these are dormant entities</i>)
Electricity	EDF; Engie
Railway	SNCF
Air & Transport	Aéroport de Paris
Post	La Poste

⁷⁷ The list is not exhaustive, other industries and companies of strategic importance exist in these jurisdictions.

Italy	
Financial Services	Consap spa
Telecoms & Mass media	RAI holding
Extractives	ENI spa
Electricity	Enel spa
Railway	Ferrovie dello Stato spa
Air & Transport	Alitalia spa; ENAV spa
Post	Poste Italiane spa
Kazakhstan	
Financial Services	JSC Development Bank of Kazakhstan
Telecoms & Mass media	JSC Kazakhtelecom; JSC Kazsatnet
Extractives	JSC KazMunaiGas Exploration Production; JSC KazMunaiGas
Electricity	JSC Samruk -Energo
Railway	JSC Kazakhstan Temir Zholy
Air & Transport	JSC International Airport Astana; other regional airports; JSC Air Astana
Post	JSC Kazpost
Norway	
Financial Services	DNB ASA; Argentum Fondsinvesteringer AS; Kommunalbanken Norway AS
Telecoms & Mass media	Telenor ASA
Extractives	Statoil ASA; Petro AS, Norsk Hydro ASA
Electricity	Statnett SF; Statkraft SF
Railway	NSB AS
Air & Transport	Avinor AS
Post	Posten Norge AS
South Korea	
Financial Services	Industrial bank of Korea, Korea development bank; Korea first bank; Kookmin bank
Telecoms & Mass media	Korea broadcasting system
Extractives	Korea National Oil Corporation Korea Gas Corporation Korea oil pipeline
Electricity	Korea Electric Power Corporation
Railway	-
Air & Transport	Korea airports Corporation
Post	-

Switzerland	
Financial Services	Export Risk Guarantee (ERG), SUVA
Telecoms & Mass media	Swisscom AG
Extractives	-
Electricity	-
Railway	Schweiz.Bundesbahnen (SBB AG)
Air & Transport	-
Post	Die Schweiz Post
United Kingdom	
Financial Services	Export Credit Guarantee Department; Northern Rock (Asset Management)**; Lloyds Banking Group (partial)
Telecoms & Mass media	British Broadcasting Corporation; Channel Four Television Corporation Ltd
Extractives	-
Electricity	British Energy; UK Atomic Energy Authority; British Nuclear Fuels plc
Railway	London and Continental Railways; Network Rail
Air & Transport	Air travel trust; National Air Traffic Services Ltd; Various regional airports
Post	Royal Mail Group PLC***

* - Nationalized in 2009 by the Austrian Government to avoid the bank's collapse.

** - Nationalized in 2008 by the British Government.

*** - Privatized in 2013.

Annex IV: Types and Examples of Centralized SOE Ownership Arrangements

Country	Name of Entity	Location of Entity
Ownership Ministries:		
Indonesia	Ministry of State Enterprises	Ministry of State Enterprises
Ownership departments in a ministry:		
Finland	Ownership Steering Department	Prime Minister's Office
France	Agence des Participations de l'Etat	Ministry of Economy and Finance
Norway	Ownership Department	Ministry of Trade and Industry
United Kingdom	UK Government Investments	HM Treasury
Ownership agencies:		
China	State-Owned Assets Supervision and Administration Commission	State Council
Company-type structures		
Hungary	State Holding Company	Directed by the National State Holding Board
Kazakhstan	Samruk Kazyna	Cabinet of Ministers
Malaysia	Khazanah Nasional	Ministry of Finance
Singapore	Temasek Holdings	Wholly owned by Ministry of Finance

Centralized SOE ownership: France

Agence des Participations de l'Etat (APE) is an ownership department affiliated with the **Ministry of Economy and Finance**. The mission and the role of APE is achieved through four main parameters, as illustrated below:



Dedicated shareholder

- APE's main task is to optimize the value of government assets. It acts as SOE shareholder within legal framework and in accordance with government guidelines.
- APE coordinates with other ministries on SOEs strategy and provides guidance for the state as a shareholder.

Effective shareholder

- APE is the main adviser of the Ministry on all matters concerning the government's position as a shareholder. This responsibility covers the main aspects of a company's life cycle: strategy, investments and financing, mergers and acquisitions, and equity transactions.



Transparent shareholder

- APE prepares and discloses combined accounts of main government-controlled entities that fall within its scope, regardless of their legal structure.

Efficient shareholder

- APE regularly communicates with SOE boards, focusing on three goals: (i) maintaining transparent relations with SOEs guiding them on strategic decisions; (ii) improving SOEs governance, and (iii) developing the government's capacity to act as an effective shareholder through analysis and preparation of informed decisions.



Source: Agence des Participations de l'Etat www.ape.minefi.gouv.fr.

Centralized SOE ownership: Ministerial Department on SOE Ownership in Norway

In Norway SOE ownership is centralized under the special department within the Ministry of Trade, Industry and Fisheries. The State's direct ownership in SOEs is managed by different ministries with central role assigned to the SOE Ownership Department under the Ministry of Trade, Industry and Fisheries. Total SOE portfolio consists of 70 companies with total estimated value of the State's commercial ownership of about NOK 644 billion, or approximately US\$72.8 billion, at year-end 2015.

The Government's objective is to maintain a diverse and value-creating ownership. This ownership strategy translates into categorization of all SOEs in Norway into four groups with different objectives for state ownership: (1) companies with commercial objectives; (2) companies with commercial objectives and national anchoring of their head office functions (i.e.

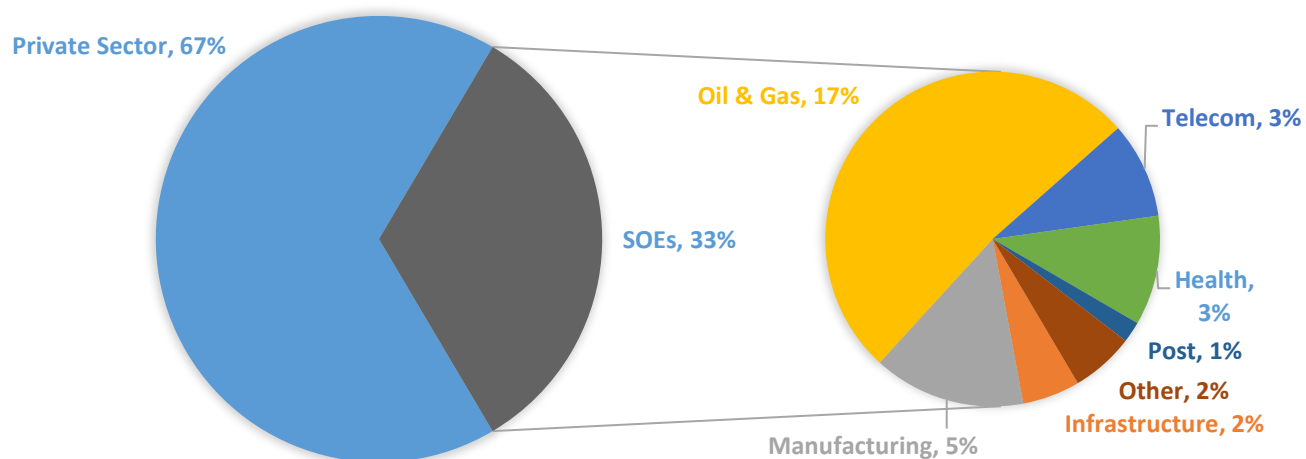
develop Norwegian markets in Norway); (3) companies with commercial and other specifically defined objectives; (4) companies with sectorial policy objectives (State Ownership Report 2015).

The state's ownership is exercised to enhance value creation of SOEs. This is achieved by promoting appropriate board composition, good corporate governance, an effective capital structure and suitable dividends, that sustainability and corporate social responsibility are integrated into the business, and transparency and good reporting.

The board of directors and the executives are responsible for ensuring that the company is managed based on the owners' interests. The state as an owner exercises its authority as an owner through the general meeting / company meeting and works constantly to improve the exercise of ownership in all the five areas. The state's voting at general meetings and company engagement is based on the Norwegian state's principles for good corporate governance in addition to other explicitly defined expectations.

One of the most important SOEs in Norway remains to be Statoil, where the state owns 67%. The oil and gas sector in general remains Norway's largest measured in terms of value added, government revenues, investments and export value. In 2014, oil & gas provided approximately 16% of the country's GDP, reducing to 12% in 2016⁷⁸. It is one of the major contributors to the Norwegian budget contributing through taxes and dividends. For example, Statoil's dividend distribution to the Government amounted to NOK 11 billion, or US\$1.28 billion, for 2016.

CONTRIBUTION TO GDP: 2014



⁷⁸ <http://www.norskipetroleum.no/en/economy/governments-revenues/>

Centralized SOE ownership: Holding and Investment Company Structure in Malaysia⁷⁹

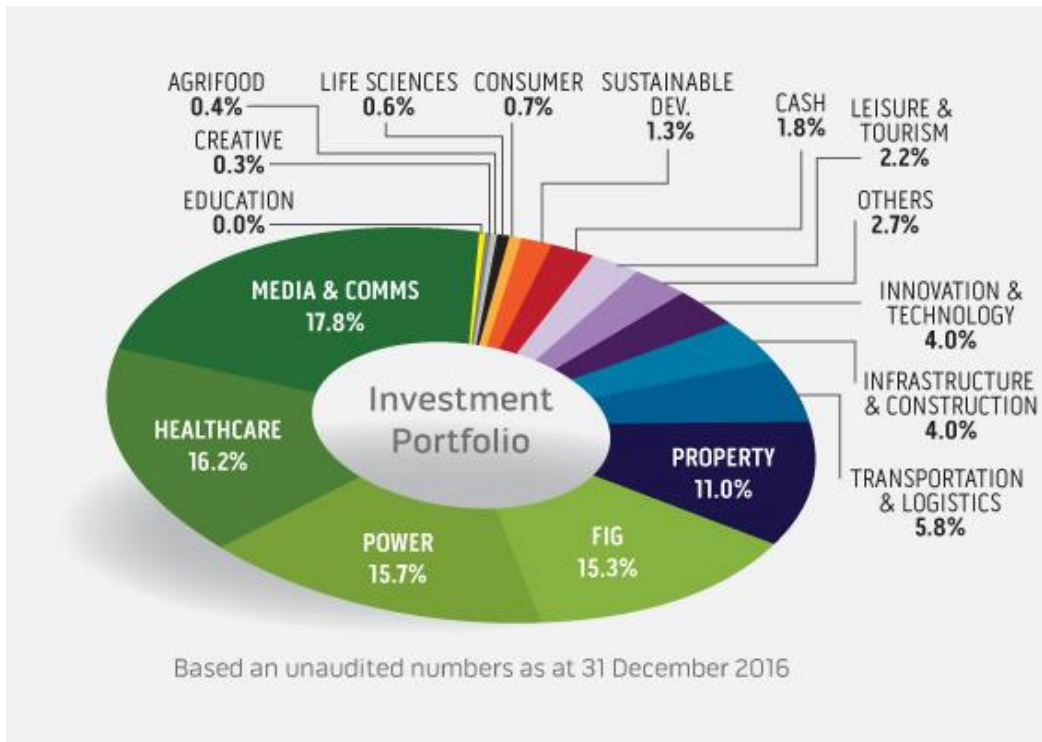
Khazanah Nasional is the investment-holding arm of the government of Malaysia. Its main objective is to hold and manage the commercial assets of the Government, and to undertake strategic investments on behalf of the nation. Khazanah's mandate is to create sustainable value and cultivate a high-performance culture that helps contribute to Malaysia's economic competitiveness.

Khazanah employs a proactive investment approach. This approach builds value through existing investment portfolio, seeks new investments and sectors, as well as new geographies vital to the country's future. Khazanah is also actively engaged in developing human, social and knowledge capital for the country's benefit.

Incorporated in 1993 as a limited-liability company and governed by the Companies Act, Khazanah is a wholly owned entity of the government. Khazanah's operations are funded by the returns generated through its investments portfolio, as well as by external funding sources, such bonds. Khazanah's investment portfolio consists of interest in over 80 companies across multiple sectors and industries, valued at RM 145 billion, or approximating to US\$33.3 billion for 2016. Khazanah's portfolio cuts across various sectors and industries, as illustrated in the graph below. Its investee companies comprise some of the most significant companies in Malaysia, as measured by their strategic importance to the nation. They include Government-Linked Companies (GLCs) in sectors such as aviation, financial services, power and telecommunications.

⁷⁹ Source: Khazanah Nasional official website: www.khazanah.com.my

Khazanah's investment portfolio across sectors and industries



Source: Khazanah's website at: <http://www.khazanah.com.my>

Khazanah's board is ultimately accountable and responsible for its overall governance and performance. The board governs its operations, and is made up of representatives from the Government and corporate sector with diverse professional backgrounds and expertise. It is chaired by the Prime Minister of Malaysia, and is assisted by executive and audit committees. The 21-member management team is collectively responsible for implementing and delivering Khazanah's strategic and commercial objectives. The team is led by the Managing Director, and consists of professionals with financial sector experience.

Khazanah does not participate directly in GLC management, but acts via GLC boards. Focus for Khazanah is the transformation of GLCs through appointment of qualified board members and senior management, assistance in adoption of quality business strategies, developing key systems and controls via governance, risk management, internal audit, and monitoring GLCs progress and performance.

One of Khazanah's most important tasks is to improve the corporate governance of GLCs to increase shareholder and strategic value. It acts as secretariat to the Putrajaya Committee on GLC High Performance, an interministerial committee formed to oversee the GLC Transformation Program. The program has taken many steps, including replacing senior managers with seasoned professionals, developing key performance indicators, adopting the GLC Transformation Manual

(with guidance on corporate governance), developing performance contracts and an incentive system for managers, removing government officials with a regulatory role from company boards, and requiring all suppliers to bid for contracts. A clear mandate, combined with operational autonomy, has enabled Khazanah to work closely with GLCs on the restructuring process and to recruit and dismiss enterprise managers based on their performance.

Annex V: Role of SOE Boards. Strengthening Boards

Strengthening Boards' Role in the Netherlands

Public and private sectors governance in the Netherlands

The public sector of the Netherlands can be characterized by a wide spread two tier-system of governance. Supervisory boards are established to improve the accountability of parastatals⁸⁰. Supervisory boards consist of external members who oversee the organization's strategy, policy and fulfilment of its statutory tasks. In all public-sector entities, most or all members of the supervisory boards are appointed by the responsible minister. Despite the similarities with the private sector there is, however, an important difference in terms of legal position. Unlike the private sector, there is not yet uniform legislation covering public-sector supervisory boards. Each has its own set of rules and regulations. Reform is underway to harmonize the legal framework for public sector supervisory boards.

Source: Hoek F., Montfort C., and Vermeer C. (2005).

The statutory duties and powers of the supervisory board of public limited companies⁸¹ are defined in the Civil Code⁸². Public limited companies in the Netherlands either have one-tier (Board of Directors) or two-tier (Board of Directors and Supervisory Body) governance structures. The two-tier structure is mandatory for open corporations that meet certain criteria, for example, when the total sum of its issued capital and the reserves, according to the balance sheet with explanatory notes, amounts up to at least a level as set for this purpose by Royal Decree⁸³ or when it employs jointly with its dependent companies on average at least one hundred employees in the Netherlands⁸⁴. Subject to any restrictions under the articles of incorporation, the Board of Directors is charged with the governance (management) of the Corporation. The Supervisory Board is responsible for exercising supervision over the administration (management) and policy of the Board of Directors and over the general course of events within the Corporation and its affiliated enterprise. The articles of incorporation may set additional provisions regarding the duties and powers of the Supervisory Board. In the case of one-tier management structure, the first Directors of the Corporation are appointed in the notarial deed of incorporation; the following (succeeding) Directors are appointed by the General Meeting. The Supervisory Directors (members of the Supervisory Board) who are not already designated as such in the notarial deed

⁸⁰ Such as universities and university hospitals, school boards, health insurance funds, national museums and regional police forces that are established as legal entities with statutory task (RWTs).

⁸¹ Often established by the municipalities to provide services of public interest, such as water supply. Additional examples include Oost (Ontwikkelingsmaatschappij Oost-Nederland N.V.) – a regional development company, owned by the central government and two provinces and the Port of Rotterdam (Havenbedrijf Rotterdam N.V.) with the central government (29.17%) and Rotterdam municipality (70.83%) as shareholders.

⁸² The Dutch Civil Code. Part 2. Open Corporations 'naamloze vennootschap'(N.V.).

⁸³ From October 1, 2004 this level is set at € 16,000,000.

⁸⁴ for three continuous years.

of incorporation, shall be appointed by the General Meeting⁸⁵. The Supervisory Board appoints the Directors of the Corporation in the two-tier structure. The Supervisory Board must approve many key strategic, business sustainability, continuity, etc. resolutions. The articles of incorporation may set additional provisions to the ones mandated in the Civil Code regarding the duties and powers of the Supervisory Board and shareholders.

Sources: Data prepared based on applicable legislation.

International Experience in Selection and Appointment of CEO by a Board of Directors in SOEs

OECD countries such as Australia, Germany, New Zealand, Norway, and Sweden now explicitly empower the board to choose the CEO.

Romania and a smaller number of other emerging market economies are doing the same.

In Poland, the managers of SOEs should be appointed by the supervisory board.

In Slovenia, the supervisory board of SOEs nominates and discharges members of the management and the CEO.

Some countries have adopted an intermediate approach. South Africa, for example, allows the board to select the CEO subject to final approval by, or in consultation with, the ownership entity and other shareholders.

Source: Board of Directors of State-Owned Enterprises: An Overview of National Practices, OECD (2012)

Examples of Requirements in Appointing Independent Board Members in SOEs

Many countries have made it obligatory to have independent board members (independent directors) on SOE boards, for both listed and unlisted companies:

- **Australia, Sweden** and some other OECD countries require the great majority of SOE board members to be independent. In these countries the definition of independence precludes government or political board members.

⁸⁵ At least one-third of the number of candidates should be nominated and recommended by the Works Council of the Corporation.

- **Republic of Korea, Mozambique** - majority of directors must be independent, including the chair.
- **India, Malaysia** stipulate that independent directors make up at least a third of the board in SOEs.
- **Indonesia** calls for a 25 percent share.

Source: Corporate Governance of State Owned Enterprises, The World Bank Group (2014)

Recent Reforms in the EU Countries in Board Composition and Nomination in SOEs

Croatia: new framework for the selection of supervisory boards was adopted in August 2015, with a reform of management board nominations expected to follow in the second half of the year. The regulation strengthens the qualification requirements for applicants and puts candidates from the private sector on a more equal footing with the incumbents.

Lithuania: formalized the process of professionalizing SOE boards - organizing the process of nominating board members, creating a database of potential board members, evaluating the competencies of existing boards, directly participating in the boards of SOEs. The country also approved new ownership guidelines, which included criteria for the nomination and appointment of CEOs, and the criteria for competence and independency of SOEs' boards.

Portugal: in 2015 introduced a reform, delegating appointments of SOE boards to the scrutiny of an independent committee (CReSAP), increasing process transparency, impartiality, accuracy and independence in the recruitment and selection of candidates.

Romania: in November 2011 promulgated Corporate Governance Rules specific to SOEs, which among others aim to assure transparent and professional selection of board members and management: (i) introducing an independent external advisor for large companies to run the selection process; (ii) establishing a minimum of one half of the members of the boards to be independent, i.e. they cannot be government representatives or civil servants. Once selected, the board of directors prepares and submits an administration plan for approval at the general shareholder meeting.

Sweden: in April 2009 issued new guidelines to enhance operation of SOE boards, and regulate terms of employment and remuneration for senior executives of SOEs.

Source: State-owned Enterprises in the EU: Lessons Learnt and Ways Forward in a Post-Crisis Context, European Commission (2016)

Professional Boards: Main Responsibilities and Composition of Board Committees

UK Corporate Governance Code

Audit Committee

The board should establish an audit committee of at least three, or in the case of smaller companies two, independent non-executive directors. In smaller companies the company chairman may be a member of, but not chair, the committee in addition to the independent non-executive directors, provided he or she was considered independent on appointment as chairman. The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience.

The main role and responsibilities of the audit committee should be set out in written terms of reference and should include:

- ✓ to monitor the integrity of the financial statements of the company and any formal announcements relating to the company's financial performance, reviewing significant financial reporting judgements contained in them;
- ✓ to review the company's internal financial controls and, unless expressly addressed by a separate board risk committee composed of independent directors, or by the board itself, to review the company's internal control and risk management systems;
- ✓ to monitor and review the effectiveness of the company's internal audit function;
- ✓ to make recommendations to the board, for it to put to the shareholders for their approval in general meeting, in relation to the appointment, re-appointment and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor;
- ✓ to review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process, taking into consideration relevant UK professional and regulatory requirements;
- ✓ to develop and implement policy on the engagement of the external auditor to supply non-audit services, considering relevant ethical guidance regarding the provision of non-audit services by the external audit firm; and to report to the board, identifying any matters in respect of which it considers that action or improvement is needed and making recommendations as to the steps to be taken; and
- ✓ to report to the board on how it has discharged its responsibilities.

Remuneration Committee

The board should establish a remuneration committee of at least three, or in the case of smaller companies two, independent non-executive directors. In addition, the company chairman may also

be a member of, but not chair, the committee if he or she was considered independent on appointment as chairman. The remuneration committee should make available its terms of reference, explaining its role and the authority delegated to it by the board. Where remuneration consultants are appointed, they should be identified in the annual report and a statement made as to whether they have any other connection with the company.

The remuneration committee should have delegated responsibility for setting remuneration for all executive directors and the chairman, including pension rights and any compensation payments. The committee should also recommend and monitor the level and structure of remuneration for senior management. The definition of 'senior management' for this purpose should be determined by the board but should normally include the first layer of management below board level.

Nomination Committee

There should be a nomination committee which should lead the process for board appointments and make recommendations to the board. Most members of the nomination committee should be independent non-executive directors. The chairman or an independent non-executive director should chair the committee, but the chairman should not chair the nomination committee when it is dealing with the appointment of a successor to the chairmanship. The nomination committee should make available its terms of reference, explaining its role and the authority delegated to it by the board.

The nomination committee should evaluate the balance of skills, experience, independence and knowledge on the board and, in the light of this evaluation, prepare a description of the role and capabilities required for an appointment.

Source: UK Corporate Governance Code (2016)

Annex VI: Examples of Board Members Nomination in SOEs

Delegation to an Advisory Body or Expert Panel

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

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

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

In 2011, Poland introduced an independent accreditation committee that recommends nominees to the Treasury for the supervisory boards of certain key SOEs, as well as dismissal of members when such a situation arises. The committee consists of 10 members who were recommended by key ministries such as treasury, economy, public finance, financial institutions, transport, communications and the president of the Polish Financial Authority and appointed by the prime minister based on their knowledge and experience.

Control by Centralized Ownership Units

While advisory bodies typically support and advise line ministries on the nomination process, centralized ownership entities may have more direct responsibility for board nominations.

Malaysia's Khazanah Nasional nominates and appoints board members of government-linked companies.

In Chile, the Sistema de Empresas Council appoints and removes board members and conducts annual board evaluations.

Peru's FONAFE (the country's state holding company) appoints all board members for companies in its portfolio.

China's State-Owned Assets Supervision and Administration Commission (SASAC) directly appoints board members in 54 of the roughly 200 companies in its portfolio.

Ownership units in countries such as India and Thailand have generated databases of qualified candidates to assist in future nominations.

Responsibility of SOE Nominating Committees

SOE-led nominations are more common in developed countries, for mixed-ownership companies, and for SOEs listed on an exchange with regulations that call for a board nomination committee.

In the case of financial SOEs, such as Canada's BDC and the Development Bank of South Africa (DBSA), the law establishes general fit-and-proper criteria for selection of board members, but board committees in both cases manage the nomination process.

In Malaysia, the nomination committee of listed SOEs identifies potential board candidates (in conjunction with Khazanah and others), prepares the short list for approval by the board, and then submits the approved list to Khazanah for appointment.

Source: Corporate Governance of State Owned Enterprises, The World Bank Group (2014)

Annex VII: SOEs Performance Monitoring. International Examples

Performance Agreements and Indicators in New Zealand

In New Zealand, SOEs negotiate a statement of corporate intent with their shareholding minister each year. The company board is required to prepare a draft statement and submit it to the minister for review. The statement should include the company's objectives, specific financial indicators, basic financial policies, and key targets. Performance indicators (financial and nonfinancial) must also have other characteristics:

- Be meaningful for the SOE's business and SOE law.
- Be specific and measurable, with no ambiguity.
- Be timely and capable of being audited, where appropriate.
- Be within the SOE's responsibility or power of control.
- Be consistent with and influence, as appropriate, the SOE's purpose and principles of operation or business.
- Respect commercial sensitivity, where appropriate.
- Encourage and reflect best practice.
- Where appropriate, ensure employee participation in, and ownership of, the indicators.

The board negotiates the draft statement of corporate intent with the shareholding minister formally and informally. It considers any comments on the draft by the minister; then the board delivers the final statement to the minister before the start of the company's financial year. The board can modify the statement through written notice to the shareholding minister if it first gives written notice of the proposed modification and considers any comments.

Source: CCAMU (2007), Corporate Governance of State Owned Enterprises, The World Bank Group (2014)

Performance linked compensation in Malaysia: “Blue Book”

In Malaysia, performance management, involving KPIs and performance linked compensation (PLC) and performance contracts were among the key GLC measures launched by the Transformation Program.

The Putrajaya Committee on Government-Linked Companies’ High Performance (PCG) conducted an audit on the implementation of the KPIs. Based on that audit, PCG recommended that personal performance reviews be on a semi-annual basis where each manager’s performance is reviewed against targets, resulting in differentiated evaluations with meaningful personal feedback, rewards and consequences. It also recommends that the base pay be comparable to industry peers and that GLCs offer meaningful performance bonuses that vary significantly with individual performance. Promotion, recognition and other non-financial rewards should be based on merit and highly correlated with performance.

The PCG launched the “Blue Book: Guidelines on Announcement of Headlines KPIs and Economic Profit” in 2006. They provide a comprehensive reference to GLCs to ensure uniformity and consistency in their reporting. Headline KPIs align expectations at all levels and promote a result driven culture, while progress reporting provides an opportunity to take stock. The announcement of headline KPIs also provides stakeholders with better insight into the performance of the company.

Each GLC should have 5 to 8 KPIs with targets along financial, customer, operational and organizational dimensions that are tightly linked to its specific strategy. The targets of each KPI should be benchmarked against comparable international peers. The CEO should be responsible for the implementation of quality KPIs and for reporting them to the market. Business performance reviews should be conducted every quarter to identify any major shortcomings and to chalk out action plans to further improve performance.

The Blue Book also provides guidance on Economic Profit reporting, on how to deliver Headline KPI results. It also provides a communication checklist for GLCs and gives advice on how to manage poor or missed results.

The Blue Book Implementation Assessment shows that, for the majority of GLCs, corporate scorecards are in place, KPIs have been formally set for CEOs and senior management and Headline KPIs are being monitored. To enhance performance and to promote results-orientation, GLCs have been announcing their Headline Key Performance Indicators (“HL KPIs”) annually and have been showing overall improvements. The number of HL KPIs met increased from 72% in FY2006 to 76% in FY2007.

Source: OECD (2010)

