Baltic Institute of Corporate Governance

Baltic Guidance on the Governance of Government-owned Enterprises

2010

FOREWORD

Governments often choose to retain ownership in strategic enterprises, or enterprises that provide key infrastructure or social services. While the overall weight of Government-owned Enterprises (GOEs) in the global economy has declined in recent years, GOEs continue to play an important role in many countries, especially in transition economies where they account for a significant proportion of gross domestic product.

GOEs face operational and governance challenges that differ somewhat from private-sector enterprises. The fundamental difference is that they are required to pursue both social and business objectives. On the one hand, they are supposed to help achieve important social and policy goals. On the other hand, they need to obey the laws of economics in order to survive and prosper in a market economy.

Furthermore, GOEs often have complex decision-making and accountability structures that can involve government, boards, management, parliament, private shareholders, and the public. Decision making is, at times, based as much on political needs as business logic. These challenges are, in turn, made acute by external factors, including globalization, technological change, and market deregulation.

Fortunately, tools are available to meet these challenges. Key to helping GOEs respond, to make them more effective, and to allow them to prosper is their corporate governance. This is in large part the rationale that drove the development of the Baltic Guidance on the Governance of Government-owned Enterprises (Guidance), by the Baltic Institute of Corporate Governance.

The Guidance has a number of noteworthy aspects, not least of which is the cogency and clarity with which it has been written. Another is its regional approach. Few international pronouncements on the corporate governance of GOEs exist, fewer still seek to embrace a regional approach to corporate governance such as this Guidance. The benefits of regional integration are clearly a key goal.

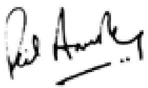
Another important aspect is the relationship between the Guidance and the OECD Guidelines on the Governance of State-owned Enterprises, which is the recognised international best practice standard. The Guidance neither repeats nor supplants the OECD guidelines; rather, it provides a roadmap on how to achieve international best practice, and tailors its recommendations specifically to meet the needs of countries in the late stages of transition in the Baltic region.

It is worth adding a word on the process that lead to the Guidance. The Guidance is the result of a transparent, inclusive, and efficient process that achieved excellent results with limited resources. The Baltic Institute of Corporate Governance acted as the catalyst with the strong backing of government and business leaders in all three countries. These leaders deserve enormous credit for their vision and support.

The content and the process involved in its development provide an excellent model for those who have yet to develop their own guidance or those who have reason to refashion their existing codes of institutional and corporate conduct.

The Guidance is a major step forward. But it is, of course, only a first step. The great challenge of its implementation lies before us. Its recommendations need to be adapted and applied in each of the individual countries. This requires further discussion, debate and creative thinking, and further commitment to make better GOE governance a reality in practice.

We are certain that this commitment will yield significant returns. Strong governance practices in the Baltic GOEs are critical in helping realise the goals of constructing a vibrant society, creating jobs, stimulating investment, hemming in corruption, building wealth, and protecting human freedom. The Baltic Guidance on the Governance of Government-owned Enterprises leads squarely in this direction.



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Better Companies, Better Societies

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ACKNOWLEDGEMENTS

A project such as the development of the Baltic Guidance on the Governance of Government-owned Enterprises can only come to fruition through a strong team effort. The Baltic Institute of Corporate Governance had the great fortune of assembling an exceptional team to make this Guidance a success. Our team included international experts, policy makers and civil servants from the Baltic governments, municipalities and public agencies as well as practitioners from both government-owned and private companies.

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Chairman, Baltic Institute of Corporate Governance

I. BACKGROUND AND INTRODUCTION

The origins:

The mission of the Baltic Institute of Corporate Governance (BICG) is to encourage better corporate governance practices in the Baltic region. In 2009, the BICG decided that it could make a significant contribution to the Baltic economies by developing guidance (the Guidance) on the governance of government-owned enterprises (GOEs).

What constitutes a GOE is defined broadly under the Guidance. Any enterprise with a commercial activity in which the state holds an ownership interest, irrespective of the legal form of the enterprise, whether the state holds a majority interest, or whether the state exercises control, is considered a GOE. The reason for this definition is to encourage the best governance of all commercial enterprises that the state holds and manages on behalf of the people. Not included under this Guidance are state agencies whose primary mission is the achievement of social/public objectives.

Government-owned enterprises provide fundamental services that are essential to the development of an economy. These fundamental services are one of the reasons that governments may seek to exercise direct control over them. At the same time, excessive government involvement can introduce a bureaucratic mindset into the management of GOEs and result in un-economic decision making. The BICG effort seeks to address some of these concerns, and to promote professional governance, and strategic and operational oversight in order to enhance the financial and social performance of GOEs.

The governance problematic:

GOEs typically have both financial and social objectives. This mix of objectives can require tradeoffs, and result in inconsistent or un-economic decision making. Part of the difficulty for GOEs in fulfilling their dual commitment is that the costs of the social policies that GOEs are supposed to achieve and the investments they are supposed to make are not fully recognised. The real costs of providing some social services are often difficult to calculate and, even when they are well understood, fair compensation for these costs is not always forthcoming.

Furthermore, the close link to the state may subject GOEs to political influences that make business objectives play a secondary role to policy goals. In many situations this leads to economic inefficiencies that, in turn, impede the achievement of social objectives. These inefficiencies can accumulate, resist resolution and lead to financial problems and even bankruptcy.

Partial or full privatisation is often viewed as the most effective measure for reforming GOE governance and enhancing GOE efficiency. However, privatisation brings with it its own difficulties and does not always succeed in practice. Thus, countries use a mix of approaches to resolve the GOE governance problematic including performance agreements/contracts between the government and the GOE, the use of private sector management techniques and incentives, and improved corporate governance practices.

The scope of the project:

The mission of the BICG is regional. This project covers the three Baltic countries as a group.

It must be recognised that the Baltic countries have different economies, histories, languages, and legal traditions that make it difficult to make standardised recommendations. On the other hand, they also have shared history and the commonality of being countries that have made the transition from central economic control to market economy. They also face common issues with respect to their integration into the EU and the global economy.

The differences between the countries mean that the relative importance of each of the individual recommendations in the Guidance will vary depending on the context. Ultimately, any future reform initiative will need to be designed and implemented at the country level, and adapted to local circumstances.

The term government-owned enterprise (GOE) is used rather than the more common state-owned enterprise to make it clear that the object of this Guidance is both state and municipal enterprises. The governance of municipal enterprises differs in some respects from that of state enterprises.

Municipal enterprises tend to be smaller and the human and financial resources available for the professional governance of municipal enterprises are generally more limited. As a consequence, municipalities need to adapt these recommendations to the local context in order to achieve the desired outcomes. This being said, the basic governance issues faced by municipal enterprises are the same, and it is expected that municipality-owned enterprises comply fully with the spirit of these recommendations.

The relationship of this Guidance to the OECD Guidelines:

Compliance with international agreements and standards of best practice is fundamental to achieving better international integration. In the area of GOE governance, the OECD Guidelines for the Governance of State-owned Enterprises are the international reference point. The OECD Guidelines represent a consensus among the countries with the most advanced thinking on GOE governance.

In comparison, the Guidance focuses on the specific issues faced in the Baltic region. The Guidance is not intended to duplicate the OECD Guidelines. It is intended to help the Baltic countries achieve the international best practice standard represented by the OECD. The reader is encouraged to consult the OECD Guidelines for a more complete listing of the governance issues that affect GOEs and a more detailed discussion of the rationale for best practices.

How the Guidance was developed:

The Guidance was developed under the leadership of the BICG. The BICG is independent from government and business, and has made every effort to produce this Guidance in a thorough, transparent and inclusive manner. The Guidance represents a consensus view of a large number of stakeholders from each of the countries in the region. Individuals who participated in the project, or provided comments or advice on the document did so in their private capacity and not in their official capacity.

The power of the document:

The BICG is a non-governmental initiative and the resulting Guidance is purely voluntary. This being said, the Guidance emanates from the views of a large number of experts, government officials, supervisory board members, GOE executives, shareholders, creditors, and other stakeholders including representatives of civil society organisations. The authority of the Guidance derives from the credibility of the individuals involved in their development and the inclusive process by which they were developed. Furthermore, the potential benefits of sound governance practices are of such significance that they call for a considered application of these recommendations.

Outcomes:

The final aim of the Guidance is more professional governance, better strategic and operational oversight, better financial and social performance and the achievement of the government's strategic objectives. Better GOE governance should have a positive impact on state budgets, on the public's perception of government, and on the quality of infrastructure and services. Better GOE governance will have other impacts including attracting foreign investment, and better integration within the region and the European Union.

In order to achieve these goals, a sustained commitment will be required. For this reason the BICG wishes to encourage high level leadership and broader public awareness and engagement. Countries are encouraged to establish a task force to: consider the issues raised in this document; discuss and evaluate the recommendations; develop action plans; and encourage their implementation.

II. RECOMMENDATIONS TO THE GOVERNMENT

Exercise leadership:

The government needs to develop a reform plan to close the gaps between current and best practices, and better systematise its oversight of GOEs. Any reform plan is unlikely to succeed without the highest level of political support.

Create an ownership policy:

The government needs to have a written ownership policy that should define: the justification and purpose of state ownership; what institutions represent the interests of the state; expected outcomes of state ownership; and the methods by which the outcomes are to be achieved.

The continued ownership by the state of GOEs may be justified when certain criteria are met such as, for example: strategic interest; market failures; public interest; or where private ownership cannot reasonably be expected to deliver on the state's goals. In some countries, even enterprises that meet such criteria may be controlled by means other than direct state ownership.

Government control of GOEs for reasons of crisis management should, to the extent possible, be through regular governance channels. Crises should not justify establishing direct control of GOEs except under the most extreme circumstances and then, the period of planned ownership should be clearly defined.

The government should undertake an impartial review of enterprises under its ownership to assure itself that ownership is consistent with the criteria fixed in its ownership policy. This impartial review should result in recommendations on whether to keep a GOE in the government's portfolio, change its legal form, or sell all or a portion to private interests. The decision to keep a GOE in the government's portfolio should be reviewed regularly.

The ownership policy should indicate that commercial GOEs are to be run according to business logic, even if they simultaneously pursue social objectives, because GOEs can only provide needed social services to the public if they are financially viable. It should also specify what to do in the case of tradeoffs between the social and financial objectives of the GOE. Ideally, tradeoffs should be arbitrated by independent regulators and/or through negotiations with management, and set down in performance agreements/contracts that are agreed with the state.

The ownership policy should mandate a clear separation between government bodies responsible for overseeing the shareholder interests of the state and those that are responsible for implementing the social or industrial policy interests of the state through the GOE. The ownership policy should clarify any potential confusion with respect to the roles and objectives of government bodies, supervisory boards and management teams with respect to these interests.

The ownership policy should be disclosed to the public including on the internet so that the objectives and policies can be understood by the public.

Establish an ownership entity:

Governments should create an „ownership entity" or central shareholder oversight in a single department or ministry in order to ensure consistent and professional governance of GOEs. The ownership entity should exercise the legal rights and responsibilities of the state as a shareholder and carry the ultimate responsibility for shareholder oversight of the GOE for the government. The consolidation of physical share ownership is also recommended.

The ownership entity should have its rights and responsibilities formalised in a written document. Its responsibilities should include: gathering information on all enterprises in which the state has ownership; providing analytical capabilities; advising government on GOE issues including on law, regulation, policies and procedures; nominating members of supervisory boards; helping in setting measureable performance targets; monitoring performance; and reporting.

The ownership entity should produce annual reports that show GOE performance on an aggregate and individual GOE basis. The reports should track key performance indicators, for example, cash flow and liquidity or any other indicator that describes the sustainability of the GOE's business model.

Additionally, performance measures should be established for the ownership entity. Ownership entity performance against these measures should be reported on an annual basis. Reports should be made public and should also be addressed to the parliament.

Information on the government's GOE portfolio:

The state needs to have complete and accurate information on GOEs in order for it to develop sound policy and exercise responsible oversight. Information must be available both in the aggregate and for all individual GOEs. The government must also have the capacity to analyse information especially budgetary impact and risks. The government must track minority participations and legacy/residual shareholdings from privatisation. Information should be shared between ministries and/or relevant agencies. Care must be given to ensure that confidential information on the GOE and information with potential insider value be properly safeguarded.

Using the proper legal form for government enterprises:

The legal form of enterprises should correspond to the nature and activity of the enterprise. Government enterprises that conduct commercial activities should take the legal form of a joint stock company or limited liability company and have the same governance structures as a private enterprise and be subject to the same legal requirements under commercial and other law.[1]

1 The legal terms used to describe joint stock companies, limited liability companies, company law, etc. may differ depending upon the country.

Depoliticising decision making and creating a stable business environment:

Short-term political objectives, political instability, or changes in government administration should not be allowed to destabilise the GOE. The politicisation of strategy, investments, and operational decisions and frequent changes due to the election cycle damage the GOE's and society's interests by causing an uncertain planning and operating environment.

The governance of the GOE should be systematised and policies formalised in order to insulate the GOE from changes in political currents, and to create continuity when individual ministers have different management styles. Professional, objective and independent oversight via the supervisory board and regulators is best suited to oversee the GOE.

Strengthening oversight and control:

Governments and ministries should not intervene directly into or micro-manage the GOE. Government officials do not usually have the business expertise or experience needed to successfully operate a GOE and government officials do not operate under the same incentives. Direct government intervention into the GOE also has the effect of demoralising supervisory boards and creating passive behaviour since the power and authority of supervisory boards is removed.

Rather than circumventing supervisory boards, efforts need to be made to strengthen them. Professional, trustworthy and well-managed supervisory boards are better tools for exercising GOE oversight.

Additional alternatives to direct intervention need to be developed such as, for example, enhanced market regulation and GOE performance contracts.

Effective regulatory regimes should be established in regulated industries:

Some GOEs operate in regulated industries. Effective regulatory regimes are needed as an alternative to direct government intervention into the management of the GOE. The regulator itself needs to apply best practice standards of governance and needs to be independent and shielded from political intervention.

Regulators should fulfil the function of independent mediator between the GOE, the state and the public. GOEs need to receive fair compensation for the services they provide to the public at the behest of the state in order to avoid financial distress and to continue to provide services in the future.

Regulatory capacity needs to be built. The selection of the staff of regulatory agencies should be based exclusively on technical competence. Sufficient staffing and budgets need to be provided and technical competencies need to be enhanced. International best practice on industry regulators should be followed.

The regulatory and tariff setting process should be ruled by clear and transparent norms. It should include all relevant stakeholders, including customers, and must be transparent to the public.

Promoting active stakeholder oversight:

The government should promote governance structures that help to monitor GOEs and incentivise performance. One of the best ways to do this is to widen the ownership base of the GOE and open its capital to outside investors. Outside investors could be portfolio investors or strategic investors. Even the listing of a small percentage of the GOE's capital on a stock exchange serves to improve reporting, create market discipline and raise governance standards. Better oversight, strengthened incentives and a more efficient allocation of resources can also be achieved to some extent through bond offerings or through lending relationships with banks and other creditors.

Dividend policy:

The GOE should have a formal dividend policy. The dividend policy should be public and enforced. Decisions on dividends should be approved by the supervisory board and take into account the investment needs of the GOE. Discretionary dividend take-outs by the government should be avoided as they may hinder planning and investment by GOEs.

The supreme audit institution:

The supreme audit institution is expected to provide an assessment of the government's effectiveness in exercising its shareholder responsibilities as well as its effectiveness in achieving its stated policy goals. Within the framework of its audits, and depending on the audit findings, the supreme auditor may also provide an assessment of the performance of individual GOEs and of the government in exercising oversight over individual GOEs. Within the scope of its work, the supreme auditor is also expected to provide an assessment of the performance of the ownership entity.

The supreme auditor should be able to choose and conduct audits with complete independence. The findings of the supreme auditor should be presented to parliament and made public.

Mandatory audit committees:

The government should examine which companies can benefit from the establishment of an audit committee of the supervisory board. Audit committees should be mandatory for larger and strategic enterprises. Even where a fully independent supervisory board exists, audit committees should be established to better handle the large volume of specialised work associated with the financial reporting and audit functions of the GOE.

Use of GOEs for government business:

The finances of the GOE should be used exclusively in the interests of the GOE. The use of GOE funds for state purposes, other than through the payment of dividends, should be prohibited. The use of GOE finances for funding political parties or political activities either directly or indirectly should be prohibited. GOEs should not be used by the government to contract articles in the press. Where the government uses GOEs to finance investment projects not directly linked to the GOE, alternative systems of funding government projects need to be developed.

Parliamentary oversight:

Parliament, as the representative of the people, needs to apply principles of good GOE governance and be regularly informed of GOE affairs. The creation of a parliamentary committee to follow GOE affairs can help bring professionalism to parliamentary oversight. The government and ownership entity should report to parliament at least annually on the state of their oversight of GOEs.

Contracting:

Commercial and other contracts must be respected. Contracts between GOEs and suppliers should not be selected by decree; fair and best practice tender procedures should be applied with special attention paid to preventing abusive related party transactions.

Civil servants:

Civil servants should receive training and proper incentives to fulfil their roles.

III. RECOMMENDATIONS ON THE SUPERVISORY BOARD

Establishment of supervisory boards:

The Guidance takes no position on the use of single, two-tier or other board structures. The position of the Guidance is that all GOEs must have an elected oversight body that is responsible and accountable to shareholders. Recognising the different legal traditions and practices in the Baltic countries, this body is referred to as a "supervisory board" throughout this document for the sake of simplicity.

The supervisory board is an essential tool for directing the GOE and holding management to account. All larger and strategic GOEs need to have functioning supervisory boards. It should be clearly stated in law and broadly understood that the supervisory board is the body that carries the ultimate responsibility for the performance of the GOE.

The general duties of supervisory board members:

Supervisory board members have a duty of loyalty and a duty of care to the GOE and its shareholders. The duty of care requires supervisory board members to act on a fully informed basis, in good faith, and with due diligence. The duty of loyalty is a duty of allegiance to the company and the company's shareholders. The duty of loyalty requires the supervisory board to maintain and increase the value of the GOE for its shareholders.

These duties provide important guidance on how to deal with the conflicts that sometimes arise between the financial and social goals of the GOE. Financial goals generally take precedence. However, where social goals are fixed in performance contracts or the law, as suggested in this document, supervisory board members owe a higher allegiance to the law.

When government is not the sole shareholder, supervisory board members are responsible equally to all shareholders. They should not represent the interests of one shareholder or shareholder group over another.

Supervisory board members should be nominated based exclusively on competence:

Supervisory board members should be nominated based upon their professional competence and their contribution to the GOE. Members should not be selected based upon political considerations. Business people and others with relevant experience should be allowed to be on supervisory boards and should be actively sought out.

The supervisory board nomination policy should be formalised, maintained by the ownership entity, and made publicly available, including on the internet. Compliance with the nominations policy of the ownership entity should be audited either by an independent external auditor or by a government audit entity on an annual basis.

Supervisory boards should be composed so as to provide the GOE with needed skills:

The supervisory board should be composed of individuals who bring needed knowledge and skills to the GOE. The skills should include, among others, knowledge of: the industry; finance; workings of a professional supervisory board; management including incentive compensation; and other areas. The supervisory board should have all of the needed skill sets as a group even if any single individual might not posses them all.

Attention needs to be paid to the interpersonal skills of supervisory board members. They need to be able to work well in a group environment and be able to provide and receive constructive criticism. Supervisory board members should receive induction training upon taking up their roles.

Independence:

The supervisory board needs to have the capacity to arrive at objective and independent judgements. Ideally, parliamentarians, ministers, vice ministers and civil servants should not sit on supervisory boards. Where this is not practically possible, clear rules need to guide supervisory board members in the exercise of their duties. These rules need to underscore the duty of loyalty of all supervisory board members to the GOE and its shareholders, and regulate potential conflicts of interest when the supervisory board member is elected by the state. At least half of the supervisory board should be composed of independent, or at least independently-minded, supervisory board members.

There are many and sometimes complex definitions of independence. However, an independent supervisory board member can be simply defined as someone who is capable of independent judgement and thinking.[2] This also means that they should not be guided by any political concerns when carrying out their duties.

The specific responsibilities of the supervisory board:[3]

The supervisory board needs to have the authority to act in accordance with its duties. The supervisory board should consider all business

2 A more explicit definition would be a supervisory board member who has no material relationship with the company beyond his position as a supervisory board member (either directly or as a partner, shareholder or officer of an organisation that has a material relationship with the company). An independent supervisory board member should be independent in character and judgment, and there should be no relationships or circumstances which could affect, or might appear to affect, the supervisory board member's independent judgment.

3 Numerous national publications and standards for board practices exist. A collection of international codes and principles can be found on the website of the European Corporate Governance Institute (ECGI) (http://www.ecgi.org/). An international consensus view on boardroom practices can be found in: Using the OECD Principles of Corporate Governance: A Boardroom Perspective.

issues that may materially impact the GOE, and be forward looking in the exercise of its duties. Some of its specific responsibilities are to:

- **Review and guide strategy:**

  The supervisory board should rigorously review management's strategy, major action plans and performance objectives.

- **Select management:**

  It is the responsibility of the supervisory board to select the CEO and negotiate his/her hiring, and provide succession planning. The supervisory board is responsible for approving employment contracts for the management team.

- **Evaluate performance:**

  It is the responsibility of the supervisory board to assess the GOE's financial performance and its performance against the social obligations it contracts with the state. Performance reviews of individual managers should be conducted at least annually. Where there are serious doubts regarding the capacity of a manager to meet future goals, supervisory boards need to be able to terminate staff.

- **Supervise and guide the remuneration of executives:**

  The supervisory board needs to ensure that remuneration and incentive compensation policies are consistent with the objectives of the GOE. The supervisory board must assess whether compensation levels are sufficient to attract, retain and motivate the level of executive required to achieve the GOE's goals. The supervisory board should also consider whether systems for remunerating and motivating employees are consistent with modern human resource management practice.

- **Financial oversight:**

  The supervisory board is responsible for ensuring the integrity of the GOE's accounting and financial reporting systems, overseeing the internal audit function and the external audit, selecting the auditors and the audit process, and the material accounting decisions of the GOE.

  These responsibilities require expertise and a significant time commitment and should be assigned to an audit committee. The central concern of the audit committee is to ensure that appropriate systems of control are in place, in particular, systems for risk management, and financial and operational control. The audit committee should be fully staffed by independent supervisory board members.

Detailed international guidance on the proper role of the audit committee is widely available and should be consulted.

- **Ensure the existence of a true internal audit function:**

  It is recommended that the larger GOEs and those playing an important public policy role establish a true internal audit function that is distinct from the internal control function. It should report directly to the supervisory board and, if requested, be able to meet with the supervisory board without members of the executive present. The internal audit function should comply with international best practice standards.[4]

- **Ensure transparency to shareholders and the public:**

  The supervisory board should inform the public on its role. This should occur at a minimum in the annual report, in the GOEs governance report and also in the context of the annual general meeting. The supervisory board is to maintain communications with the public on how government-pacted objectives are being achieved.

- **Compliance:**

  The supervisory board is responsible for ensuring that systems are in place that monitor the GOE's compliance with the law and its respect of contractual obligations including written performance agreements/contracts with the state.

- **Develop and oversee implementation of ethics codes:**

  The supervisory board should have an ethics code. The code should cover, among other things, instructions on how to handle conflicts of interest and related party transactions. The supervisory board should oversee the development and implementation of an ethics codes for the staff of the GOE's. Ethics codes needs to be made publicly available.

- **Self-evaluations of supervisory boards:**

  The supervisory board should familiarise itself with best corporate governance practices, and regularly evaluate its own performance and governance against these best practices. Supervisory boards need to develop and implement improvement plans.

4 Internal audit standards and best practices are provided by the Institute of Internal Auditors. The Committee of Sponsoring Organisations (COSO) provides best practices for internal control and risk management integration.

Stabilisation of the supervisory board:

Supervisory boards should be able to work in a stable context. Members should be appointed for fixed terms, preferably not less than 3 years, and should be able to complete their terms irrespective of personnel changes in ministries or government administrations.

Establishing formal supervisory board procedures:

It is recommended that GOEs adopt formal supervisory board procedures. These procedures should be developed in collaboration with the state, the supervisory board and GOE executives and should take into account international best practice. Procedures need to underscore that the supervisory board is ultimately responsible for the performance of the GOE. Attention must be devoted to properly defining the roles and responsibilities of the supervisory board versus the state, and management.

Compensation for supervisory board members:

Supervisory board members should be compensated for their duties. This is usually in the form of an annual retainer and/or meeting attendance fees with additional fees sometimes paid for additional work such as work on a committee. Their fees should be determined by market practice and should neither be set very much below nor above fees paid at a peer group of companies.

IV. RECOMMENDATIONS ON THE MANAGEMENT TEAM

The selection of the management team:

The government should not be involved in the selection of the management of the GOE. The responsibility for hiring and firing the CEO belongs to the supervisory board. The CEO, in turn, is responsible for selecting the management team.

For the sake of simplicity, and given different terminology, legal traditions and practices in the Baltic countries, the group of high-level managers responsible for the day-to-day operations of the GOE are referred to as the "management team".

Management should be selected based exclusively on their competence. Members of the management team must be full-time employees of the GOE.

Operational autonomy and managerial accountability:

Professional managers are best suited to manage commercial enterprises, and management teams must be given the operational autonomy to bring their skills to bear. The government should not be directly involved in operational decision making.

At the same time, systems need to be developed to better hold management to account so that the state can feel comfort with the greater operational autonomy of managers. Greater autonomy can only be given in exchange for greater transparency and accountability. A strong supervisory board is of fundamental importance to generating trust and for the government to shift operational control.

Performance goals:

The management team needs to be given clear goals. These goals need to be agreed with the CEO and formalised. To the extent possible these goals should be measureable; however, the achievement of qualitative goals must not be neglected. Managers need to be assessed annually on the achievement of goals.

Remuneration and incentive compensation:

Managers and employees of GOEs should receive fair compensation. Fair compensation is important not only to attract and maintain staff, but also to encourage employees to perform. It is important to match compensation to the importance of the employee's function, and to allow employees to make a dignified living. Incentive compensation schemes should be considered for all staff members.

Ethics codes:

The GOE should have an ethics code for all staff members. Having an ethics code is in the long term interest of any GOE since an ethical enterprise is also a credible and trustworthy partner. Systems for checking compliance with the ethics code need to be established.

V. RECOMMENDATIONS RELATING TO REPORTING AND AUDIT[5]

All material information should be publicly disclosed:

GOE disclosure needs to be enhanced to hold both the GOE and public sector officials accountable to the public. Disclosure requirements for GOEs should be equivalent to private sector disclosure. In addition to disclosure required of listed companies, GOEs should disclose: any social commitments made; costs of providing social services; subsidies or financial assistance provided by government or other GOEs; or any other material engagement into which the enterprise enters as a result of its status as a GOE. Disclosure needs to occur on a timely basis and be available on the internet. GOEs should report on relations with stakeholders, especially clients and employees.

Reporting standards:[6]

The state should have access to the same quality information on its GOEs as provided by private sector companies to the financial markets. As a consequence, GOEs should comply with the same reporting standards as listed companies. Financial reports should be produced in accordance with International Financial Reporting Standards (IFRS) and audits should be conducted in accordance with International Standards of Audit (ISA). Adherence to better accounting and disclosure standards will make GOEs more accountable and encourage better performance.

Conduct of an annual external audit:

An annual audit should be conducted by an independent, competent and qualified external auditor in order to provide an objective assurance to the supervisory board and shareholders that the financial statements fairly represent the financial position and performance of the GOE. The quality of the assurance services provided by external auditors needs to be closely examined.

5 In depth reviews of accounting and audit practices in Estonia, Latvia and Lithuania have been conducted in the context of the World Bank's Reports on the Observation of Standards and Codes (ROSC). These contain numerous recommendations on the accounting and audit framework that support better corporate governance and should be consulted.

6 Financial and non-financial reporting requirements should comply with EU Directives. Pronouncements of the Committee of European Securities Regulators (CESR) and the International Organisation of Securities Commissions (IOSCO) also provide guidance on good practices.

The interaction between the auditor and the GOE:

The interaction between the independent external auditor and the GOE's supervisory board needs to be greatly enhanced. Supervisory boards need to consider reporting issues far more carefully and the audit profession needs to insist on calling the attention of the supervisory board to its work. The supervisory board agenda must cover at a minimum: systems of control, risk, the internal audit, the external audit, and material accounting decisions.

Reporting on corporate governance:

The GOE should benchmark its corporate governance practices against a high quality standard and report on its practices to the public. The benchmark could be a national code of corporate governance for listed companies or an international benchmark. Countries should maintain up to date corporate governance codes that correspond to best practice. The GOE's corporate governance report should be made publicly available including on the GOE's web site.

Key messages

The Baltic Institute of Corporate Governance (BICG) is a non-governmental organisation devoted to raising standards of corporate governance in the Baltic Region. Its most recent initiative is designed to enhance the governance of government-owned enterprises (GOEs), both at the state and the municipal level. Some of the important messages found in the Baltic Guidance on the Governance of Government-owned Enterprises are:

- GOEs are important economically, politically and socially. They are too important to tolerate inefficiencies, self-interested rent-seeking or their use as political playgrounds.
- Better GOE governance will have a positive impact on state budgets, on the public's perception of government, and on the quality of infrastructure and services.
- The proper governance of GOEs requires depoliticisation of decision making and the operational separation of the state's shareholder oversight from its industrial policy and regulatory functions.
- A written ownership policy needs to guide the state. It should define: the purpose of state ownership; what institutions represent the interests of the state; expected outcomes of state ownership; and the methods by which the outcomes are to be achieved.
- A professional supervisory board is essential for directing the GOE and holding management to account. Supervisory board members should be professional and competent, and not nominated based upon political considerations
- Professional managers are best suited to manage commercial enterprises. They require operational autonomy. At the same time, managers need to be held fully accountable for their performance.
- Both GOEs and the public sector bodies responsible for their oversight need to be accountable to the public through greater disclosure and transparency.

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