

FOREWORD

State property management reform has become a high priority for the government of Ukraine in recent years. Although the long-awaited Law of Ukraine "On Privatisation of State-Owned and Municipal Property" came into force this year, its feasibility and the real effects of it are still to be seen in the nearest years. Until that time, more than 1,500 state-owned enterprises (SOEs) will still be managed by Ukrainian government.

SOEs continue to play an important role in Ukraine, accounting for a significant proportion of Ukraine's GDP and employing up to Imln people in areas like energy, machine-building, and infrastructure. Being one of the largest state sectors in Europe, Ukrainian SOEs remain inefficient and often unprofitable.

Much effort in recent years has been put into building public's trust that SOEs are managed transparently and professionally. This effort included requirements to publish financial statements and undergo international audit, new and transparent way to appoint CEOs, creating first, truly independent boards in an effort to isolate the jewels of Ukrainian economy from political meddling, and raising management compensation to a market level to attract top talent and motivate them to put on a good fight. Yet more is needed to achieve sustained progress.

One of the key remaining reasons for poor SOE performance is their contradictory nature combining both social and business objectives. While achieving important social and policy goals, SOEs are expected to adjust to market economy and compete with private-sector enterprises in profitability and effectiveness. Another challenge of having successful SOE sector is a complex chain of stakeholders that involve government, parliament, SOE boards and management, private shareholders and last, but not least, the public. All of that requires proper governance and accountability structures, as well as subtle decision-making and transparency. Often, these two aspects create a compound and puzzling task for the ownership function of most of the countries. Given corruption and political instability, the governance of SOEs in Ukraine becomes even more challenging. But, certainly not impossible.

The key to successful SOE governance in Ukraine is bringing the best global standard, adjusting it to the Ukrainian context, yet raising the bar high so that we achieve the goal fast and with a maximum public's support. OECD Guidelines on Corporate Governance of SOEs has become an undisputed benchmark and a firm consensus among the countries with the most advanced thinking on the SOE governance. Therefore, delivering these standards and tailoring them to Ukrainian situation has become the rationale for preparing this document.

The Recommendations, as a political manifesto to Ukrainian government, has a major advantage compared to initiatives and laws already introduced to pursue the SOE reform in Ukraine. The manner in which our document is structured provides for simple and immediate implementation. The "challenge-good practice-recommendation" structure allowed us to adjust the global governance standard to Ukrainian context and would help the government and SOEs apply it with no further delay.

UCGA took the lead in this project and gathered around a group of international and local experts, all realizing how critically important reforming the SOE sector is to Ukraine and its European aspirations. Drafting the Recommendations embodied inclusive and open discussions which raised questions far beyond of what the Recommendations were meant for. It could only mean that this manifesto is only the first step in helping bring good order, accountability, transparency and latest global trends into reforming the SOE sector of Ukraine. Further discussions and consultations will be needed to ensure Ukraine's right direction and UCGA will gladly lend it's guidance and administer the process.

We have no doubts that the Recommendations is a kind of document Ukraine needed for a long time. Such elements as independence of the board, gender diversity, centralization of SOE management function are all proven globally to lead us towards better results and higher public confidence. Building awareness and bringing the global standard of governance closer is the goal of our document. Keeping the same level of engagement and expertise will improve the SOE governance in Ukraine and lead to positive economic development in the country. UCGA will continue to guide in this direction.

Chairman,
Ukrainian Corporate Governance Academy



Aivaras Abromavicius



ACKNOWLEDGEMENTS

The roots of the project of the Recommendations on the Governance of SOEs of Ukraine lay in a successful launch of the Guidance on the Governance of Government-owned Enterprises prepared by the Baltic Institute of Corporate Governance. Their initiative served as an inspiration to initiate the document with a homogeneous aim in Ukraine.

Preparing the Recommendations could only be possible by means of a strong commitment of the UCGA Advisory Group. Our Advisory Group included international experts from countries such as Sweden, Norway, United Kingdom, Israel, Latvia as well as policy experts from international organizations of OECD and IFC. The Recommendations would become vague if not a vigorous participation of local experts, among which the representatives of Ukrainian government, ministries and authorities, NGOs and law firms. The most valuable input that one could make for the Recommendations was the participation of Ukrainian SOEs, which made our document genuine and actual, thoughtfully illustrating the challenges Ukrainian SOEs are facing. We express our gratitude to CEOs and board members of the largest SOEs of Ukraine: NAK Naftogaz, Ukrzaliznytsia, Ukrposhta, Ukrenergo, Ukrtransgaz and others.

Special thanks to the executive team of the Ukrainian Corporate Governance Academy and congratulations on its first policy document.

And of course, a special appreciation to a person that was an architect of the document and the main expert of our project — Richard Frederick, an international corporate governance consultant and contributor to numerous corporate governance initiatives around the world. Without his experience and direction, patience and diligence the Recommendations would lack authority and relevance.

We owe our appreciation to the European Bank of Reconstruction and Development and their financial assistance to our project. Its sound commitment towards non-governmental initiatives like ours gives us a profound belief in bettering Ukrainian economy in the nearest years.

President, Ukrainian Corporate Governance Academy

Adomas Audickas



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I. BACKGROUND AND INTRODUCTION

A. Context

The mission of the Ukrainian Corporate Governance Academy (UCGA) is to help build well-governed enterprises in Ukraine through education and leadership and by promoting good corporate governance practices. As one of its first projects, UCGA decided to contribute to the reform of Ukraine's state-owned enterprise (SOE) sector, which represents a considerable part of the Ukrainian economy with a promising future, and take the lead in preparing these Recommendations on the Governance of State-Owned Enterprises of Ukraine (the Recommendations).

Given the limited understanding of fundamental principles of good corporate governance, the Project aims at raising awareness and giving guidance on good governance practices to those who exercise state ownership and to the boards and management of SOEs. Drawing up these Recommendations is, above all, an endeavour to improve the efficiency of SOEs, promote a healthy and transparent governance system, raise the quality of important services for Ukraine's citizens, and contribute to developing the economy of Ukraine.

It is important to define what is meant by state-owned enterprise at the outset. For the purpose of these Recommendations, any corporate entity that is recognised by law as an enterprise and in which the state exercises ownership can be considered an SOE. This could include statutory corporations established under specific legislation, joint stock companies, or limited liability companies. It may also apply to autonomous government administrations. The definition refers to enterprises that have a commercial focus. It would, thus, exclude entities such as tribunals, theatres, schools and hospitals though these too can benefit from following principles of good governance.

The definition of SOE also includes a criterion for control. Though the state has an obligation to act responsibly and professionally in its stewardship of any asset it holds, the Recommendations apply to enterprises that are under state control. Control usually implies a right and an obligation to exercise a role in the governance of the enterprise. In some cases even a minority-owned enterprise can be under the effective control of the state. Equity investments held via an investment or pension fund would not be considered SOEs.

For the purpose of these Recommendations any entity that falls under this definition should be treated as an SOE irrespective of its legal form. With these Recommendations. UCGA seeks to address the governance and operating challenges facing these entities and promote a unified and coherent approach to the exercise of state ownership.

Finally, for the purpose of these Recommendations, the term "board" is used to refer to a supervisory board in a two-tier board system. Under the two-tier system, the body that comprises executives is referred to specifically as a "management board".

B. SOE governance challenges

The key challenges in the governance of SOEs in Ukraine are:

- I) Weak and informal oversight institutions and an absence of auniform state ownership policy.
- 2) Fragmented legislative framework governing the operations of SOEs that sets conflicting strategic, financial and social objectives, undermines the overall strategy and leads to mismanagement.
- 3) Excessive and complex legal forms that subject SOEs to different governance and operational requirements.
- 4) A complex chain of authorities responsible for the exercise of the ownership function and extensive bureaucracy that undermines the ability of SOEs to act in a timely and effective manner.
- 5) Lack of clarity of roles evidenced by insufficient board autonomy, as well as excessive interference by the state.
- 6) Differences in the regulation of SOEs and private enterprises, in particular, special legal regimes for SOEs in taxation, bankruptcy and competition.
- 7) Governance roles and decision-making dispersed amongst numerous institutions with frequent conflicts of interest.
- 8) The government simultaneously acting as shareholder, financier, policy maker, regulator, supervisor, clientand/or supplier.
- 9) Limitedunderstanding of essential features of good governance and management, such as the role of independent board members, planning andmanagement by objectives, performance incentives, the recruitment and motivation of talent, transparency and accountability to the public.
- 10) Practices that enable corruption, and reveal a fragile commitment towards international standards of good governance.
 - 11) Weak regulators in regulated industries with non-competitive markets.

C. Relationship between the Recommendations and the OECD Guidelines

UCGA recognises the OECD Guidelines on Corporate Governance of State-owned Enterprises as the global standard of governance for SOEs. These Recommendations

are not intended to supplant the OECD Guidelines (http://www.oecd.org/corporate/guidelines-corporate-governance-SOEs.htm). Rather, they are designed to help policy makers and public officials responsible for exercising the ownership function of Ukrainian SOEs achieve better compliance with the international standard.

D. Methodology

These Recommendations were developed by the UCGA Advisory Group on SOE Governance under the leadership of the UCGA Secretariat. UCGA is an independent non-governmental body and is neither an advocate nor lobbyist for or against government or business. UCGA's objective was to develop these Recommendations by building a consensus amongst a variety of stakeholders all of whom shared the common goals of enhancing the effectiveness, efficiency, transparency and integrity of Ukraine's SOE sector.

The Advisory Group consists of government officials, board members, SOE executives, regulators, International Financial Institutions, as well as international and local experts on state ownership and corporate governance. The membership of the Advisory Group can be found in the Annex. Individuals who participated in the project, or provided comments or advice on the Recommendations, did so in their personal capacity and did not necessarily represent the views of the institutions with whom they might be affiliated.

Increased public awareness is needed to get the full benefit of the Recommendations. UCGA therefore encourages a continuing public discussion of SOE governance issues and a regular dialogue between the public, SOEs and the state as an owner. Future updates to the Recommendations are planned by the UCGA in response to national and international developments.

E. Power of the Recommendations

UCGA is an independent non-governmental body. These Recommendations are, therefore, entirely non-binding and voluntary. The Recommendations have been produced by UCGA with the contribution of a group of stakeholders, as mentioned above. It is the reputation and expertise of this group of individuals that brings authority to the Recommendations. Despite their voluntary nature, the application of these Recommendations is considered an important precondition for the betterment of SOEs in Ukraine.

F. The goals

The UCGA Recommendations have the overall goal of improving the exercise of state ownership and SOE management with the following more specific objectives:

Protect state assets and improve the health and value of Ukraine's SOEs:

- Improve the financial health of SOEs and thereby strengthen the financial position of the state.
- Provide consistent legal framework for SOE governance in Ukraine synchronizing the standards for all companies.

Enhance outcomes for the public and enhance operating efficiency:

- Improve the quality of the services provided by SOEs to Ukraine's citizens and businesses.
- Improve the effectiveness and efficiency with which SOEs operate and demonstrate a good return to taxpayers.

Enhance competitiveness and macro-economic development:

- Help SOEs achieve results at least equal to those of private sector counterparts.
 - · Create a more competitive business sector and a stronger economy.
 - Help develop Ukraine's capital market.
 - Enhance SOE competitiveness on the international markets.

Ensure transparency and accountability to the public:

- Improve the accountability of the government to the public and encourage transparent government.
- Achieve greater compliance with international agreements and standards of best practice, encourage better international integration and image of Ukraine.

Reduce operating and political risks:

- Reduce financial and operating risks within SOEs including the risk of mismanagement and corruption.
 - Defuse potential political risks resulting from poor SOE performance.

G. The scope of the recommendations

There are over 1,500 SOEs in Ukraine of which only about 50 are significant. The rest are relatively small and may be privatised or liquidated in future. While these Recommendations are addressed principally to the larger and/or economically

important SOEs that will likely remain state-owned, many of the recommendations also apply to smaller enterprises though they may need to be implemented differently or to a lesser degree. Some judgement will be required to discern which recommendations should apply to such enterprises and the degree to which they can be applied.

H. Target audience

These Recommendations are addressed to government owners, board of directors of SOEs, and to SOE management. They can also be useful for non-state shareholders, and other stakeholders, including the accounting and audit, and risk management professions.

II. RECOMMENDATIONS FOR GOVERNMENT OVERSIGHT

A. Leadership

Challenge:

The government is generally a passive shareholder. It has not taken any clear position on the governance of SOEs or expressed any unified vision on how to improve the governance and performance of Ukrainian SOEs. Nor is it conscious of how weak governance practices are harming SOEs, the economy and the public. There is a grave absence of knowledge of good governance practices within the administration which is, in turn, aggravated by weak knowledge of good public sector governance practices. The absence of knowledge and commitment limit the positive effect that good governance practices can have on the performance of SOEs and the economy.

Good practice:

Countries that have a strong SOE sector tend to have a clear vision of the rationale for state ownership and how state ownership is exercised (how governance is exercised) in order to achieve the state's goals. These are expressed in an SOE ownership policy and executed by an SOE ownership entity (see below). Good governance practices tend to emerge only slowly or not at all in the absence of a clear government vision and commitment to governance reform. In leading countries, good SOE governance is inevitably accompanied by good public sector governance.

Recommendation:

The administration needs to lead by expressingits commitment to SOE reform and to the development of an improvement plan that aims at reforming SOE governance

practices. These UCGA Recommendations can be considered a first step in contextualizing and developing such a strategic reflection. They should lead to a step-by-step action plan that defines outcomes and actions and those who are responsible for their execution. The plan should envisage the creation of an ownership policy and an ownership entity and various other actions as described below. It is essential that SOE governance reform be accompanied by a program to enhance public sector governance since the two go hand-in-hand.

B. Ownership policy

The challenge:

The government does not have a unified "ownership policy" that defines the rationale for state ownership overall and for individual SOEs, its objectives, or the roles of various state bodies. The current governance framework is overly complex and outdated. At times it establishes conflicting authorities and objectives, and does not provide a sound foundation for good SOE governance. Furthermore, the government lacks clear and comprehensive policies and development strategies for certain sectors such as energy and agriculture. The overall result is a lack of clarity in priorities and strategic direction and the role of the state and SOEs in achieving the state's goals.

Good practice:

An ownership policy helps guide the state in its role as an owner of SOEs. It is a written document that, depending upon the country, may be found in the form of a law or a government policy.

Ownership policies typically:

- Describe the rationale for state ownership in terms of:
 - The state's strategic interests.
 - Natural monopolies.
 - Market failures.
 - Sectoral and public policy objectives that cannot be carried out by the private sector.
- Define the State's role in the governance of SOEs and the state institutions involved in the governance of SOEs.
- Distinguish between the roles and objectives of government bodies, boards and management.
- Describe how the state should exercise its ownership responsibilities, the state's principles for corporate governance and what expectations the state has of SOEs.
- Reference and synthesise the main elements of any policies, laws and regulations applicable to SOEs, as well as additional guidelines that inform the exer-

exercise of ownership by the state.

- Define the objective of state ownership for each SOE, the rationale for owning that SOE, and describe what other roles the state has in that SOE.
- Clearly mandate any public policy objectives the SOE might be expected to achieve.
- Include information on the state's policies and plans regarding the potential privatisation of SOEs.

One of the great values of an ownership policy is that it professionalises the government's interaction with the SOE and guides the state in what decisions it can make versus the board and/or management.

Recommendations:

The government should have a written ownership policy to guide its actions as an owner. For Ukraine, given its legal tradition, it may be better to have this policy embodied in law. The government should undertake a regular review of its ownership policy, including the objectives of state ownership for each SOE, every three to five years. The review should: a) determine if the ownership policy is fulfilling its objectives; b) ascertain if it is necessary to adjust the objectives of individual SOEs; c) assure itself that state ownership of individual SOEs is consistent with the criteria set out in the ownership policy; and d) assess whether the objectives of the individual SOEs are best reached through state ownership or by other means. This impartial review should result in recommendations on whether to keep an SOE in the government's portfolio, change its legal form, or to privatise. The ownership policy should be disclosed to the public including on the internet so that its objectives and policies can be examined by the general public.

C. Ownership entity

The challenge:

The government's governance of SOEs is fragmented and decentralised. Ukraine currently has no unified institution specialised in corporate governance to govern SOEs. At present, there are multiple autonomous centres which makes it difficult to devise or implement consistent SOE policy.

Good practice:

Good practice suggests that governments consolidate the ownership functions found within the state administration into one body. This body is generally referred to as an "ownership entity". An ownership entity may be located in a ministry of finance or economics, in a separate administrative entity, or within a sectoral ministry.

An ownership entity acts to: a) inform the state on the status of the SOEs under its stewardship (for example, by identifying weak enterprises and major risks); b) help the state devise sound SOE governance policies (for example, remuneration practices for boards or mandatory disclosure practices for SOEs); c) professionalise ownership practices; and d) conducting information meetings with SOEs if needed.

One of the main objectives of an ownership entities to enshrine principles of good corporate governance across a diverse portfolio of SOEs and ensure that SOEs are given enough operational freedom and independence to achieve both their commercial objectives and their overarching policy goals. Another key objective is to exercise the crucial role of "shareholder" (i.e. that the SOE is governed with a view towards creating shareholder value) whilst the oversight of the achievement of public policy goals remains under the authority of ministries and, at times, of sectoral regulators.

Having a central body responsible for shareholder style oversight of SOEs is also an effective way to separate the ownership function from regulation and policy making (or any other activity performed by the state where there might be a conflict of interest e.g. tariff setting in electricity generation). Ownership entities typically have their rights and responsibilities written down in a separate charter or articles.

Recommendations:

Ukraine needs to establish an ownership entity. An independent ownership entity should promote good governance practices and exercise the role of a shareholder on behalf of the state. The ownership entity should have the requisite capacities and competencies, including knowledge of corporate governance, corporate strategy, management, financial analysis and public policy.

D. Aggregated reporting on the SOE sector

The challenge:

The Ministry of Economic Development and Trade publishes a report on the top 100 SOEs. However, the quality of information, especially financial information, is lacking. At present, there are no aggregated reports on the entire SOE sector. As a consequence, it is not possible to ascertain exactly how many SOEs there are, the degree to which they are performing well, if they are contributing to the state budget (if they represent a financial drain to the state), or the degree to which they might present a financial risk to the country. Nor is it possible to ascertain the degree to which they are well governed. So, for example, it is not possible to assess the quality or effectiveness of SOE boards. The absence of such information makes it difficult to develop SOE policy in areas such as proper board composition.

Good practice:

One of the main roles of an ownership entity is to develop annual status and financial reports on the SOE sector. Aggregated reporting helps hold boards and management accountable. Furthermore, good policy can only be built based on good standardised information. The ownership function should establish uniform principles of portfolio review (issues and indicators to be assessed) to help guide a rigorous evaluation, allow for comparison between companies and performance over time, and to define the report format. Reports should contain information on all SOEs including who is responsible for exercising the state's ownership function, the SOE's board members, the company's development in the previous year and other key information. The report should also show performance against key indicators established for SOEs (including qualitative and quantitative indicators and information that describes the sustainability of the SOE).

Recommendations:

The government should produce an annual report on the state and performance of all SOEs. This report should describe the financial and operational performance of SOEs, the implications of SOE performance on the national debt and the budget, and potential future risks. This report should be made publicly available on the website of the ownership entity.

E. Interference in SOE management and politicisation of SOEs

The challenge:

In Ukraine, ministries are often directly involved in the management of SOEs. The drawback of this approach is that ministerial staff generally have political and government backgrounds but have limited private sector experience or skill in the management of commercial businesses. As a consequence, political and policy needs are often allowed to prevail at the expense of the economic and commercial interests of SOEs and, indeed, the public. Over the long term, this leads to a weakening of SOEs, a reduction in the quality of the services they provide, a drain on public fianances and, in some cases, insolvency.

Good practice:

The oversight and direction of the SOE should be exercised by an autonomous board of directors who are well-versed in business management. SOEs should not be managed directly by the state or by individuals who only have public sector experience. It is entirely legitimate for the state to establish public policy goals for the SOE. However, the costs of public policy goals must be evaluated truthfully and compensated by the state. SOEs should not be unduly destabilised by elections, changes in administrations, or short-term political needs. SOEs should never be used as a source

offinancing for political activities. Dividends or tax contributions from commercial SOEs can be used to fund political activities through the normal state budget process.

Recommendations:

The state should not interfere in the management of SOEs. Rather, the state's role should be to set the ownership policy and determine the high-level objectives for each SOE, elect a competent and independent board, and monitor SOE performance. The relevant ministries should develop clear public policy goals for SOEs with government approval. SOEs decision making should not be politicised. It is important that the state trust the board to make decisions that ensure that the SOE achieves the outcomes set by the state. If there is no such trust, the state can replace the board and/or individual board members. SOEs should never be used as a source of financing for political activities. Dividends from commercial SOEs can be used for political activities through the state budget process. Directions given to the SOE from the owners should go via the Chair of the Board. The state should avoid issuing instructions directly to the CEO.

F. The identification and fair compensation of the costs of public policy goals

The challenge:

The role that SOEs can play in the achievement of public policy goals is not disputed. However, allowing policy objectives to consistently override the economic and business needs of an SOE, or the lack of compensation by the state for the achievement of public policy objectives leads to a gradual debilitation of the SOE which can eventually lead to its insolvency and closure. Many SOEs in Ukraine are in poor financial condition because the costs of policy goals have not been taken fully into account, or these costs have not been compensated by the state.

Good practice:

Public policy objectives need to be clearly contracted and approved by the government. Good practice is for the SOE, in collaboration with the state, to fairly assess the costs of the policy initiatives that the state requires of the SOE and for the State to compensate the SOE for the achievement of these objectives. To do otherwise, endangers first the condition of the SOE, and its future capacity to deliver services and, eventually, to survive. The assessment of the costs of policy initiatives needs to be fair and is usually aided by the input of both the state and management. In some cases, the involvement of an external arbiter such as a tariffs regulator can help ensure agreements based on fair conditions. Compensating the SOE for policy goals also helps distinguish between the roles of the state as an owner, regulator, and purchaser of SOE services and establishes the basis for efficient SOE operations.

Recommendations:

The costs of providing public goods must be assessed fairly and compensated based on realistic and fair accounting data. For regulated industries (such as electricity and water) it is necessary to have a truly independent tariff regulator. Management should always have an input into the setting of prices. It should never be left exclusively to public authorities.

G. Legal form of enterprises

The challenge:

SOEs operate under a complex variety of unstandardized legal forms including the following:

- State-owned unitary enterprises (staturory enterprises) established under Ukrainian law, operatingas a state-owned commercial entity or as a budget-supported entity.
 - · Joint-stock companies which exist in the following legal forms:
 - State-owned management holding company.
 - State-owned holding company.
 - National or state-owned joint-stock company.
 - State-owned business associations (a group or other types).
- Limited liability companies mainly established in the process of privatisation of smaller state-owned commercial entities or by incorporation together with other entities of which only a limited number exist.

These different legal forms create different authorities, and require different procedures that make the implementation of uniform SOE policy difficult. Ukraine lacks consistent legislation regulating the incorporation and operation of public sector entities. Existing legislation provides no clear guidance on the criteria and scope of public sector operations and, as a result, legal structures are sometimes used where they are not practical or feasible. Futhermore, subsidiaries of some SOEs operate with various legal forms, which may cause confusion.

Good practice:

The legal forms under which SOEs operate are generally simplified and standardised based on corporate and commercial law provisions applicable to privately-owned companies. It is preferable to use standard legal forms such as limited liability and joint stock structures and avoid the creation of statutory enterprises (SOEs created by bespoke laws).

Recommendations:

The legal form of enterprises in Ukraine should be standardised especially for SOEs engaged in commercial activities. Such enterprises should be constituted either as limited liability or joint-stock companies. The legal form of SOEs should not give the many privileged status or provide special protections. SOEs undertaking commercial activities should not be exempt from the application of general law, the tax code, bankruptcy and/or regulation. Creditors should be able to press their claims against SOEs and initiate insolvency procedures. There should be no legal limitations on SOEs beyond those normally placed on private enterprises such as restrictions on diversifying products or services, or operating inforeign markets.

H. Performance contracts for the SOE

The challenge:

Performance contracts between the SOE and the state are not generally used in Ukraine, although there is a formal requirement in law to have a written contract between the management and the SOE which has to include duties and responsibilities and KPIs (See IV.B). The performance expectations of the state are generally set in a heterogeneous fashion by sectoral ministries. Objectives are not always clear, are often conflicting and are changed due to political exigencies. As a consequence, it is difficult for SOE boards to establish strategic goals and set Key Performance Indicators.

Good practice:

One of the most important roles of the state is to ensure that a strategic planning process takes place that results in realistic performance objectives for SOEs that are set down in performance contracts. The state does this in close co-operation with boards and executives. A collaborative and iterative process helps ensure clear and realistic expectations. There have been international trends away from putting excessive detail into performance contracts. Performance contracts are better if they focus on outcomes and leave the precise methods for achieving outcomes up to boards and management. Good performance indicators may be, for example, to ensure that the SOE operates profitably, or generates a certain return. There can also be non-financial performance indicators such as ensuring services to a certain percentage of the population, or the publication of financial reports on a timely basis. It is of crucial importance that the terms of performance contracts be respected both by the SOE and the State.

Recommendations:

All SOEs should have performance contracts between the government and the SOE that specify what financial indicators must be achieved and all other major public policy outcomes. SOEs should also have non-financial performance indicators (e.g. productivity or customer satisfaction). Performance contracts need to be agreed

between the state and the board. Performance contracts should focus on high-level outcomes and avoid entering into excessive detail. It is vital that both the State and the SOE comply with the terms of such contracts. The process of agreeing performance objectives should be inclusive and should rely on the expertise and knowledge of management. Performance objectives should be measureable. Progress against performance objectives should be reviewed regularly but no less than on a quarterly basis.

I. Procurement

The challenge:

Procurement procedures are cited by both SOEs and government as a persistent problem, and are often viewed by members of the public as a source of corruption. SOEs view procurement rules as inflexible and wasteful and against the government's own self-interest. On the other hand, government officials generally seek to tighten rules, procedures and oversight to the maximum degree to prevent abuse and corruption. The present state of affairs is that neither the goal of rapid and rational economic decision-making, nor the prevention of abuse are being achieved.

Good practice:

Internationally, sound procurement practices are considered essential. Governments tend to have a variety of approaches with some centralising procurement and others decentralising procurement and putting it entirely in the hands of the SOE. The different approaches have different advantages and disadvantages and the choice of which to pursue depends on the local context. However, the fundamental outcome of good procurement is the same: a) to ensure that SOEs are able to fulfil their procurement needs as quickly as possible and according to their needs; b) to create efficiencies through procurement; and c) to prevent any malfeasance. Excessive bureaucracy and poorly conceived procurement rules are commonly identified problems that need to be rooted out. There has been increasing awareness of the fact that more rules do not always lead to better outcomes and that efforts need to be made to streamline rules to provide companies with needed flexibility.

Recommendations:

Ukraine should review its procurement rules and adapt them to international standards of best practice. Procurement procedures should be based on fair competition and contractors should be reputable, trustworthy and transparent, so that any related party taking part in the tender is scrutinised. Suppliers should be able to challenge the fairness of the tender procedures, and hold SOEs and the state as a shareholder to account via the courts in case of an infringement of the law of contractual obligations. As a matter of general practice, the state should guarantee that all remedies (courts, tribunals, ombudsman etc.) are available on an independent and timely basis.

All participants of the disputes should be treated fairly and equitably by the judicial system. Best practice procurement procedures should be applied with special attention paid to preventing abusive related party transactions.

III. RECOMMENDATIONS FOR THE BOARD

A. Authority and accountability

The challenge:

At present, government bodies exercise substantially all oversight and decision-making responsibilities. Ukrainian SOE boards may, as a consequence, be passive and allow ministries to manage SOE executives directly. The drawback of running SOEs directly is that the government does not have the human resources with the necessary management skills. Furthermore, most of the skills needed to manage a competitive enterprise are absent in government. Boards with some level of independence were created in a handful of the biggest Ukrainian SOEs as part of ongoing governance reforms. The establishment of SOE boards is hailed as an important first step. But, today, the government remains unsatisfied with how boards operate and refrains from giving authority to boards in practice. The government's concern is the potential loss of control and accountability.

Good practice:

All SOEs are expected to have an active board whose role is to guide the enterprise and hold management to account. Boards are, in turn, accountable to shareholders for the performance of the SOE. SOE boards are expected to have the necessary authority, competencies and objectivity to carry out the functions of guidance and monitoring. (The roles and responsibilities of board members are described in III.B-C.) Boards could be either unitary (combining executives and non-executives) or two-tier board structures (with a supervisory board composed of outsiders and a subordinate management board composed of executives) as long as the choice facilitates the effectiveness of the SOE's governance and its performance.

Recommendations:

SOE boards need to have greater authority and greater accountability for decision-making. All Ukrainian SOEs should have active boards with defined roles and responsibilities that correspond to good practice. There should be a clear distinction between the role of the state as a shareholder versus the role of the board. It

is critical for the state to not assume the powers of the board. Board autonomy is particularly important where the SOE has commercial objectives. But, boards should only be given greater authority and autonomy when they have sufficient capacity to oversee management and when the shareholder can hold the board to account. The role of SOE boards should be clearly defined in SOE articles and by-laws and should correspond to those of a limited liability and/or joint stock company under company law.

B. Fiduciary duties

The challenge:

SOE board members are not generally aware of their fiduciary duties as board members or the implications of their duties on their decision making. Major problems arise when SOE board members act against the interests of the SOE out of a sense of loyalty to the individuals who appointed them or to the state. Many board members are unaware that they have a duty to act in the interests of the SOE because this requirement is relatively new and the relevant legal concept is underdeveloped. The legal concept of fiduciary duties (duty of care and duty of loyalty) is similarly undeveloped and no relevant court practice exists.

Good practice:

Under good practice, the board is fully accountable to the owner and has a duty of care and a duty of loyalty to the SOE. Board members should act on a fully informed basis, in good faith and with due diligence while treating all shareholders equitably. The duties of loyalty and care imply that board members act in the interest of the SOE and only act in the interest of an outside stakeholder (such as under a state public policy initiative) when the interests of the SOE are protected. It is important that when carrying out their duties, individual board members do not act as representatives of different constituencies. A board members' duty to the SOE also implies that the overriding objective of the board is to increase the value of the SOE for its shareholders.

Recommendations:

Ukrainian SOE boards need to recognise their duty to the SOE and exercise their duties of loyalty and care. It is essential that, in the event that the interests of the SOE and the public policy interests of the State conflict, that the board ensure that the interests of the SOE prevail. Trade-offs between policy and business goals need to be considered in a fair manner and decisions that go against the interests of the SOE should be fully compensated. So, for example, while the state may have the right to demand the provision of a public service (such as providing clean water at prices that make water widely accessible), the costs of providing such services should be fully compensated and not be allowed to damage or degrade the operations the SOE. In addition, it is important to ensure that fiduciary duties are properly described and

detailed in legislation, regulations on SOE governance and in voluntary codes of conduct. The issue of fiduciary duties needs to be included in induction training especially when board members are civil servants.

C. The roles and responsibilities of board members

The challenge:

Most SOE boards in Ukraine do not fulfil the roles and responsibilities of a board as suggested by good practice. Many board members are unaware of what their roles and duties are.

Good practice:

The board should consider all business issues that may materially impact the SOE. Some of its specific responsibilities are to:

1. Set the strategy and supervise management.

SOE boards should effectively carry out their functions of setting strategy and supervising management, based on the broad outcomes and objectives set by the government. For SOEs, the development of the enterprise strategy may respond to objectives set down in a national development plan. For example, there may be a national electrification or sanitation plan that requires the SOE to provide services to certain societal groups. However, it is important that the state only define the desired outcomes on the broadest level, refrain from interfering in management decision making, and allow the board and management to devise strategies for achieving the agreed outcomes. It is of utmost importance that boards and the shareholder develop mutual trust so that the objectives set by the state are arrived at through a dialogue with the board and between the board and management that ensures that strategies are realistic and realizable.

2. Appoint and remove management.

SOE boards should have the power to appoint and remove the CEO. Selecting the CEO is, arguably, the most important task of the board. CEOs should be appointed exclusively based on merit and experience and not based on political loyalties. It is the responsibility of the board to provide succession planning. Where there are serious doubts regarding the capacity of a manager to meet future goals, boards need to be able to terminate staff.

3. Evaluate financial and operating performance.

It is the responsibility of the board to assess the SOE's performance against commercial and non-commercial indicators, including:

- Profitability (revenues, profits, profit margins, EBITDA).
- Efficiency/return indicators (return on equity, return on assets, dividend pay-outs, sales/employee).
 - Leverage and solvency (free cash flow, debt/equity ratio, liquidity ratio).
- Non-financial performance indicators (sector specific measures, policy objectives, customer satisfaction, employee satisfaction, market share, environmental and social objectives, investment in staff and/or technology, productivity).

The board should track performance of the SOE against major Key Performance Indicators at least on a quarter-annual basis.

4. Supervise and guide the remuneration of executives

The board needs to ensure that remuneration and incentive compensation policies: a) foster the medium-term and long-term interests of the SOE; b) are consistent with the objectives of the SOE; and c) comply with the remuneration policy of the state. The board must assess whether compensation levels are sufficient to attract and motivate qualified professionals. The board should also consider whether remuneration systems are equitable and are consistent with modern human resource management practices. Ideally, remuneration plans should be linked to the achievement of goals as would be the case under a management by objective (MBO) scheme.

5. Ensure an effective control environment

The board is responsible for ensuring an effective control environment. The main elements of the control environment are: I) the audit committee of the board; 2) the independent external audit; 3) the internal audit; 4) internal controls; 5) the compliance function; 6) risk management; and 7) a channel for external and internal whistle-blowers. An SOE should follow best practices as established by the private sector. The SOE control environment may be complemented by a national audit or comptroller's office.

6. Ensure transparency to shareholders and the general public

The board should inform the general public on its role, financial and non-financial performance. This should occur at a minimum in the annual report and in the SOE's governance report. The disclosures are to be made taking into account the size and the type of activity carried out by the SOE. The standards of such disclosures should be the generally accepted international practices for the disclosure of listed companies. Financial reports should be provided on a timely basis. Where there are multiple shareholders, financial reports should be provided to the shareholders simultaneously (fair disclosure) and should not advantage one shareholder over another.

7. Ensure compliance with ethics codes and other rules and regulations

The SOE board should develop, implement, monitor and communicate on its ethics and compliance programmes. Ethics codes should cover, among other things: a) preventing fraud and corruption; b) instructions on how to handle conflicts of interest; c) related party transactions; and d) responsible business conduct. An ethics code may also cover compliance with laws, such as laws on human rights, environmental protection, labour relations and financial accountability. The board is responsible for ensuring that programmes are in place to monitor the SOE's compliance with its ethics code, law and contractual obligations. Ethics codes needs to be publicly disclosed.

8. Evaluate its own governance and conduct self-evaluations

The board should familiarise itself with good corporate governance practices and, under the Chair's oversight, carry out an annual, well-structured self-evaluation to appraise its performance and efficiency.

Recommendations:

Individual SOEs should develop board charters that specify duties, roles and responsibilities, in particular, where legislation is insufficiently detailed. All SOE executives, board members and government officials who are engaged in the governance of SOEs should be required to take training on their roles and responsibilities and the roles and responsibilities of boards.

D. Board composition

The challenge:

Ukrainian SOEs boards tend to be comeposed of individuals with political backgrounds, who represent constituencies, and who have insufficient business experience. As a consequence, decision making tends to give priority to political and policy implications and does not generally give proper consideration to business considerations.

Good practice:

Properly constituted boards are composed of individuals who bring relevant knowledge and skills to the SOE based on the SOE's objective. They are diverse as regards age, gender, geographic provenance and educational and professional backgrounds. (Useful backgrounds and skills are discussed in III.F below.) Good practice SOE boards commonly have at least 5 members and do not exceed 12 members. A more appropriate target size may be 7 to 9. The Chair of the board and the CEO are not the same person. All board members, including any public sector officials, are nominated based on relevant capabilities and have equivalent legal responsibilities and duties to the SOE. Generally, ministers and other top administration officials should not serve on boards and the number of civil servants board members should be kept to a minimum.

Recommendations:

Boards should have members that have the needed capabilities (but, in particular business backgrounds), and the competencies and character to achieve better SOE performance. No active ministers or vice-minsters or politicians who are in a position to materially influence the operating conditions of the SOE should sit on boards. The number of civil servants sitting on boards should not exceed two. It may be useful to work with independent search consultants to find the best possible talent and to ensure that candidates meet these specifications. Gender balance and other forms of diversity should be considered when putting boards together as these can improve board deliberations and decision making. The recommendation is to create gender balance by having a minimum of 40% of board members women and a minimum of 40% men. The ownership entity or a committee independent of the SOE may help to identify appropriate candidates.

E. Board member independence

The challenge:

The law requires 50% of SOE board members to be independent and a handful of Ukraine's largest SOEs follow best practices. At the same time, the capacity for objective and independent thinking and action in the interest of the SOE can be enhanced. At times, the subordination of boards and board members to Ministries prevents them from exercising independent judgment in the interest of the SOE.

Good practice:

The board is able to arrive at independent decisions. Independence of mind is having the courage, conviction and strength to challenge the ideas of other members of the supervisory body, to ask questions and to be able to resist "group think". This is generally aided by requiring a minimum number of independent board members. Parliamentarians, ministers, vice-ministers and civil servants do not qualify as independent and are not generally expected to sit on boards. Board members are expected to act in the interest of the SOE free from any political pressures, constraints or instructions. The ownership entity or other ministries do not propose decisions to the board. Rather the government as an owner should set the broad outcomes expected of each SOE, elect competent board members and monitor SOE performance. Other ministries can achieve sectoral-objectives through regulation or as purchasers of SOE services.

Recommendations:

All Ukrainian SOEs should aim to have at least half of the board composed of independent board members. Being an independent board member means being free of any material interests or relationships with the SOE, its management, other major shareholders and the government, or foreign governments, or the ownership entity that could jeopardise the exercise of independent judgement. The government should

develop a standard, unified and consistent definition of independence and enforce rules for having a minimum number of independent board members. Rules already exist in company charters and/or by-laws that require all board members to be objective and exercise independent judgment, act in the interest of the SOE, and that protect them from political interference. These rules need to be better implemented in practice. The Chair should act as the sole channel of communications with a sectoral oversight ministry or the ownership entity in order to avoid undermining the Chair's authority or sending mixed instructions to various board members or executives. The role of Chair should be separate from that of CEO, as required by law. The Chair should be independent.

F. Board member skills

The challenge:

SOEs boards are generally missing key skills and board members are not necessarily nominated based on the skills that the SOE needs.

Good practice:

Board members are selected based on the skills that are relevant to the SOE and found to be missing on the board. This will vary from one SOE to the next. Board members should, at a minimum, have knowledge of:

- · Sectoral and industry issues.
- Finance, accounting and audit.
- Good corporate governance.
- Private sector management practices.
- Incentive compensation.
- Law and other areas.

The board is expected to have all of the relevant capabilities as a group even if individual board members might not possess them all. Attention needs to be paid to the interpersonal skills of board members.

Recommendations:

The essential means of securing the needed skills for an SOE is through the nominations process (described immediately below). Having demonstrable skills is an essential pre-requisite to devolving authority to boards. In order to supplement the skills that they bring, board members should receive induction training upon taking up their roles. All board members will benefit from training in good governance practices. Induction training is always paid by the company though there may be a good argument for the government to fund basic training of board members, executives and oversight ministries in SOE governance. Ongoing training is generally paid by the company, but is subject to prior approval by the board. External or independent expertise of

specialised local and international institutions, consulting companies or NGOs should be called upon as necessary to provide training services. An oft-overlooked point is interpersonal skills and group dynamics. In many cases, boards need to be trained on how to be more effective as a team.

G. Board member nominations policy and process

The challenge:

There is no comprehensive, transparent and merit-based system for the nomination of SOE board members. The process does consider the merits of candidates but is, ultimately, subject to political influence. Ministers in Ukraine generally have the right to appoint or nominate members of the board.

Good practice:

A structured board nomination process is an important prerequisite for active and informed ownership by the state. The nomination and election of board members, should be transparent, clearly structured and based on an appraisal of the skills, competencies and experiences required for the SOE. In the nomination and election of board members, the ownership entity should focus on the needs of SOE boards. When the state is a controlling owner, it is in a unique position to nominate and elect the board without the consent of other shareholders. This legitimate right comes with a high degree of responsibility for identifying, nominating and electing board members.

Recommendations:

A fundamental right and authority of the government as a shareholder is the nomination of board members. The ownership entity should nominate board members based on the needs of the SOE. The board should be able to influence its own composition. It is, therefore, advisable to involve the SOE board in the nomination process. Involving the board will contribute relevant information about the needs of the SOE. So, when the government is a controlling owner, it should seek help from the board or external consultants. The government may also establish a specialised nomination commission within the ownership entity or a ministry, which can serve as a body to ensure appropriate board succession.

The government should develop a formal nominations policy that has as its goal the identification of the best-suited candidates to meet the needs of the SOE at a particular point in time. This policy should require that posts be open to applicants from the public. Business people and others with relevant experience should be allowed on boards and should be actively sought out. The policy should define the exact powers of the government in selecting board members, and require the use of independent external consultants to assist in the identification and evaluation of candidates. The board nomination policy should be formalised, maintained by the ownership entity, and made publicly available, including on the internet. It is essential that nominations be viewed by the public as objective and independent.

Compliance with the nominations policy should be audited either by an independent external auditor or by a government audit entity on an annual basis. It may be advisable to establish a specialised commission or "public board" to oversee nominations in order to ensure the independence and professionalism of the process. Furthermore, it is useful for the state to establish a database of qualified board members to facilitate search.

H. Fit and proper testing

The challenge:

There are, at present, only minimal requirements for "fit and proper" testing for SOE board members. In some cases, board members have been nominated that would clearly have failed a fit and proper test.

Good practice:

"Fit and proper" criteria are general attributes that establish a candidate's fitness to act as a board member. Fit and proper tests typically examine a candidate's honesty, integrity and reputation. A potential candidate that does not meet fit and proper criteria should not be nominated to the board. Candidates should not become board members if they have a history of:

- Adverse finding in civil proceedings related to commercial or professional matters.
- Guilty findings for any criminal violation related to commercial or professional matters or that would raise doubts on their character as a potential board member.
 - Disciplinary actions by regulatory authorities, professional bodies, or agencies.
- Refusals of the right to carry on a trade, business or profession requiring a license.
- Having undergone (either personally or as a major shareholder or officer of a company) insolvency, liquidation or administration in the last five years.
- Disqualification from acting as a board member or from acting in a managerial capacity for misconduct.

Recommendations:

There needs to be mandatory fit and proper testing of board candidates. Fit and proper testing is best conducted by an independent external service.

I. Committees

The challenge:

All boards of Ukrainian SOEs are required to have audit committees. Despite legal requirements for audit committees, such committees do not fully understand their roles and responsibilities under best practices and do not always have the capacity to effectively oversee the control environment (see Section VI below). Board compensation and remuneration committees are comparatively rare.

Good practice:

Committees are designed to professionalise the work of the board. Board committees permit the board to:

- Handle a greater number of issues in an efficient manner by allowing specialists to focus on specific areas.
- Develop subject-specific expertise on the company's operations, for example on financial reporting, risk management and internal controls, as well as corporate governance.
- Enhance the objectivity of the board's judgment through the presence of independent board members, and insulate it from potentially undue influence.

The most important committee of the Board is the audit committee (in state-owned banks, board risk committees are also common). The audit committee is expected to exercise independent judgment and be independent from management. Ideally, the audit committee should be fully staffed by independent members. The work of the audit committee requires a strong technical foundation. All members of the committee need to have some financial expertise as a user and/or experience in the preparation and audit of financial statements. A written charter that describes the roles, responsibilities, powers and reporting procedures of the audit committee should be approved by the board and disclosed on the SOE's web site. Best practice boards will also often have a remuneration and nominations committee.

Recommendations:

In the short term, the audit committee should be staffed by a majority of independent and financially literate board members. In the longer term, audit committees should be staffed entirely by independent board members. The head of the audit committee should be independent and should be a finance professional. Ukraine should make reference to international best practice in audit committee governance. Greater effort should be made to find more financially literate individuals and individuals with experience in the control environment to staff audit committees. In addition, SOEs are encouraged to consider establishing board nominations and/or remuneration committees. Nominations and remuneration committees help in the search for appropriate executives and board members (often in collaboration with outside bodies) evaluate executive performance and remuneration and set compensation levels. These do not necessarily have to be standing committees. It may also be useful to combine the remunerations and nominations committees based upon the needs of the SOE.

J. Board member remuneration

The challenge:

The topic of board remuneration is new in Ukraine and there is insufficient experience and knowledge of good practice. Generally, low fees make it difficult for SOEs to attract the best qualified candidates. Furthermore, it is unclear if board members should receive incentive compensation.

Good practice:

Honoraria and fees are generally set by the state with some variability allowed based upon the size of the SOE, its relevance and the need to attract board talent. The state should have a written remuneration policy for board members that establishes the basic parameters for board member compensation and benefits. Remuneration should be competitive with the private sector but should not lead private sector practices. It is unusual for SOE board members to receive incentive compensation or equity-based remuneration since these may unduly align board members and executive interests (over whom the board is supposed to exercise oversight) and endanger board members' capacity for independent judgement.

Recommendations:

The ownership entity should establish a clear remuneration policy for SOE boards. For SOEs with predominantly economic objectives board remuneration levels should reflect (but not lead) market conditions insofar as this is necessary to attract and retain highly qualified board members. The government should be aware of how sensitive remuneration levels from the public perspective and ensure that whatever remuneration level is chosen that the process for fixing remuneration is transparent and the remuneration levels are well justified. It is important that SOEs ensure high levels of transparency regarding the remuneration of board members. Failure to provide adequate information to the public could result in negative perceptions and fuel risks of a backlash against the ownership entity and individual SOEs. Information disclosure should include remuneration levels and the policies that underpin them.

IV. RECOMMENDATIONS FOR MANAGEMENT

A. The role of management and managerial autonomy

The challenge:

Ukrainian ministries frequently bypass boards and take an active part in the management of SOEs. Intervention in management can be seen in human resources, financial, investment, operational and pricing decisions among others. When the state engages in the management of SOEs, it effectively takes over the responsibility for SOE performance. This implies that the ultimate accountability for SOE performance shifts from the SOE to the state. Another negative effect of the direct management of SOEs by the State is that executives refuse to take responsibility and push all decisions—even the most minor—upwards to state authorities.

Good practice:

SOEs operate best when there are clear distinctions between the roles of owners, boards and managers. Each plays an important and distinct function. The conduct of the day-to-day business of the SOE should be exclusively in the hands of management. The CEO and management team are, in turn, accountable to the board which is accountable to owners.

Recommendations:

The government should allow SOEs full operational autonomy to achieve their defined objectives. The proper role of the state is to nominate a competent board and contract performance expectations with the SOE. The role of the board, in turn, is to monitor management, hold it accountable for its actions and ensure that management implements the strategic plan and performance expectations. Management is responsible for and should be held accountable for day-to-day operational decisions and outcomes. Neither the state nor boards should intervene directly in management. But, greater autonomy should only be given to executives in exchange for greater accountability for outcomes. General shareholder meetings should never be used for operational decision making and should be convened only once per year except under truly extraordinary circumstances

B. Setting performance objectives for management

The challenge:

There is a formal requirement in law to have a written contract between the management and the SOE which has to include duties and responsibilities and KPIs. Performance objectives may be unilaterally determined by the state and/or unrealistic. Many SOEs are missing practices that allow for the setting of performance objectives for lower levels of management and employees.

Good practice:

The broad objectives set by the state (See II.H) should be supported by detailed performance objectives for all levels of management. Well-managed companies put in place Management by Objectives (MBO) plans. MBO is a management technique whereby objectives are set and tracked. Typically, the objectives of higher level employees are more general and are, in turn, supported by the objectives of lower level employees which are defined in greater detail. MBO plans are typically linked to incentive remuneration plans.

Recommendations:

MBO plans should be put in place for Ukrainian SOEs. These MBO plans need to be designed to support the achievement of the SOE's larger strategic objectives and should be linked to incentive compensation plans for management and employees.

C. Composition of the management team

The challenge:

The selection of CEOs and management is subject to the same politicisation as the selection of board members. In practice, turnover amongst CEOs can either be very high (several times per year in politically sensitive SOEs) or very low to the point where management becomes entrenched. Overall, the time that managers occupy posts does not appear to be determined by their performance. In many cases vested interests resist change and attempt to keep management in place.

Good practice:

CEOs are selected by boards who rely on the expertise of search firms to identify the best talent. The CEO and management selection process is entirely depoliticised though a state may retain a final right of approval. CEOs are responsible for evaluating managers and holding them to account for their performance.

Recommendations:

The government should not be involved in the selection of the CEO or other managers. The responsibility for hiring and firing the CEO and succession planning belongs to the board which should rely on independent search consultants to help find the best suited candidates. The CEO, in turn, is responsible for selecting the management team. Management should be selected based exclusively on their competence. Members of the management team must be full-time employees of the SOE.

D. Management remuneration and incentive compensation

The challenge:

Ukrainian SOEs, with some exceptions, are being held back by antiquated remuneration practices which do not permit competitive salaries. The current remuneration system is based on the pay grades applicable to civil servants which makes it difficult for SOEs to attract quality candidates for most positions. Remuneration policies fail to create incentives or promote performance. Pay schemes are not linked to modern management tools such as management by objectives (MBO).

Good practice:

Boards take an active interest in remuneration and use it to incentivise management. Though pay is often less than in the private sector, efforts are made to approximate SOE pay to private sector levels. Executive compensation is typically composed of: a) a fixed salary; and b) a variable component that pays out depending upon the executive's performance. The variable component is typically linked to the achievement of objectives under an MBO plan.

Recommendations:

SOEs should have the latitude to adopt commercial human resource practices as appropriate, particularly compensation and benefits, to attract the right caliber of professionals. The board should set executive remuneration levels that will help the SOE to retain the best available talent and that are in the long-term interest of the enterprise. They should ensure that the CEO's remuneration is tied to performance and duly disclosed. Compensation packages for senior executives should be competitive, but care should be taken not to incentivise management in a way inconsistent with the long term interest of the enterprise and its owners. The level of fixed and variable compensation should be aligned with the market, but not exceed it. Incentive compensation should be variable and linked to the achievement of performance objectives whereas basic salaries should be fixed. It is often necessary to draw upon the expertise of independent remuneration consultants to devise effective incentive compensation plans. Salary and compensation plans should be tailored to the industry and nature of the business. Malus and claw-back provisions should be used to hold executives responsible for gross mismanagement. Such provisions should appear in employment contracts.

V. RECOMMENDATIONS ON REPORTING AND AUDIT

A. Essential disclosure requirements

The challenge:

Few Ukrainian SOEs publish financial reports on a timely basis and otherwise provide scant information on other important aspects of enterprise performance and governance.

Good practice:

The general public, shareholders and potential shareholders (the markets) are provided with sufficient information on the financial condition, ownership structure and control rights of the SOE in order to properly assess potential risks and to make informed investment decisions. It is particularly important that the public know, for example, the powers that may accrue to controlling shareholders or any conditions that may prejudice their rights as shareholders. Capital structures, voting agreements, or other arrangements allowing disproportionate control of the SOE should be fully transparent both to shareholders and the markets. For SOEs, transparency remains important even when the SOE is wholly-owned by the state. The reason is that the public can be viewed as an ultimate owner who has information rights.

Recommendations:

Disclosure requirements for SOEs should be equivalent to the disclosure of listed companies in Ukraine. SOE reporting should include as a minimum:

- Audited financial and operating reports.
- · Non-financial information.
- Remuneration policies.
- · Ethics codes.
- Related party transactions and related party transaction policies.
- An annual report on corporate governance.
- Governance structures (such as board charters) and governance policies (including governance codes).
 - Management report.

Such requirements already exist for all joint-stock company SOEs and should be expanded to all other SOEs. All disclosure should be subject to appropriate protections against the revelation of confidential information or trade secrets. SOEs should disclose whether they follow any code of corporate governance and, if so, indicate which one. Regarding disclosure of the remuneration of board members and key executives, it is viewed as good practice to carry this out on an individual basis. The information should include termination and retirement provisions, as well as any specific benefits or in-kind remuneration provided. The state together with all related stakeholders should improve existing principles of corporate governance with the object of developing a national code of corporate governance which would serve as a benchmark against which to make governance disclosure.

B. Financial reporting standards

The challenge:

Ukrainian SOEs generally comply with national public sector financial reporting standards. Some are required to prepare financial statements according to IFRS.

Good practice:

There is a trend away from using national accounting standards or public sector accounting standards for SOEs and towards IFRS. Even small SOEs have been found to be entirely capable of implementing IFRS standards.

Recommendations:

Ukraine's SOEs should be as transparent as publicly traded corporations. The government should make IFRS mandatory for all SOEs and require other generally accepted international reporting standards where relevant including for non-financial performance reporting.

C. Audit standards

The challenge:

There is a legal requirement for the financial reports of SOEs to be audited using International Standards of Audit (ISA). Yet, the implementation of ISA is not often perfect. Many audit firms are missing the capacity to conduct a fully compliant ISA audit. As a consequence, the assurances provided for some financial reports are weak. Even when audited financial statements are available, many receive a qualified (negative) opinion from the auditors thus reducing their information value.

Good practice:

The state can expect to want financial reports that are equally reliable as those used in the capital markets. SOEs are, therefore, generally expected to comply with the same external auditing standards as listed companies.

Recommendations:

Financial reports should be audited in accordance with International Standards of Audit. Government audit standard are not a substitute for ISA—unless these are in full compliance with ISA. Adherence to better accounting and disclosure standards will make SOEs more accountable and encourage better performance. The state should monitor the accounting and audit profession in order to ensure that the profession has the capacity to produce and audit reports for SOEs according to ISA.

D. The external independent audit

The challenge:

SOEs constituted as joint-stock companies are required to have their financial reports audited by an internationally reputable independent auditor. Many SOEs are subjecting their statements to an independent audit for the first time. State audits do not occur on an annual basis and audit findings are not available to the public.

Good practice:

SOEs' annual financial reports are generally subject to an independent external audit based on ISA. Government audits are not considered a substitute for an independent external audit.

Recommendations:

To reinforce trust in the information provided, the state should require all SOEs be subject to external audits that are carried out in accordance with ISA. Adequate procedures should be developed for the selection of external auditors and it is crucial that they are independent from the management as well as large shareholders, i.e. the state in the case of SOEs. Moreover, external auditors should be subject to the same criteria of independence as for private sector companies. Boards should have a sufficient number of members who are financially literate and understand external audit. It may be useful for boards to have members with backgrounds in banking and/or financial analysis in order to contribute the perspective of users of financial reports. Boards should exercise their responsibility to ensure external auditor independence through their audit committees. There are various methods of doings so including regular rotation of audit firms and/or audit partners.

E. The internal audit function

The challenge:

The internal audit function in Ukrainian SOEs is more akin to internal control than internal audit as described in international standards. This could potentially create significant risks in SOEs.

Good practice:

Internal audit is like a consulting function whose purpose is to test the quality of internal controls and make suggestions for their improvement. Internal audit distinguishes itself from internal control in that it: a) is a punctual function (it conducts a limited number of audits per year); and b) is independent from management. Internal auditors are able to decide freely on what they will audit in a year and are obliged to develop their own audit plan. The annual audit plan is then reviewed and approved by the board. While the internal audit function is administratively under the management, it is hierarchically directly accountable to the audit committee of the board. This reporting relationship is designed to protect it from influence by management and enhance its capacity to arrive at independent judgements on systems of control. Internal audit provides independent and objective evaluations to help SOEs improve risk management, control and governance. It should abide by international standards of good practice. Internal control, on the other hand, is an ongoing management system that works every day to control operations.

Recommendations:

Ukrainian SOEs need to know whether they have a true internal audit function. If not, one needs to be established. The internal audit function should report directly to the board through its audit committee. The audit committee should have a say in the hiring, firing and evaluation of the head of the internal audit function. Internal auditors should have unrestricted access to the Chair and members of the entire board and its audit committee. This reporting relationship is important for the board's ability to evaluate company operations, risk and performance. Consultation between external and internal auditors should be encouraged. Members of the board should have unrestricted access to findings of the internal audits, which also have to be communicated to the management.

VI. RECOMMENDATIONS ON THE CONTROL ENVIRONMENT

The challenge:

The control environment refers to an organisation's combined systems of control. The effectiveness of these systems of control is profoundly influenced by intangible factors such as the attitudes of the board, management, and owners towards control issues. The control environment in Ukrainian SOEs is generally seen as weak because boards have a limited appreciation of controls and exercise only limited oversight over them. Control is often considered a technical issue that is left to state audit institutions.

Good practice:

The control environment is the foundation on which an effective system of internal control is built. The oversight of the control environment is one of the board's main roles (See III.C.5). The control environment aims to:

- Help achieve the strategic objectives of the organisation
- · Provide reliable financial reporting to internal and external stakeholders
- Operate the business efficiently and effectively
- Comply with all applicable laws and regulations
- Safeguard the organisation's assets

The main elements of the control environment are: 1) the audit committee of the board; 2) the independent external audit; 3) the internal audit; 4) internal controls; 5) the compliance function; 6) risk management; and 7) a channel for external and internal whistle-blowers.

Recommendations:

SOE boards should recognise their responsibility for ensuring a sound control environment. The availability of board members who have experience in developing and maintaining a contemporary control environment is useful. SOEs should establish an audit committee (See III.I) that can assist the board in complying with this responsibility.

VII. RECOMMENDATIONS ON OUTSIDE/MINORITY SHAREHOLDERS

The challenge:

Minority shareholders are vulnerable to decision making by fiat by the state. This causes outside investors to assign a considerable risk discount to SOEs.

Good practice:

Outside shareholders are protected and are treated equitably. SOEs are expected to comply with the same requirements with respect to minority shareholder as listed companies. Shareholders, in particular, minority shareholder are able to participate effectively in general shareholder meetings. The company is transparent on its ownership structure, control, and ownership rights.

Recommendations:

Whenever a part of an SOE's capital is held by public shareholders, institutional shareholders or private individual shareholders, the state should recognise and respect their rights. These rights should be equivalent to those of owners of a private enterprise. Other shareholders should be protected against abusive action and should have access to effective recourse. It is important that the state not abuse its role as a dominant shareholder, for example by pursuing objectives that are not in the interest of the enterprise and are therefore prejudicial to minority shareholders. The board should ensure that: a) minority shareholder rights are respected; b) decision making is equitable; and c) there is no disadvantage to foreign shareholders. Furthermore, governments should disclose the existence of any shareholders' agreements, capital structures or any other indirect exercise of control that allows a shareholder to have a disproportionately dominant decision-making position in comparison to their actual equity ownership in the SOE.

VIII. RECOMMENDATIONS ON STAKEHOLDERS

The challenge:

The main stakeholders in Ukraine's SOEs are employees, clients, suppliers, local communities and, of course, the general public. In Ukraine, each of these stakeholder groups expresses some degree of dissatisfaction with their interaction with SOEs. Problems remain, not least in the network industries where many remaining SOEs are market incumbents that continue to enjoy monopolies. State-owned natural monopolies have both the opportunity and the incentives to act in an anti-competitive way. SOE's seeking to extract the rent through disadvantageous pricing or otherwise, not only distort competition, but inevitably hinder SOE efficiency. There is no independent tariff regulator in infrastructure and its establishment is not reported to be a key priority for the government. In the majority of infrastructure natural monopolies, prices are set under opaque rules and do not receive close monitoring.

Good practice:

SOEs are expected to be transparent towards their stakeholders, take their interests into account, comply with all extant stakeholder law and regulation, and otherwise abide by stakeholder agreements. The expectation is that boards will always take into account stakeholder issues and the effect that stakeholders have on the SOE (without being obliged to act in the interest of anystakeholder over the interests of the SOE).

Recommendations:

SOEs should fully respect the rights of stakeholders, as established by law, regulations and mutual agreements. In addition, they should ensure that stakeholders have access to relevant, sufficient and reliable information on a timely and regular basis to be able to exercise their rights. SOEs should seek to actively engage with their stakeholders and explore strategies designed to generate common benefit and should report on their relations with stakeholders. SOEs should actively survey their stakeholder groups in order to:a) better appreciate their expectations; b) understand how stakeholder groups impact SOE performance; and c) devise better methods for achieving the mission and objectives of the SOE. In some industries, (such as air traffic control) boards may be charged with the duty of balancing different stakeholder interests. In such cases, the representation of certain stakeholder groups on the board may be considered if consistent with international best practice.

IX. ANNEX: UCGA ADVISORY GROUP MEMBERS

Richard Frederick (Project Leader), global SOEs governance expert, one of the principal authors of the original OECD Principles of Corporate Governance in 1999 and contributor to other international standards including the OECD Guidelines on the Governance of State-owned Enterprises (the only international standard on SOE governance) and the United Nations Guidance on Good Practices in Corporate Governance Disclosure.

Advisory Group (International Experts)

- I. Lars Erik Fredriksson, Chair of OECD's Working Party on State Ownership and Privatization Practices (Sweden).
- 2. Anders Berg, ex-Chair of OECD's Working Party on State Ownership and Privatization Practices (Norway).
- 3. Lucie Lambert Deputy General Counsel, UK Government Investments (the United Kingdom).
- 4. Mira Mines Head of Directors Affairs Division at Israel Government Companies Authority Ministry of Finance (Israel).

- 5. Vladislavs Vesperis Deputy Head, Head of division at Cross-sectoral coordination centre (Latvia).
- 6. Kristine Veierland Senior Advisor in the Ownership Department in the Norwegian Ministry of Trade, Industry and Fisheries (Norway).
- 7. Sara Sultan Policy Analyst at Organisation for Economic Co-operation and Development (OECD).
- 8. Hans Christiansen Senior Economist at Organisation for Economic Co-operation and Development (OECD).
- 9. J. Chris Razook, IFC Corporate Governance Lead for the East Asia and Pacific region.

Advisory Group (Local Experts)

- 10. Aivaras Abromavicius, Chairman, Ukrainian Corporate Governance Academy.
- 11. Adomas Audickas, President, Ukrainian Corporate Governance Academy.
- 12. Olyana Gordiyenko, EBRD Associate Director, Board Member at Ukrainian Corporate Governance Academy.
- 13. Elena Voloshyna, Head of IFC Ukraine, Board Member at Ukrainian Corporate Governance Academy.
- 14. **Taras Ivanyshyn**, Executive Manager, Ukrainian Corporate Governance Academy.
 - 15. Oleksandr Sayenko, Minister of Cabinet of Ministers of Ukraine.
 - 16. Timur Khromaev, Chair of National Securities and Stock Market Commission.
- 17. Maksym Libanov, Commissioner, National Securities and Stock Market Commission.
 - 18. Mindaugas Bakas, CEO at National Depository.
- 19. Maksym Nefyodov, Deputy Minister, Ministry of Economy and Trade of Ukraine.
 - 20. Kateryna Rozhkova, Deputy Governor of the National Bank of Ukraine.
 - 21. Yulia Kovaliv, Head of Office. National Investment Council of Ukraine.
 - 22. Evgen Kravtsov, Acting CEO, Ukrainian Railways.

- 23. Bruno Lescoer, Board Member, NAK Naftogaz.
- 24. **Volodymyr Kudrytskyi**, Director, Strategy & Investments, Ukrenergo; Board Member, NAK Naftogaz.
 - 25. Maria Sukhan, Corporate Secretary, NAK Naftogaz.
 - 26. Vsevolod Kovalchuk, CEO, Ukrenergo.
 - 27. Igor Smelyanskyi, CEO, Ukrposhta.
 - 28. Sergiy Makogon, Investment Director, Ukrtransgaz.
- 29. Oksana Markarova, First Deputy Minister of finance of Ukraine, Government Commissioner on Investments.
- 30. Anton Yashchenko, Executive Director at Reforms Delivery Office, Cabinet of Ministers of Ukraine.
- 31. Oleksiy Perevezentsev, State Secretary, Ministry of Economy and Trade of Ukraine.
- 32. Kostiantyn Marievych, Deputy Head of Vice Prime Minister Service of Ukraine.
- 33. Volodymyr Bondarenko, State Secretary of the Cabinet of Minister of Ukraine.
- 34. Oleksandr Bevz, Director of Licensing Department, National Bank of Ukraine.
 - 35. Oleg Bondar, Managing Partner, ECOVIS Bondar&Bondar.
 - 36. Olena Kuchynska, Partner, Kinstellar.

FOR NOTES

