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Auditing State-Owned Enterprises

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State-owned enterprises (SOEs) are major players of influence in the world economy. In a 2009 survey amongst OECD member countries, the more than 2,000 SOEs representing a total value of $1.2 trillion accounted for 15 percent of aggregate GDP. Globally SOEs account for 20% of investment and provide between 5 and 40 per cent of national employment. SOEs are internationally the most likely suppliers of utilities. Additionally, in many countries they provide the core of the financial infrastructure, they govern and exploit natural resources and critical infrastructure, and, even in most well-established and competitive markets, they undertake large-scale manufacturing and provide major services. Notwithstanding the privatisation waves of recent decades, governments remain major owners of commercial enterprises in many parts of the world (World Bank, 2014; Wong, 2018).

SOEs play a large role in modern economies and may be seen both as a vehicle for accelerating economic growth and a provider of public services and public values. In economies in the Middle East and North Africa, SOEs play a 'fundamental role', as they operate in crucial systemic sectors of the economies and provide important services to citizens (OECD, 2019).

Given their finance-intensive nature and their pivotal role in national economies, SOEs are especially vulnerable to corruption (OECD 2019). Internationally, there is universal agreement that the rationale for establishing and operating any SOE should be that the state exercises the ownership of SOEs in the interest of the general public. (OECD 2018). This makes auditing SOEs an essential task for supreme audit institutions, to establish whether SOEs are operating in the public interest, to ensure that the products and services provided by SOEs are efficient and effective, and also to ensure that their operation is fully transparent, accountable and compliant with laws and regulations.

Operational audits of SOEs need to be based on accepted standards. From joint reports of international organisations like the OECD, the World Bank, IFC and the IMF, we can distil internationally accepted standards on:

a. the definition of an SOE;
b. the rationale and aims of an SOE;
c. good governance of SOEs.

Definition of and rationale for SOE's

SOEs are internationally defined as 'any corporate entity recognised by national law as an enterprise, and in which the state exercises ownership' (OECD, 2015: 14). An SOE can take different forms and pursue a wide range of activities. One of the aims of an SOE is to conduct activities of an economic nature.

Governments can have multiple reasons for establishing SOEs. There is however international agreement that a fist fixed norm for establishing a SOE is that 'the state exercises the ownership of SOEs in the interest of the general public. It should carefully evaluate and disclose the objectives that justify state ownership and subject these to a recurrent review' (OECD 2015, 17).

Despite their crucial role in the economies of the Middle East and North Africa, there is very little data available on the ownership, regulation, objectives and output of SOEs. Generating this data is crucial for the efficiency of the individual SOEs and for the economic development of the country. Transparency and accountability are crucial for curtailing the unique governance and regulatory risks associated with SOEs.

When SOEs operate inefficiently and are subject to weak governance arrangements, they can create a strain on public resources, crowd out more productive private-sector activity and, in the worst case, be used as tools for political patronage or for self-enrichment at the expense of society at large. This in turn can erode the trust of citizens, companies and investors in public institutions and markets' (OECD 2019, 142).

There are several arguments for establishing an SOE (Christiansen, 2013; OECD, 2015). First, SOEs are used mostly for non-commercial activities, for example providing drinking water or electricity. In many cases, these activities might otherwise be carried out by government departments or autonomous institutions.

Second, SOEs are used worldwide to exploit 'natural monopolies'. These are industries with very high infrastructural costs, overwhelmingly favouring the largest (and often the first) supplier. This means that the production of multiple firms is more costly than production by a monopoly. Examples are rail, water treatment, sewerage and electricity (networks).

The third reason is often related to a natural monopoly: incumbent operators or leaders in a particular industry. These kinds of operators are typically found in network industries, where, operating among a range of private operators, one incumbent operator has certain public-service obligations, such as to distribute mail to all parts of the country.

The fourth reason for ownership is the assurance of services that are deemed crucial for the development of the whole economy. States regard outsourcing or privatising these service as being too complex or risky. Governments use this 'imperfect contract' argument for exercising public control of ports, shipping lines, airports and airlines.

A sixth related argument for SOE ownership is industrial policy and development strategies. Strategies can take at least three forms:

1. There are offensive strategies, pursued by creating 'national champions', or to stimulate industrialisation.

2. In defensive strategies, SOEs are used for protective purposes, especially in order to maintain a bigger share of employment than a private operator could, or to cater to specific political constituencies.
3. A third strategy is proactive: governments use the externalities of the SOEs to stimulate broader economic development. This can take the form of a classic industrial policy or 'state capitalism'. A classic example is developing the infrastructure required to create a profitable private sector.

The final reason for SOE ownership is political or strategic, i.e. the state wishes to exercise control for reasons of security (as in the case of the Suez canal) or for political reasons (as in the case of the media).

SOEs are very influential in the economies in the Middle East and Northern Africa (MENA). Most SOEs operate in three sectors in the MENA area (OECD 2019):

- *Services*: In all MENA countries, governments own at least a minority share in large companies focusing on utilities (such as water and electricity), capital-intensive modes of transport (aviation, railways, shipping and ports) and finally in banking and telecoms.
- *Minerals and hydrocarbons*. This sector typically accumulates a large part of national tax revenues. Resource exploitation is the exclusive domain of national SOEs.
- *Manufacturing industry*. Historically, government involvement in heavy, large-scale and capital-intensive industries (such as refining, steel and cement) was seen as method for industrialization; while involvement in labour-intensive industries stemmed from a desire to safeguard employment in the wake of job losses in other areas (such as cotton weaving).

Internationally, there is a growing tendency to segment SOEs into explicit categories (such as natural monopolies, temporary financial interests and strategic interests). This helps to make the ownership objectives explicit, to increase accountability, and to facilitate executive management and control (Wong, 2018).

Ownership models

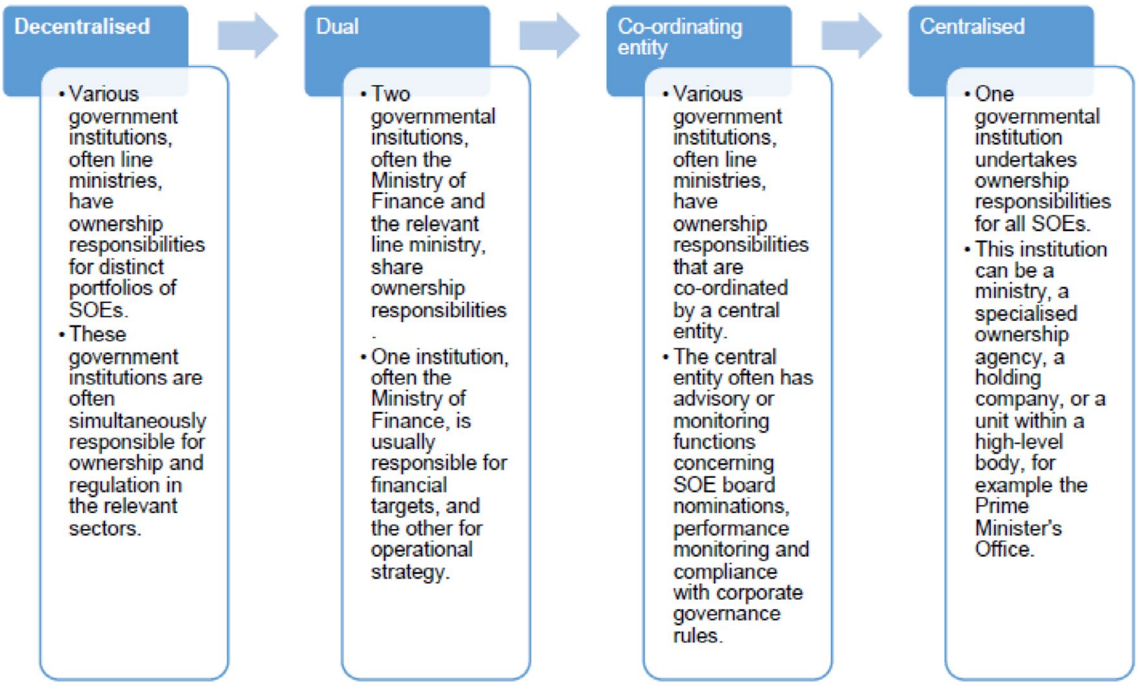
There are different ownership models for SOEs. There is an international trend towards centralising the ownership of state-run companies. In this model, a central body sets financial targets, decides on strategic issues and monitors the performance of the state-owned portfolio. In the MENA area, the fully decentralised model is most common, and is shared with only three other countries in the world (OECD, 2019).

In a fully decentralised model, each SOE is owned by various institutions, often line ministries. Ownership, regulation and governance vary from sector to sector. The public often perceives the SOE as being run *de facto* by the line ministry in question and the company as being an extension of ministerial power.

Decentralised ownership → Centralised ownership

Centralised model	One government institution carries out the mission as shareholder in all companies and organisations controlled by the state. This institution can be either a specialised ownership agency or a designated government ministry. Financial targets, technical and operational issues, and the process of monitoring SOE performance are all conducted by the central body. Board members are appointed in different ways but instrumental input comes from central unit.
Dual model	Two government institutions –often one line-ministry per SOE plus the finance ministry - share in the ownership function commanding each individual SOE. Typically, one ministry sets financial objectives and another ministry formulates operational strategy.
Twin track	Functionally equivalent to the centralised model, but with two individual portfolios of SOEs overseen by two different government institutions. This model has often been referred to as "dual", but in practice it differs materially from the dual model in that only one government body is involved in the ownership of each SOE.
Coordinating agency	Specialised government units act in an advisory capacity to other shareholding ministries on technical and operational issues, and their most important mandate often is to monitor SOE performance. The more limited role of these central agencies, coupled with the autonomy that line-ministries thus maintain, leads to considerable overlap with the decentralised model.
Decentralised	No one single institution or state actor acts on the responsibilities of the ownership function. Public perception often perceives line-ministries to be *de facto* running the SOE as an extension of their ministerial powers. For each of the three ownership function responsibilities, a unique state unit or a mix of state units subsume the role.

Source: OECD, 2018.



Source: OECD, 2019.

The OECD advises centralising the ownership role to a single or a coordinating body. This helps to separate ownership from the regulatory function, facilitates the implementation of a ownership policy and helps to form a single pool of experts at central level for accounting and reporting (OECD, 2018; 2019).

Audit questions

The first steps in identifying the rationale, arguments and ownership models for SOEs (i.e. the SOE system) follow a system-oriented audit approach (ISSAI 300/26; ISSAI 3100 62/63). The system-oriented approach does not focus primarily on policy or goals, and instead looks at effective government systems as a condition for effective and efficient policies. This type of audit can use descriptive questions such as:

- What is the objective of the SOE system?
- Who are the responsible actors within the SOE system?
- What are the responsibilities of each actor in the SOE system?
- Which rules, regulations and procedures are relevant?
- What are the relevant information flows?

Once a big picture of the system of SOE ownership and rationale has been built up, more normative questions can be answered in the second stage. Suggested audit questions here are:

- Is there an official policy for state ownership of enterprises which maximises value for society and insures the efficient allocation of resources?
- Does the ownership policy set out the overall rationale and criteria for state ownership and the state's role in the governance of SOEs?
- Is the ownership policy subject to procedures of political accountability and are results regularly disclosed and evaluated in the public domain?

The state's role as owner

The state's ownership role should be transparent, accountable and efficient. There are internationally accepted guidelines which help to ensure this role. The first thing is to establish a sound legal and regulatory framework for the ownership and corporate governance of SOEs. In order to create a level playing field with other businesses and decrease the tension of political involvement in the running of state companies the framework must be explicit about the rationale and arguments for state ownership (World Bank, 2018).

Secondly, there should be a clear separation between the state's ownership function on the one hand and the function of market regulation and other state functions that affect conditions for SOEs on the other hand. The objectives of the government's SOE policy or of the ownership of an SOE need to be set or altered in a transparent way. An adequate ownership model helps to strengthen focus, consistency and transparency about ownership. The ownership entity should be accountable to the relevant representative bodies and have clearly defined relationships with relevant public bodies, including the state supreme audit institutions.

In order to ensure that individual SOEs satisfy the objectives of the government's SOE policy, there should be managerial autonomy for individual SOEs. This means that the government should not intervene in the management of an SOE.

An unbiased arbitration system and judiciary guarantee this process and also help to guarantee equal opportunities for competitors and creditors, and to uphold property rights. As a guiding principle, SOEs should not enjoy favourable market conditions. This means that SOEs should not be granted tax or regulatory exemptions that do not apply to other firms, nor should they enjoy favourable terms for debts or loans.

Transparency, accountability and disclosure in relation to SOE policies and the objectives and results of individual SOEs are crucial to ensure that public value is delivered. As an additional guarantee, policies should be evaluated periodically and SOEs should be scrutinised by means of a public audit. Transparency and disclosure are even more important in those cases in which SOEs combine public policy objectives and commercial activities. The separation of income and expenditure relating to public policy objectives from those relating to commercial activities helps to ensure this. The cost incurred by the state in paying SOEs to achieve certain public policy objectives should be publicly disclosed (OECD, 2018; World Bank, 2018).

Text box: Activities performed by the Ministry of Finance

In many countries, a unit in a central ministry – typically the Ministry of Finance – is responsible for the financial management framework for SOEs and monitors their operations.

This unit works in close collaboration with the macroeconomic unit and budget office at the Ministry of Finance to ensure that the costs and the budget transfers to SOEs, together with subsidies and (quasi-)tax exemptions, government guarantees and other contingent liabilities are correctly estimated and included in the budget or fiscal risk statement.

Additionally, the unit may have the following tasks (Allen & Vani, 2013):

- Coordinating overall financial reporting by SOEs;
- Reviewing SOEs' strategic plans and financial forecasts;
- Reviewing the annual financial performance of SOEs;
- Providing consolidated financial data on SOEs for inclusion in the budget documents;
- Maintaining a database of performance information on SOEs, including their strategic objectives, business and financial plans, financial performance, government guarantees, borrowing and debt financing;
- Scrutinising requests by SOEs for government guarantees and other debt financing agreements;
- Identifying SOEs with high financial or corporate governance risks and advising the minister of finance on remedying measures;
- Following up on the analysis and recommendations of the supreme audit institution on SOEs;
- Making assessments of capacity gaps in SOEs with respect to their financial reporting, management capacities, corporate governance and the typical (financial) risks associated with SOEs.

Such a monitoring unit can be effective only if it has the backing of an enforceable regulatory framework for SOEs. This means that a regime of administrative, financial and judicial sanctions should be part of the legal framework.

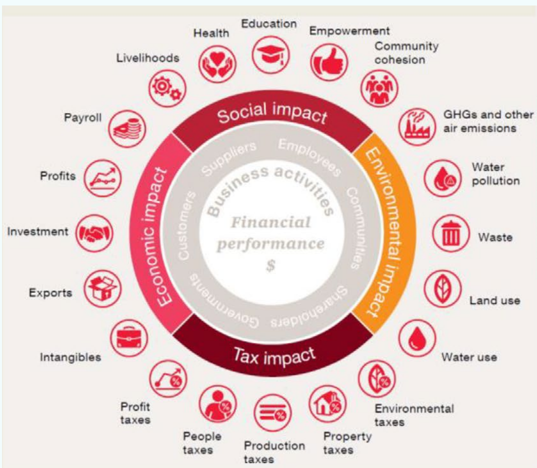
Typical steps in the public financial management of SOEs by the central government (or the Ministry of Finance) consists out of the following steps. First, a strategy should be prepared for managing the fiscal risks associated with SOEs. This strategy should be part of a broader government strategy for managing public assets and liabilities. The first step in this strategy is a comprehensive analysis of SOEs. In many countries, governments do not have complete information on all the enterprises that they own. After the government's portfolio of SOEs has been mapped out, the next step is to compile financial and non-financial information on each SOE, including its subsidiaries.

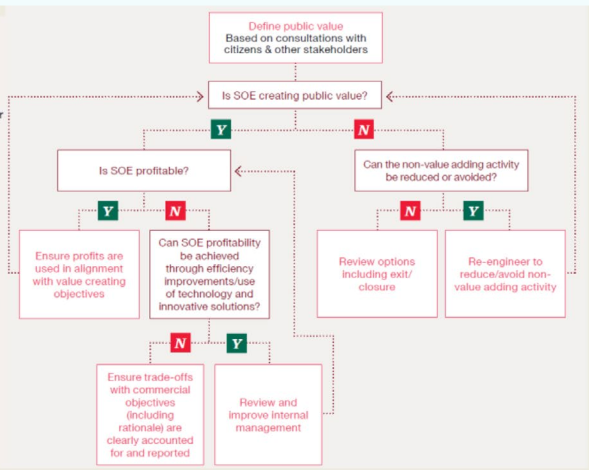
After this, the following measures can be taken:
1. Develop a comprehensive legal and regulatory framework for SOEs;
2. Establish a clear set of arrangements among central ministries for implementing the regulatory regime;
3. Create an internal governance framework for SOEs, clearly defining the role and responsibilities of the board of directors and the audit committee;
4. Introduce specific measures for strengthening the accounting and financial reporting arrangements applying to SOEs, together with arrangements for external supervision by the supreme audit institution and the legislature.

Factors relating to the operations of SOEs that may create fiscal risks and potential costs for the state budget include the following:
- **Macroeconomic**: changes in exchange rates or international commodity prices.
- **Operational**: delays or cost overruns in implementing capital investment projects.
- **Sectoral**: changing costs of production or reduced market shares as a result of competition.
- **Force majeure**: natural disasters, civil strife and other uncontrollable risk factors.

Key performance indicators (KPIs) typically used by the Ministry of Finance to minimise the potential costs for the state budget and assess the efficiency of SEOs include the customary financial ratios such as:
- Current ratio = current assets: current liabilities
- Debt to equity = total liabilities: equity
- Return on assets = net profit after tax or EBIT: total assets

Since many SEOs in developing countries tend to provide critical (subsidised) public services, focusing solely on private-sector indicators undervalues the wider public value delivered by SEOs. This wider public value should be reflected by the KPIs used for SEOs. The picture on the left contains suggestions for other areas of public value creation by SEOs, while the diagram on the right helps to diagnose the decision-making process for state ownership (PWC, 2015).





Audit questions on state ownership

If a government's policy on SOEs is well-documented and mature, and if data is publicly available, an attempt can be made to establish whether the policy produces relevant societal value. A country's policy can be contrasted with the international standards on SOE governance and rationale, thus enabling auditors to determine whether policy is in line with accepted international standards on equity, economy, efficiency and effectiveness. This is known as a problem-oriented approach to auditing, as it starts by asking 'what problem does the policy seek to solve?' Similarly, what hypotheses can be formulated for the causes of success or failure? (ISSAI 3100/60).

Relevant performance audit questions for a problem-oriented approach:

- Which social problem does the policy seek to address?
- What is the policy's intended outcome?
- What are the policy outputs?
- What were the original policy aims?
- Is there a gap between policy aims and policy implementation (resulting in outputs and outcome)?
- If so, what is the cause of this gap? What factor account for success or failure?
- What are the costs of the policy?

Corporate governance of SOEs

The term 'corporate governance' refers to the structures and processes for the direction and control of enterprises. It specifies the distribution of rights and responsibilities among the organisation's stakeholders (including shareholders, directors and managers) and articulates the rules and procedures for making decisions on corporate affairs. Corporate governance therefore creates a structure for defining, implementing and monitoring an organisation's goals and objectives and for ensuring accountability to stakeholders. Good corporate governance systems ensure that the business environment is fair and transparent, that company directors are held accountable for their actions, and that all contracts entered into by the organisations can be enforced.

Compared with private-sector companies, SOEs face distinct governance challenges that directly affect their performance (World Bank, 2014; OECD, 2015):

- Multiple principals
- Multiple and often competing goals and objectives
- Protection from competition
- Politicised boards and management
- Low levels of transparency and accountability
- Weak protection of minority shareholders

A growing number of publications point to the vulnerability of SOEs to corruption. Almost half of all SOEs that participated in a recent OECD survey identified a corrupt act or another irregularity. There was no other sector in which bribes were promised more often (OECD, 2018: 20, 21). The IMF found that, in countries where corruption was widespread in the business sector, 71% of respondents attributed this to malpractices in SOEs (IMF, 2017: 97).

Table: *Main corruption risks based on previous experiences with corruption (OECD, 2018: 29)*

Respondents that did not see corruption risks materialise in their company in the last three years	Respondents that did see corruption risks materialise in their company in the last three years
1. Violations of data protection and privacy 2. Non-declaration of conflict of interest 3. Favouritism (nepotism, cronyism and patronage) 4. Procurement/contract violations (delivering sub-par goods/services, violating contract terms with suppliers) 5. Interference in decision-making 6. Violations of regulations (health and safety, environmental) 7. Influence peddling 8. Receiving kickbacks 9. Illegal information brokering 10. Fraud	1. Violations of data protection and privacy 2. Stealing or thefts of goods from the company 3. Fraud 4. Receiving bribes 5. Favouritism (nepotism, cronyism and patronage) 6. Non-declaration of conflict of interest 7. Procurement/contract violations (delivering sub-par goods/services, violating contract terms with suppliers) 8. Illegal information brokering 9. Receiving kickbacks 10, Interference in decision-making

To counter these challenges, the boards of SOEs should be independent and competent, and they should be given authority to manage the SOE in question efficiently. The following international standards (OECD, 2015; World Bank, 2014) help to guarantee this:

- The broad framework of national SOE policy should act as a strategic guidance for the boards of SOEs.
- The role and responsibilities of the boards of SOEs should be identical to those of other boards under corporate law.
- The selection of board members should be based on merit and qualifications.
- All board members, including civil servants, should have the same legal responsibilities.
- The main objective of board members should be to attain the SOE's long-term objectives and assure its continuity.

It is therefore crucial that boards should have a clear mandate and ultimate responsibility for the performance of the SOE, for monitoring the SOE';s management and for upholding corporate integrity. *This means that the board should be responsible for appointing and dismissing the CEO*. The board must be responsible for the annual, structured evaluation of the SOE's performance and efficiency.

The need for accountability and transparency dictates that financial figures and information on objectives, output and operation should be made publicly available. Internationally recognised standards for reporting and disclosure are key here. Reporting by SOEs should be subject to the same standards as reporting by private firms and listed companies. Reports should be scrutinised by an independent external auditor. The board should ensure that internal audit procedures are established and monitored (OECD, 2015; World Bank, 2014).

Audit standards for the governance of individual SOEs

If a government's policy on SOEs is well-documented and mature, and if data on the performance of individual SOEs is publicly available, an attempt can be made to establish whether the policy works in practice, and to verify the output and performance of individual

SOEs. This is known as a result-oriented approach to auditing. Audits focus on the results of policy and the achievement of goals. The desired results and outputs are contrasted with the actual results and outputs (ISSAI 3100/59).

Relevant performance audit questions in a result-oriented approach:
Does the auditee:
- formulate objectives? If so, are these SMART (i.e. Specific, Measurable, Attainable, Realistic and Time-bound) and consistent?
- define and describe the target group for the policy?
- define the required form and degree of coverage of the target group?
- describe the output to be delivered according to the objectives?
- provide sufficient budget and means in order to attain the objectives?
- inform the target group?
- reach the target group in the required form and to the required degree?
- ensure that relevant, reliable and valid information is available to provide evidence of the achievement of the objectives set?
- succeed in delivering the output?
- succeed in achieving the objectives?

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