



White Paper on Good Governance in State-Owned Enterprises

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1. Goal of Good Governance in State-Owned Enterprises

1.1 Motivation for State-Owned Companies

Motivations for state property may increase or decrease over time, but state-owned companies appear to be a sustainable feature of the economic environment and will remain an influential force on economies for at least a few years from now. This is especially true in the current context when the crisis related to the Covid-19 pandemic has again highlighted the demand from the society for the Government's intervention role in the economy. Therefore, state-owned companies remain an important element in the range of tools of any Government for creating societal and public value. At the same time, the experience over time has shown that they can both serve as means of correcting market failures, but can themselves become a source of governmental failures, given poor administration or inappropriate presence in certain sectors, which slows down free competition. Based on this context, the governance mechanism of state-owned companies should start from the state's motivations to own companies. Based on the realities of the Republic of Moldova, the following actions are recommended in this chapter:

- **Establish the objectives and functions of state property, as well as the good governance principles in the legal framework, by Parliament's vote.** Though the Law on Administration and Denationalization of Public Property¹ states the objectives of public property administration: i) harmonize the public property proportions and structure and the administration mode, ii) attract investments in the public sector, iii) ensure efficient management; iv) develop the competition, they have a general character. At the same time, the law does not state the objectives and functions of ownership or governance principles related to state-owned companies.
- **Formulate an adequate justification for state property.** International good practices recommend that state property policy should take the form of a concise, high-level policy document outlining the general reasons for state-owned companies. It can be considered a good practice to include in the state property policy some objectives such as: creating value, providing public services or strategic objectives such as maintaining certain industries that are nationally owned. The role of the state is to decide on rationale for state property, but whatever they are, they should be clearly communicated to the public and all stakeholders, including the executive, that exercise property rights or are involved in the implementation of property policy. Currently, the law on the administration and denationalization of public property contains an annex listing the enterprises that may not be subject to privatization, which in fact means entities of strategic importance to the state. Though this list may be amended only by the Parliament, which is an element of state property protection, there is neither a clear vision or algorithm of why these companies are included, nor clearly stated grounds for reviewing the list. In the same context, the other state-owned companies may be included at the discretion of the Government in another list² of companies that may be subject to privatization. However, as in the case of companies not subject to privatization,

¹ Law No 121/2007 on Administration and Denationalization of Public Property, https://www.legis.md/cautare/getResults?doc_id=115473&lang=ro

² GD No 945 of 20.08.2007 implementing the Law No 121-XVI of 4 May 2007 on the Administration and Denationalization of Public Property, Annex 2, https://www.legis.md/cautare/getResults?doc_id=125547&lang=ro#

changes to this list are not made always in a clear and understandable manner and for the broad public, for the same reasons of the lack of a systemic approach regarding the justification of state ownership.

- **Review periodically the public property, by the Government, which should be part of political accountability procedures and should be disclosed to the general public.** The property justification policy should be reviewed periodically (for example, each year). This policy must be made public (subject to specific omissions to protect the confidentiality of commercially sensitive information, if such information is included). The property justification policy will be an important document, for which the Government will be politically responsible, both before other state institutions and citizens. The Government will thus be motivated to ensure that the objectives set out in the property policy are achieved.
- **Define, by the property entity (PPA), the reasons for holding individual state-owned companies and subject them to a recurring review.** Any public policy objectives assigned to state-owned companies should be clearly mandated and disclosed by the competent authorities. For each of the subordinated/coordinated state-owned companies, the property entity should clarify the motivations for owning the enterprises/stocks of shares, in order to clarify their objectives regarding these enterprises: commercial and profitability objectives, objectives for the provision of universal services under the operation of regulated monopolies, or objectives for the implementation of public policies.

As a long-term motivation for holding stakes in public enterprises, the Government should set targets for public enterprises to focus on research, development and innovation, as well as on the development of human capital, so that they can ensure their competitiveness, profitability and long-term value generation. The property entity (PPA), depending on the specifics and operational-financial situation of each public enterprise, will pursue these motivations in setting specific expectations from each public enterprise.

1.2 The State Role as Owner

International best practices, such as the OECD Guidelines on Corporate Governance of State-Owned Enterprises, pointed that the state should act as an informed and active owner, ensuring that the governance of state-owned enterprises is conducted in a transparent and accountable manner, with a high degree of professionalism and effectiveness.

On this dimension, the authorities of the Republic of Moldova have already implemented or are in the process of implementing some recommendations deriving from OECD good practices, the most important being:

- i. centralize the property in a single public institution – PPA and the exercise of its related property rights;
- ii. optimize the size and structure of public property management by reorganizing state-owned enterprises into other legal forms provided by law, in particular transforming many state-owned enterprises into public institutions, where activities are not specific to entrepreneurship, as well as reorganizing or closing joint stock companies.

At the same time, there are several activities to improve the national system of governance in public property administration, which are going to be implemented, namely:

- **Set up and monitor the implementation of broad mandates and objectives for state-owned companies by PPA, including financial targets, capital structure objectives and risk tolerance levels.** If the state

is not the sole owner of a state-owned company and is generally unable to formally 'mandate' the achievement of specific objectives, it should communicate its expectations through standard channels as a significant shareholder. The mandates of state-owned companies are concise documents that provide a brief overview of their long-term objectives, in accordance with the reason established for state ownership in the enterprise. A mandate will usually define the predominant activities of a state-owned company and provide some guidance on its main economic objectives and, where relevant, public policy. The structure of such a document, issued by the property entity, should contain with approximation:

1. a summary of the Government's policy in the field in which the enterprise operates, including the medium and long-term budgetary and fiscal objectives of the state;
 2. the general vision of the founder/shareholders regarding the mission and objectives of the state company, in connection with the Government policy in the respective field;
 3. clarification of the main purpose of the state-owned enterprise (commercial, natural monopoly or public service);
 4. clarification of the obligation object and the commitment of the state regarding the way of compensation/reimbursement of the obligation, mandatory section if the enterprise has to fulfil public service obligations;
 5. the dividend policy applicable to the company;
 6. expectations regarding the company's investment policy;
 7. shareholders' wishes to communicate with Board members;
 8. expectations in the field of ethics, integrity and corporate governance.
- **Establish processes of nominating well-structured, merit-based and transparent boards of directors in wholly or majority-owned enterprises**, actively participating in the appointment of all boards of state-owned enterprises and contributing to the diversity of boards. In the process of selecting and appointing board members, the property entity shall have prepared for each state-owned company the mandate document, so that potential board members have a clear understanding of the founder's expectations of financial and non-financial performance indicators which subsequently are to be assumed and implemented (*see details in Chapter 2*).
 - **Create the conditions for the boards of state-owned companies to exercise their responsibilities and respect their independence** – employees of the property entity or professionals from other parts of the administration should be elected to the boards of state-owned companies only if they meet the required level of competence for all members of the board and if they do not act as a tool for political influence that extends beyond the role of ownership. They should have the same duties and responsibilities as the other members of the board and act in the interest of the company and all its shareholders/founders. Disqualification conditions and conflict of interest situations should be carefully assessed and guidance should be provided on how to manage and resolve them;
 - **Introduce a clear remuneration policy for boards of state-owned companies to stimulate the long-term and medium-term interest of the company** and which attracts and motivates qualified professionals (see details in Chapter 2);

- **Develop reporting systems which allow the property entity to monitor, audit and evaluate regularly the performance of state-owned companies** and to supervise and monitor their compliance with applicable corporate governance standards;
- **Develop a disclosure policy for state-owned companies** to identify what information should be disclosed to the public, appropriate disclosure channels and mechanisms for ensuring the quality of information;
- Maintaining a continuous dialogue with external auditors and specific state control bodies;

1.3 Governance Code – The Main Tool of Corporate Governance

The Corporate Governance Code (CGC) is a set of governance standards to guide management and shareholders in applying the general recommendations of effective management of a company. It must represent an umbrella document on governance for the companies implementing it, indicating the set of rules governing the administration, supervision and control system.

For state-owned companies, the Governance Code targets the safety of the public assets, management clarity and responsibility, risk mitigation and perpetuation of an environment dominated by integrity.

Figure 1. The Corporate Governance Code of state-owned companies



Source: by authors

The approval of the Corporate Governance Code by NCFM³ in 2015 is a result of the commitments of the Republic of Moldova assumed by signing the Association Agreement with the EU⁴, this activity being part of the National Action Plan for the implementation of the Republic of Moldova – European Union Association Agreement for 2014-2016. The provisions of the CGC are based on the principles of corporate governance developed by the OECD⁵. The provisions of the Code are mandatory for public interest entities and are recommendatory in the case of joint stock companies that do not fall into the category of public interest entity

³ The Corporate Governance Code approved by the Decision of the National Commission of the Financial Market No 67/10/2015, https://www.cnpf.md/ro/codul-de-guvernanta-corporativa-6301_92846.html

⁴ Chapter 3, Article 27 'Company law, accounting and auditing and corporate governance' and Annex II of the Moldova-EU Association Agreement, <https://mfa.gov.md/img/docs/Acordul-de-Asociere-RM-UE.pdf>

⁵ OECD/G20 Principles on Corporate Governance, 2015 <https://www.oecd-ilibrary.org/docserver/9789264236882-en.pdf?expires=1613050376&id=id&accname=guest&checksum=4660895F262A2E0C454D26E3E82EB9AB>

The main specific and new elements of the Corporate Governance Code include:

- It is recommended that some aspects concerning the exclusive competence of the General Meeting of Shareholders be voted with voting norms higher than those provided by the normative acts in force;
- New powers are added for the company's Board;
- It is recommended to set up specialized committees by the the Board to examine the most significant topics in the company's activity (nomination committee, remuneration committee, etc.);
- The Board of the company should consist of a sufficient number of independent members, at least 1/3;
- A set of criteria for assessing the independence of the members of the company's Board are introduced;
- The obligation of the company's executive body to add a separate chapter to the annual activity report to describe the extent to which the company applies or does not apply the provisions of the Governance Code;
- Criteria for determining the amount of remuneration for the members of the company's Board of Directors, the executive body and the Revision Commission;
- The need for Board approval of Code of Business Conduct, the Board will also be responsible to supervise its implementation;
- Several measures are set out to be taken into account when correctly identifying and approving decisions in the event of a conflict of interest transactions;
- It is recommended that companies approve internal rules on the selection and approval of audit firms;
- The Code lists the minimum amount of information that a public interest entity is required to disclose on its website;
- The obligation to prepare a Corporate Governance Statement 'Compliance or Justification' according to the template in the Annex to the Code, by which companies are to provide a detailed written justification regarding the recommendations in the Code that have not yet been applied in practice.

Based on the role and tools it can provide, a full involvement of all stakeholders is needed to adopt, adjust and implement the provisions of the governance codes. For this the following recommendations are made:

- **Ensure compliance with NCFM Decision No 67/10/2015 on the development and approval of Corporate Governance Codes** – following the 2018 amendments⁶ approving a Corporate Governance Code has become mandatory for public interest entities. However, though large state-owned enterprises and large commercial companies where the state ownership is higher than 50 percent are public interest entities according to the Law on Accounting and Financial Reporting⁷, an insignificant number of enterprises have complied with this requirement. This is so in spite of the compliance period of 6 months, which expired in 2018.

⁶NCFM Decision No 14/1 of 19-03-2018 on amendments and addenda to the Corporate Governance Code, https://www.legis.md/cautare/getResults?doc_id=102334&lang=ro

⁷Law on Accounting and Financial Reporting No 287 of 15-12-2017, https://www.legis.md/cautare/getResults?doc_id=125231&lang=ro#

- **PPA To develop a framework document with the main provisions of a Corporate Governance Code**, which have to be adjusted and implemented by each enterprise in accordance with the size, importance and scope of work carried out.
- **PPA to encourage the expansion of the number of state-owned companies that must approve and implement Governance Codes**, for example by including entities that fall into the notion of medium-sized enterprise under the Law on SMEs.
- **PPA to monitor the implementation of the Governance Codes** by including the Corporate Governance Statement – Compliance or Justification as part of the Management Report drawn up annually by enterprises.

2. Boards of directors – key pillar of Good Corporate Governance

The Boards of directors play a key role in the process of managing large companies. In most cases, this management body has the primary responsibility for the business strategy and is responsible for the management team performance (the executive body), as well as for the performance of the company as a whole. Although the role of the Boards has been developed over time in private companies, it is no less important in state-owned enterprises. Moreover, given the public nature of these companies, the role of the Boards become paramount in maximizing the public interest in conditions of free competition.

Directly, the Boards of Directors act as an intermediary between the state, as a shareholder/owner, and the executive management, and has the duty to act in the interest of both in the sense that it must defend the interest of the state but also support the executive body in developing an appropriate framework in accordance with the specificity and importance of the company.

In terms of state-owned enterprises, the Republic of Moldova has a number of vulnerabilities that come out from the poor management mechanism, especially in relation to the Boards of Directors. Both the periodic monitoring reports, as well as the latest studies in the field⁸ confirm this fact, the general conclusion being that **‘the current situation transforms state-owned enterprises from a solution to the economic development to part of the problem’**. Box 1 shows the main deficiencies in terms of state administration:

Box 1. Systemic deficiencies in the management of state-owned companies

Lack of competition

The process of appointing Board’s members does not ensure access exclusively on the basis of professionalism and skills. Under these conditions, the risk of mismanagement and politicization of the activity of state-owned enterprises are quite high.

Lack of independence

Proximity to the politics create a favourable environment for appointing people loyal to politicians, who cannot be the necessary barrier to fraudulent procurements,

⁸ World Bank Group, Support to SOE preliminary diagnostics and reform assessment, <http://documents.worldbank.org/curated/en/762831499412473409/Moldova-Support-to-state-owned-enterprises-SOE-preliminary-diagnostics-and-reform-assessment-Phase-1>; Moldova, Rekindling Economic Dynamism, <http://documents.worldbank.org/curated/en/679951561566645653/Moldova-Rekindling-Economic-Dynamism>

	embezzlement schemes and other arrangements to the detriment of the public interest.
Low transparency of the nomination process	There is no clear procedure for nominating state representatives to ensure the selection of the most suitable people on the basis of meritocracy, expertise and good reputation.
Formal involvement	The activity of Boards members is often limited to perfunctory approval of some decisions rather than activities focused on the development of internal policies, business plans or supervision of the executive body.
Summary assessment	The quality of Board's work is not reviewed in terms of company's results and the actual contribution of each Board member.
Lack of accountability	Board members are literally not accountable in any form for the results and the condition of state companies, though by law they must supervise the company's activity.
Remuneration policy	The current proposed models do not link the remuneration of Boards members to the overall performance of state-owned enterprises. Moreover, this is always a subject of political speculation, whether it is capping or raising.

Source: Compilation of authors

2.1 What should be the 'architecture' of the Boards of state-owned enterprises

Recent years have shown that the situation of state-owned enterprises can worsen significantly in times of crisis (e.g. the Covid-19 crisis) as the Government registers a growing budget deficit but, at the same time, has to provide additional goods and services to citizens, which the private sector fails (or is not interested) to offer. Therefore, the Republic of Moldova needs quickly a clear vision on how to manage state-owned enterprises. As the Boards are the governing body that represents the interest of the state, the management mechanism should aim at increasing the powers, quality and role of the Boards. Thus, the Board setting up and 'architecture' should ensure at least the following:

- **Rigorous nomination process** - Board members, both representatives of the State and independent members or other representatives, should be appointed on the basis of a rigorous, well-structured, transparent and merit-based mechanism. The merits derive from the qualities that each person demonstrates in terms of professional skills, integrity and good reputation. These should be confirmed on the basis of an equivalent objective and competitive assessment for all candidates.
- **Adequate numerical composition** – the composition of the Board should be sufficient to ensure that the work is organized in the most efficient way, with objective and balanced debates in the decision-making process. In this respect, depending on the size, importance and specificity of the activity of each company, the Board will be composed of an adequate number of people who will be able to cope with the duties.
- **Diversity, professionalism and good reputation** – the composition of the Board should be diverse, including different people as specialization, personal qualities and expertise. In this sense, it is important to select people with financial, economic and legal expertise, but also at least one person specialized in

the field of the company's activity. In addition to professional skills, candidates to Board members should also meet the requirements of integrity and good reputation, which can be assessed on the basis of a number of criteria.

- **The presence of independent members** - At least 1/3 of the Board members should be independent. They must be selected according to a clear nomination procedure that ensures transparency and objective evaluation of candidates based on criteria of professional qualification, reputation and time management. The criteria assessing the Board member independence will be based on an in-depth analysis of at least the following situations:
 - does not hold and has not held in recent years management positions in the company;
 - is not an employee of the company or of another entity controlled by it;
 - is not and does not represent in any way a shareholder owning some percentage of the total shares issued by the company;
 - does not have and has not had business any relations with the company in the last reporting period;
 - is not and has not been in the recent years an associate or employee of the audit firm contracted by the company;
 - has no ties with the administrators/executive body of the company due to the position held in other companies;
 - has not been a member of the Board or executive body of the company for a period longer than 3 terms;
 - is not a person affiliated in any way with the company and/or a person affiliated with the persons in management positions.

- **Establishment of specialized committees** – depending on the size, internal organization and complexity of the activity, the Board should set up specialized committees to examine the most important issues, such as:
 - nomination of independent members;
 - nomination of the executive body's members;
 - development of the remuneration policy;
 - development of a policy of ethical conduct, including assessing situations of conflict of interest.

The specialized committees are composed of Board members, with at least 1/3 of them being independent members.

- **Establishment of performance indicators** – the practice of private companies to evaluate people in management positions, including Board members is an example for state-owned companies. There are several possibilities for the evaluation, both collectively, of the entire Board and individually, of each member. It can also be carried out by the Chairman of the Board, by a supervisory authority of state-owned companies, by a team of independent experts. However, whoever the evaluator, it is important that the evaluation is objective, evidence-based and gives a clear assessment of how Board members have performed their duties.

- **Reporting to shareholders and the general public** – The Board should submit an annual account (annual report) that is accessible to the general public. This will include the collective activities of the Board and the committees, as well as the individual activities of their members. At the same time, the activities are to be presented in terms of significant consequences for the company and shareholders, implementation of the strategy and business plan, implementation of a precaution management framework, ensuring corporate governance in accordance with the required standards.

2.2 What responsibilities should be given to the Boards of Directors of state-owned enterprises

Implementing good governance is the primary responsibility of the Board, which through its role, functions and responsibilities creates a framework in respect to the importance of state-owned enterprises. The governance framework represents the set of internal procedures/policies that transpose the rules and principles of the relations that appear between the management bodies and other stakeholders in the process of managing the company. Therefore, given the public interest in state-owned enterprises, the Board should ensure the following:

- i. **Adequate supervision and ongoing monitoring of the management decision-making process** – The Board is responsible for the overall business activity of the company and its financial soundness. The Board elects the executive body and ensures a permanent dialogue with it in order to achieve the proposed objectives. At the same time, the relationship between the Board and the executive body should be based both on supervision and accountability.
- ii. **Remuneration policy aimed at attracting, motivating and retaining qualified staff, as well as encouraging people in management to act in the interests of society and the public interest** – the establishment of this policy has to be the basic responsibility of a *Remuneration Committee* – part of the Board, composed mostly of independent members, to avoid any conflicts of interest. The remuneration policy should detail the reasons behind the determination of the remuneration formula for people in management positions and submitted to the vote at the general meeting of shareholders.

The remuneration of the Board members, of the executive body and of the revision commission shall be based on their actual contribution to the success of the company's business. It should take into account the achievement of the strategic commitments and objectives/targets mentioned in the business plan or other activity documents of the company. In order to transpose the level of achievement of the strategic commitments, the remuneration formula should take into account such elements as:

- a) fixed remuneration in accordance with the average salary per company/economic branch;
- b) variable remuneration in accordance with the long-term performance of the company.

- iii. **Solid organizational values, followed by all those who work in and with the company** – it is the Board's responsibility to ensure the establishment of an ethical environment, by establishing a framework of values that promote personal and corporate integrity. The development of ethical standards and their observance are to be ensured by an Ethics Committee, part of the Board. Ethical standards, represented by moral and professional rules, will be detailed in a *Code of Ethics*, whose role is to guide the behaviour of management, staff and employees in their daily work.

The Ethics Committee will ensure that staff understand and follow the rules set out in the Code of Ethics and discuss any suggestions for its improvement. Each ethical issue will be addressed individually by the Committee on the basis of the rules, guidelines and resources stated in the Code. They will address the most pressing cases of misconduct that may occur in the company's activity and will ensure the transposition of state commitments to certain topics of public interest, without being limited to rules related to:

- moral and honest behaviour;
- equal opportunities for all employees;
- security of employees, technological equipment, information and intellectual property of the company;
- fair competition and fair practices;
- anti-corruption practices and conflict of interest management;
- proper dress code;
- adherence to the principles of combating climate change;
- respecting the human rights;
- social responsibility, sponsorship and philanthropy;
- cautious interaction with the political environment;
- transparency and disclosure of information of public interest.

- iv. Management of conflicts of interest situations and transactions with consistency, impartiality and responsibility** – The Board will ask the executive team to establish internal procedures for early identification, disclosure and proper management of conflicts of interest according to the latest legal provisions, and ensure quality control of regulations and their applying through internal control bodies. Thus, in order to ensure the service of the public interest with impartiality and objectivity, the employees, including the people with management positions, will be guided by procedures that treat conflicts of interests within the terms and manner provided by *Law No 133/2016 on the Declaration of Wealth and Personal Interests*⁹. People with management positions whose activity, judgment or results may be adversely affected by a conflict of interest shall refrain from making any decisions.

Conflict of interest transactions are conducted in a manner that ensures the proper management of conflicts of interest and protects the interests of company and other stakeholders. These are performed according to Articles 85 - 86 of *Law No 1134/1997 on Joint Stock Companies*¹⁰. The company discloses the information regarding the conclusion of a transaction with conflict of interest by placing relevant information on the webpage, within 3 working days. Data on the conclusion of transactions with conflicts of interest shall be included in the annual report of the Board and shall include at least a description of the conflict of interests and a statement on their compliance with the provisions of existing law and this Code.

- v. Zero tolerance for corruption** – The Board should ensure that procedures are in place to prevent, detect and respond to acts of corruption and other unlawfulness. In this regard, the Board should request that the executive team establishes a mechanism of disclosing illegal practices and protecting the rights of whistle-

⁹ Law No 133/2016 on the Declaration of Wealth and Personal Interests, https://www.legis.md/cautare/getResults?doc_id=125110&lang=ro

¹⁰ Law No 1134/1997 on Joint Stock Companies, https://www.legis.md/cautare/getResults?doc_id=123873&lang=ro#

blowers according to *Law No 122/2018 on Whistle-blowers*¹¹ and that control bodies monitor the quality of development and implementation.

vi. **Defence framework against any political interference by State officials, public institutions** –The Board will implement mechanisms by which no interference will be accepted with regard to:

- a) **employment** - avoid employing relatives/acquaintances/friends of public officials, politicians, other than via a competitive selection process. Also, no special positions will be created for such people or for public officials, including in anticipation of their service termination;
- b) **sponsorship** - sponsorships will be made in full transparency, according to *Law No 1420/2002 on Philanthropy and Sponsorship*. Sponsorships are pro bono, with no expectations of any future benefits;
- c) **political contributions** – the people with management positions and employees will know and respect the provisions of *Law No 294/2007 on Political Parties*, as well as other related legal regulations. The contributions and support provided by the company will reflect and support the values and objectives established by the business strategy and the principles of social responsibility adopted, and not the political opinions of the mentioned people;
- d) **provided services** - in relation to customers or suppliers, the company will establish zero tolerance for bribery, extortion, fraud, unfair competition and abuse of power, money laundering and other similar activities. Trade interaction with the political environment is treated with care, including from the perspective of a conflict of interest.

¹¹ Law No 122/2018 on Whistleblowers, https://www.legis.md/cautare/getResults?doc_id=105486&lang=ro

3. Internal Control

3.1 Internal control and its role

Internal control is a fundamental pillar of corporate governance. The internal control system has a key role in ensuring a sustainable, low-risk business of an enterprise.

What is internal control? Internal control is designed to provide reasonable assurance on achieving the objectives of operational, reporting and compliance processes. Internal control mitigates the risks regarding the effectiveness (compliance with plans) of the operational activity, the credibility of the financial and managerial reports and compliance with both internal procedures and external regulations and legal obligations.

Within an enterprise, internal control is the function that ensures that information flows are consistent and complete for making timely appropriate decisions at all levels of internal management, from operational to strategic, but also at the level of owner of institutions (Government and local public authorities), as well as ensuring the correct informing of the public, which is the owner and final beneficiary of publicly owned enterprises.

The internal control process includes:

1. The control environment that includes the management philosophy, ethical and integrity values and the accountability system
2. Control activities that can be manual or based on automated systems
3. Monitoring activities through evaluations and audits
4. Risk assessment including risk identification, analysis and treatment solutions
5. Both internal and external communication and information that must be relevant and timely

The corporate governance of an enterprise must take into account these components of the internal control process and ensure the consistent regulation and resources necessary for its proper functioning. Thus, within a company, 3 key functions are most often established:

1. Risk management, unit responsible for developing risk policies, as well as for identifying, analysing and addressing the risks to which the company is subjected, in agreement with the functional units of the organization.
2. The compliance function, responsible for assessing and ensuring the company's compliance with the regulatory framework, branch regulations, constant alignment of internal procedures and regulations with the regulatory and compliance requirements.
3. Internal audit, responsible for assessing the compliance of reports and information with the actual situation within the company, assessing internal systems if they ensure control over risks, but also the compliance of internal processes with internal regulations and the applicable national regulatory framework.

Also, the state-owned enterprises, in most cases, have the obligation to set up an Audit Committee in support of the Supervisory Board, responsible for the evaluation and supervision of the internal control functions.

3.2 International recommendations and practices on internal control

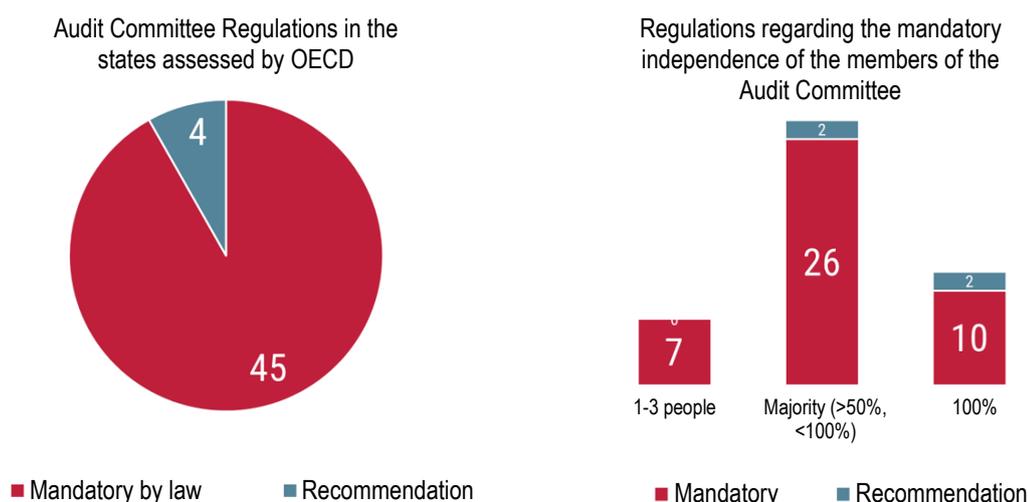
The OECD Guidelines on Corporate Governance of State-Owned Enterprises also set out recommendations for internal control, which should be a mandatory element of state-owned enterprises:

'The boards of SOEs should develop, implement, monitor and communicate internal controls, ethics and compliance programmes or measures, including those which contribute to preventing fraud and corruption. They should be based on country norms, in conformity with international commitments and apply to the SOE and its subsidiaries.'¹²

Specific internal standards and best practices on each of the elements of internal control have to be taken into account in establishing appropriate internal control in enterprises. Thus, risk management since 2015 has become a mandatory element of the quality standard ISO 9001¹³, and the organization of risk management is regulated by the international standard ISO 31000: 2018¹⁴. In order to organize the audit function, international standards and practices in this field have to be taken into account, such as, for example, the International Standards on Auditing and Accounting, 2018 edition¹⁵.

Within OECD countries, there are various practices of strengthening internal control in state-owned enterprises. However, there are certain trends that determine good practices for regulating this issue. Thus, most OECD countries participating in the survey require by law an Audit Committee in support of the Supervisory Board and most of them require by law that most members be independent, and in 10 countries the entire body of the committee must be represented by independent persons.

Figure 1. Regulatory practices of audit committees in OECD countries.



Also, in at least half of the OECD countries, risk management and internal control are assigned to the responsibility of the steering committees, and the other states recommend these responsibilities through the Code of Principles. Only a small fraction of countries do not regulate these issues.

¹² <https://www.oecd.org/corporate/guidelines-corporate-governance-soes.htm>

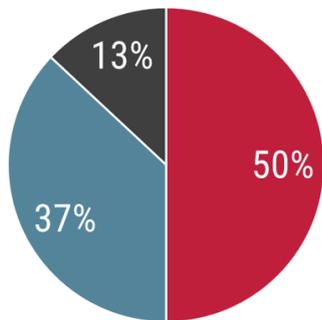
¹³ <https://www.iso.org/standard/45481.html>

¹⁴ <https://www.iso.org/standard/65694.html>

¹⁵ <https://www.iaasb.org/publications/2018-handbook-international-quality-control-auditing-review-other-assurance-and-related-services-26>

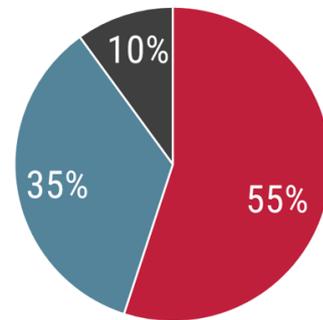
Figure 2. Regulatory practices for risk management and internal control in OECD countries.

Risk Management assigned at the level of management committees, % states



- Mandatory by law
- Recommended by the Code of Principles
- There are no rules

The compulsoriness to implement internal control and risk management, % of states

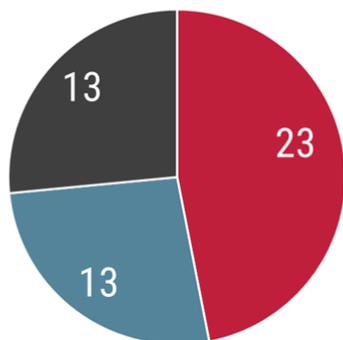


- Mandatory by law
- Recommended by the Code of Principles
- There are no rules

Risk management is becoming an increasingly important function in an ever-changing business environment. This increases the tendency to recommend or even the compulsoriness to set up separate risk committees. However, at present this function in most OECD countries is, according to old practice, the responsibility of the Audit Committee.

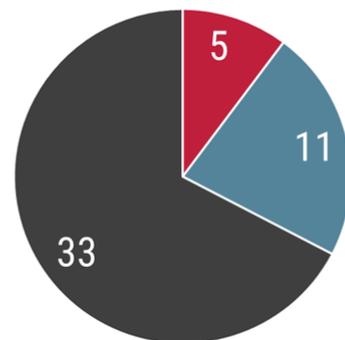
Figure 3. Practices for assigning the risk management supervision function in OECD countries.

Risk Management assigned to the responsibility of the Audit Committee, no states



- Mandatory by law
- Recommended
- There are no rules

The compulsoriness to implement a separate risk committee, % states



- Mandatory by law
- Recommended
- There are no rules

3.3 Current situation. Causes of malfunction.

The regulatory framework provides several acts related to the organization of internal control aspects in public organizations and joint stock companies:

1. Law No 271 of 15.12.2017 on the Audit of Financial Statements
2. Law No 229 of 23.09.2010 on the Internal Public Financial Control
3. Law No 1134 of 02.04.1997 on Joint Stock Companies
Chapter 10. Article 71. The Company's Revision Commission
1) The Company's Revision Commission assess the economic-financial activity of the company and is subordinated only to the general meeting of shareholders.
Chapter 17. Article 89. The Audit
1) The compulsory audit of the annual financial statements shall be performed at the public interest entity and at the company, in which the state share exceeds 50% of the share capital.
4. Law No 246 of 22.11.2017 on State Enterprises and Municipal Enterprise
Article 10. Revision Commission
Article 11. The audit of financial statements
(1) The annual financial statements of state-owned enterprises shall be subjected to mandatory external audit
Article 8, (7), q). The Board of Directors shall select the External Auditor
5. Government Decision No 484 of 18.10.2019, Annex 6, which includes the Template Regulation and the Template Report of the Revision Commission
6. National Standards of Internal Audit, approved by the Order of the Ministry of Finance No 113 of 12.10.2012
7. The Code of Ethics of the internal auditor and the Internal Audit Charter (Regulation-template for the operation of the internal audit unit), approved by Order of the Ministry of Finance No 139 of 20.10.2010
8. The Code of Ethics of the internal auditor and the Internal Audit Charter (Regulation-template for the operation of the internal audit unit), approved by Order of the Ministry of Finance No 139 of 20.10.2010
9. The methodological norms for the implementation of the internal audit in the public sector, approved by the Order of the Ministry of Finance No 118 of 29.12.2008

The regulatory framework contains a law dedicated to internal control in public institutions (Law No 229 of 23.09.2010 on Public Internal Financial Control). This law was recently updated (December 2020) and is best aligned with international practices. However, this law does not provide for any requirements regarding the compliance function and compliance control, including in the audit process, and for risk management, which becomes a requirement for the internal control system, it is not specified to set up the risk management function at least for companies of major importance.

Law 271 on the audit of financial statements provides sufficiently detailed regulations on the relationship between the internal audit and the Audit Supervisory Committee, as well as the requirements and the procedure of setting up the audit supervisory committee. But law No 1134 of 02.04.1997 on Joint Stock Companies provides for another mandatory structure 'Revision Committee', which overlaps with the function of the Audit Supervisory Committee. Thus, in practice, there are already state-owned companies that have set up both governing bodies, which create an exaggerated bureaucracy with low efficiency. Moreover, the Revision Committee is a structure with outdated roles and anachronistic with the modern requirements for a body to supervise the aspects of financial control

within the audit. These confusions complicate the establishment of well-aligned and structured internal control systems for the roles they have to exercise.

Internal control systems in state-owned enterprises are only in the formative stage. Some companies due to the implementation of ISO 9001 standards have a more robust internal control system and a system of internal procedures that ensures a higher degree of compliance. However, most of the time ISO processes are limited to operational and product aspects and less to financial aspects, legal compliance, IT security, fraud, etc. Functional conflict and segregation of functions within enterprises is rarely aware and applied, it takes place rather through the implementation of structures inspired by other sources. But, it is crucially important to become aware of the functional conflict that is a form of conflict of interest, and to take it into account when setting up organizational structures in state organizations. Thus, the internal audit cannot be in any way a part of another functional department or combined with other functions, this service must be fully independent and directly subordinated to the General Director, the Supervisory Board and the Audit Supervisory Committee. The finance and economic analysis departments must not be managed by the same manager who also manages the IT and/or information security departments. The operational activity must be separate and subordinated to different deputy directors from those who manage the accounting and ensure the reporting. Failure to ensure proper segregation of duties, can lead to major risks in the internal control system and too late detection of major problems in the organization.

In order to assess the quality of the internal control system, it is sufficient to assess how problems arise in the enterprise and how they are resolved. If in the company most of the problems appear ad-hoc, they are detected and responses are taken most of the time when the problem risks blocking certain processes, and its solution is based on a fire-fighting system, this is a direct indication that the internal control system is non-functional or is far from performing its functions.

The causes of malfunctions in the internal control system of state organizations are multiple:

1. Incomplete and sometimes contradictory normative framework.
2. Lack of a central professional policy from the part of the Public Property Agency (PPA) and robust advisory support on the organization of internal control systems for state-owned enterprises. There is a lack of organizational guides, operating models, model regulations and implementation options depending on the size of the enterprises and the types of risks they are associated with. PPA as a government-mandated institution for business management does not have a comprehensive and effective corporate governance policy, despite the fact that PPA has a Corporate Administration, Methodologies and Regulations Directorate, which also includes a Methodology and Regulations Section.
3. Lack of awareness and perception on the way coherent and professional internal control functions operate, which should avoid becoming an excessive bureaucracy and a burden for the company, but a tool for continuous efficiency and optimization of the activity processes and increase the sustainability of the organization.
4. There is a lack of a mechanism for exchanging experience and good practices between state-owned enterprises. Such a mechanism would significantly enhance the learning and efficiency of internal control systems.

3.4 What solutions are needed to improve the internal control system in state-owned enterprises

The establishment of modern internal control systems is still in its infancy and needs to be improved in a number of directions. The main priorities include harmonization of the normative framework, elimination of critical

deficiencies and the focus of PPA on developing complete methodologies and standards for the organization of Internal Control within the managed state enterprises.

Thus, the following recommendations and improvements are proposed:

1. Strengthen the team of the Methodology and Regulations Section of PPA to have sufficient capacity for monitoring best practices in state-owned enterprise management, internal organization, in particular of the Internal Control, and develop methodologies, guidelines, operational models and regulatory models for state enterprises. It is critical that this unit to be mandated to use consultants and expert teams to develop or even operationalize certain models within state-owned enterprises. This unit may not and should not have all the competences in the methodological field, instead it has to be a good coordinator and contractor of professionals to deliver the methodologies and consultations necessary for the optimization of different methodological aspects of the state enterprises. Ensuring a working group focused on internal control and those 3 dimensions is imperative:
 - a. Risk Management
 - b. Compliance
 - c. Audit
2. It is necessary to analyse the regulatory framework and harmonize it. In particular, it is necessary to eliminate the anachronism related to the request of having both a Revision Commission and an Audit Committee. The Revision Commission must be permanently abolished and replaced by the Audit Committee. Also, its roles should be analysed well and an effective integration with the internal control system defined in other regulations should be ensured. A periodic review and alignment of the roles set out in the regulatory framework with international good practice is needed.
3. In order to increase the level of education and practical information, it is imperative to create a platform (congress, conference, forum, etc.) for presenting the best internal control solutions with the participation of state enterprises, but also open to private enterprises that want to learn or present case studies of success or failure. It is important to be present professionals and organizations focused on solutions that improve internal control systems, which can bring optimizations, new techniques for improving the control system (audit companies, IT, process professionals, risk management, security, etc.). Such a platform would significantly increase the professional quality of staff involved in internal control systems, the quality of policies and applied tools and accelerate the process of adopting and implementing of good solutions in internal control field.

4. Transparency and Disclosure

Despite the Government's efforts to privatise public property, it continues to play an important role in several areas of the national economy. Thus, the management, control and reporting of state-owned economic entities are very important, including from the perspective of sustainable corporate governance practices. At the same time, a number of international organizations such as the OECD, the World Bank and the IMF emphasize the importance of ensuring the transparency of their activity in relation to the general public, especially in the context of intensifying debates on public debt, corruption, conflict of interest, the shadow economy and taxation. For example, OECD principles for the corporate governance of state-owned enterprises clearly illustrate that the lack of transparency may indicate the existence of managerial deficiencies not only within the economic entities concerned, but also the inability of the state to manage efficiently the available resources.

In particular, the performance of state-owned enterprise in the Republic of Moldova reveals the existence of transparency deficiencies and, implicitly, highlights the need to strengthen the efforts aimed at eliminating inconsistencies related to public access to information about given entities performance. Moreover, the mentioned deficiencies are based on both the general regulatory framework (even optional) and the absence of effective accountability mechanisms for all parties involved in the external reporting of information, designed to strengthen management discipline and optimize public assets management.

At the same time, there are several challenges specific to the administration of state-owned economic entities that are implicitly reflected on transparency, based on their proximity to the executive/legislative power, but also to political decision makers (sometimes even affiliation with the political environment). Simultaneously, such interference can be identified as a major risk to effective corporate governance, which could, inter alia, materialize in the following directions:

- The commitments and responsibilities arising from this involvement form a fertile ground for corruption;
- In certain circumstances, the a priori favourable position of state-owned economic entities may distort the market, due to unfair competition or various conflicts of interest;
- The possibility for other economic entities of the state or state bodies to act both as customers and suppliers, creates a potential risk for the conduct of fair public procurement;
- The existence of a 'relaxed' attitude towards the actions of verifying the observance of the legislation, carried out by the competent bodies with control functions;
- The special status of economic entities with state capital in relation to the private sector, implies an increased protection against some major risks, even in case of poor management;
- Last but not least, in the absence of pressure from society on the management of these entities, which is under the 'state protectorate', it is undermined the motivation for the efficient use of public financial flows.

These risks are even more pronounced against the background of the persistent feeling in the society that public property is neither operating efficiently nor managed properly. Moreover, the characteristic non-transparent public property management does nothing but confirm the hypotheses, which could indicate systemic problems at all levels.

Therefore, transparency and disclosure of information related to the economic activity of these entities are vital for the efficient management of public property, in line with best corporate governance practices. Besides, an

efficient system of transmitting and disseminating information in a fast and reliable way to the general public, can not only contribute to ensuring the integrity and efficiency of public property, but can also serve as a means of increasing credibility with the authorities and their overall actions.

4.1 How are the transparency and disclosure regulated and what are the deficiencies in the field?

Improving the reporting of state-owned companies, but also the presentation of information to the general public are often considerable challenges, which exceed those faced by private sector counterparts in the Republic of Moldova. For these reasons, we are aware that they are publicly owned entities which, for certain objective reasons (e.g. the state security field), cannot be obliged to disclose information to the public or whose low economic importance does not justify the administrative effort to ensure transparency. However, most of the times the lack of will among the management of these entities, as well as the tools of accountability from the specialized authorities, in tandem with the reduced capacities to prepare or present the information properly results in the existence of a fragmented or incomplete external communication.

It should be noted that there are several forms of financial and non-financial reporting available to state economic entities, which can be measured by a large number of dimensions, including from the perspective of completeness, accuracy, timeliness and relevance. Despite this, as well as thanks to the often optional (or so perceived) regulatory framework, public information on the performance of state economic entities is incomplete and so delayed that they lose their practical relevance. At the same time, the Government's efforts to efficiently manage the public assets by corporate governance, especially from the perspective of implementing a certain degree of transparency in the field, are still insufficient and largely related to state institutions and less to economic entities:

- The Ministry of Finance a mechanisms for permanent monitoring of the performance of business entities with public capital meant to ensure transparency in the sector. According to Government Decision No 56 of 17.01.2018, it shall perform financial monitoring of self-governing public authorities, state/municipal enterprises and companies with full or majority public capital.

However, we point out that this tool has certain deficiencies, and these are related to the general provisions of the Regulation itself, which do not exhaustively establish the responsibilities of the parties at all stages of monitoring. This results in lack of and failure to submit full and relevant information on the economic and financial performance of entities with full or majority state capital, which does not ensure the whole picture of the public area subject to financial monitoring.

At the same time, as this Regulation covers only 'companies with full or majority public capital', there is no regulation on MoF monitoring of entities with the Government's share under 50%, which does not ensure a full picture on the efficiency of public property management.

Last but not least, it should be mentioned that, according to the same regulatory act, the results of the financial monitoring have to be published by the Ministry of Finance on its official website. Although they are found on the entity's website, they are chaotically located or incomplete. At the same time, the results of the financial monitoring in aggregate format can be found in the draft of the state budget law, as well as in the report on the execution of the state budget (these documents are publicly displayed).

- More detailed information can be found in the Report on the Management and Denationalization of Public Property, prepared by the Public Property Agency. This report contains data on the economic and financial

results of the activity of state-owned enterprises and joint stock companies with a state share of more than 30%.

At the same time, in order to ensure wide access to information on the results of the economic-financial activity of enterprises with a state share of more than 30%, the annexes of the Report are published on the single government open data portal www.date.gov.md.

The limited data available publicly neither provide a clear view of the economic activities of these entities, nor allow comparing their performance against the objectives set per entity (only performance thresholds for the whole sector are available). In addition, the information is presented in a user-hostile format and does not always allow tracking developments over time.

- It is important to note the intentions to comply with the regulatory framework on corporate governance in joint stock companies in the Republic of Moldova to international standards of corporate governance, based on the commitments made under the Association Agreement Moldova – European Union.

Thus, the provisions of the new Corporate Governance Code approved by NCFM Decision No 67/10 of 24.12.2015, are based on international practice in corporate governance, especially on the OECD principles of corporate governance. Moreover, joint stock companies (including those of public interest, but not state-owned enterprises) are encouraged to adopt and comply with the provisions of the new Code.

Although this document offers a wider range of provisions on disclosure of information, its optional nature (targeting JSC) has not generated any obvious effects in the field of transparency of public assets management.

- The new Law No 246 of 22.11.2017 on State Enterprise and Municipal Enterprise contains provisions on transparency and follows the spirit of the new Corporate Governance Code, intended to ensure the disclosure of information on their economic and financial activity.

Thus, those entities must prepare and publish comprehensive data on their economic activity. Although, it would seem that the new legal framework imposes higher transparency requirements for state-owned enterprises, including the publication of reports within 4 months from the end of each management year on the website, including the founder's page, until now, such data are rarely available to the public.

- The newest initiative that contains provisions related to transparency, is represented by NCFM Decision No 7/1 of 18-02-2019 approving the Regulation on the Disclosure of Information by Issuers of Securities.

At the same time, the new regulatory framework targets exclusively public interest entities¹⁶. Although the rules provide for the mandatory disclosure of public information, it is found only on the platforms of the Official Information Storage Mechanism, but very rarely in electronic form, on its own official website as stipulated in the Regulation.

Given the above, we could conclude that at present there is no functional system for disseminating information on how public property is managed, but rather attempts to comply with certain legal requirements (mainly by central

¹⁶Public interest entity - entity whose securities are admitted to trading on a regulated market; the bank; insurer (reinsurer)/insurance company; undertakings for collective investment in transferable securities with legal personality; large entity that is a state-owned enterprise or is a joint stock company in which the state's share exceeds 50% of the share capital.

authorities and less by economic entities). On the other hand, the attested situation can be argued by the absence of an exhaustive and mandatory framework (including sanctions for non-compliance), lack of any processes that would form attitudes or change the managerial culture in the public area, as well as methodological rules (Guidelines for external communication) adapted to the legal, cultural and economic framework of the Republic of Moldova. However, the main barrier is the reluctance of both the management of state-owned economic entities and their founders to disclose information, maintaining directly the 'convenient' status quo in transparency.

4.2 What are the international recommendations and best practices?

Though provisions on ensuring transparency of the activity of economic entities with state capital are in place, in practice compliance is often limited to financial data. At the same time, unlike the 'disclosure' of financial information, economic entities with state capital literally do not disclose any non-financial information. Such information as the objectives or mandate of these entities, social or political commitments, any privileges or exclusive rights enjoyed by the state as owner, who are the members of the boards of directors, their relations with other state entities, the risks they face or how they are managed, are practically nowhere to be found. However, as mentioned in the OECD Guidelines, such disclosure, often of a qualitative nature, can provide stakeholders with key insights into the functioning of public property and its perspectives, as well as its relationship with the state and third parties.

In fact, in order to support initiatives aimed at contributing to the efficiency of public assets management, in 2005 (with some changes in 2015) the OECD published a comprehensive set of recommendations on corporate governance of state-owned enterprises¹⁷, which also contain the fundamental principles of transparency. These recommendations go beyond the information requirements and present a series of specific proposals that promote the mandatory or voluntary publication (depending on national legislation) of the following information:

1. A clear statement to the public of enterprise objectives and their fulfilment;
2. Enterprise financial and operating results, including where relevant the costs and funding arrangements pertaining to public policy objectives;
3. The governance, ownership and voting structure of the enterprise, including the content of any corporate governance code or policy and implementation processes;
4. The remuneration of board members and key executives;
5. Board member qualifications, selection process, including board diversity policies, roles on other company boards and whether they are considered as independent by the SOE board;
6. Any material foreseeable risk factors and measures taken to manage such risks;
7. Any financial assistance, including guarantees, received from the state and commitments made on behalf of the SOE, including contractual commitments and liabilities arising from public-private partnerships;
8. Any material transactions with the state and other related entities;
9. Any relevant issues relating to employees and other stakeholders.

¹⁷ OECD Guidelines on Corporate Governance of State-Owned Enterprises, 2015

At the same time, in order to ensure compliance with high standards of transparency, it is considered appropriate to develop external communication guidelines that would include standardized reporting formats for state-owned economic entities that would contain reporting requirements and standardized formats for financial and non-financial information, which would facilitate the process of disseminating information to the general public (in addition to complex statistical reports).

Box 1. A draft of the ‘Transparency Mode’ (for the entity’s webpage)



A good practice to increase transparency and inform the public in real time about state-owned enterprises in the country is related to the use of IT resources. In this sense, it is recommended the development of digital modules dedicated to transparency that are to be completed only regularly by the economic entity (the templates being made available free of charge by the central authority). These digital tools with an intuitive interface would provide useful information for civil society, academia, business associations and other non-governmental entities.

4.3 What should be done to ensure sufficient transparency?

It is undeniable that the lack of transparency implies a higher risk of corruption, and poor information can undermine public confidence in the authorities and cause some reluctance to any actions/initiatives in the field. Even so, the major task for the authorities and economic entities they manage will be to accept and be aware of the existence of problems in the public field arising from the lack of transparency and integrity.

Although the state's efforts to ensure transparency, especially in terms of improving the legal framework, are welcome, their general and discretionary nature does not ensure the sustainability of the given initiatives, and the tools used to hold all parties involved in managing public assets remain unused (in particular at economic entity level).

Therefore, sustained efforts are needed to change the principles of governance in the Republic of Moldova that derive from various international recommendations (OECD, WB, IMF, etc.) and best practices, consisting in implementing a series of actions to ensure the sustainability of reforms in transparency of state-owned companies and the reconfiguration of the perception of the general public above, such as:

- Consider the existing regulatory requirements for transparency and disclosure of information, by reviewing both the elements that are subject to transparency and the mechanisms for implementing these requirements;
- Align the existing legal requirements with OECD corporate governance recommendations and principles;
- Clarify the responsibilities and obligations of all parties involved in the process of ensuring transparency and disclosure of information;
- Include a mechanism for sanctioning entities or their managers for non-compliance with legal reporting requirements and ensuring transparency;
- Assign the obligation of the regulatory framework related to transparency and disclosure of information to economic entities with state capital;
- Develop specific methodological documents (external communication guides) meant to complete the regulatory framework, encouraging the efforts of the economic entities for external reporting of the performances registered in a standardized format;
- Ensure active communication between authorities and managed economic entities in order to fully understand the reporting obligations and the reasons behind such disclosures. This communication could target both the economic entities concerned and the relevant authorities, as well as the general public and the media;
- Support state-owned economic entities in their efforts to adapt to transparency and publication requirements. Thus, taking into account their low capacity, the most recommended tool would be for the central administrative authority to develop a digital template (Transparency Module), which is to be filled in and disseminated independently by the economic entity.

Certainly, changing the mindset and implicitly the attitude of all relevant stakeholders towards compliance with transparency requirements and understanding the positive results derived from it, is a slow process, which in most cases will be met with resistance, even if we can see some efforts in this regard. However, we must be aware that this new type of thinking is difficult to integrate in the public field, as long as in society, the notions of loyalty and corruption still play an important role, and their existence erodes a successful change in corporate culture.