

## Everything about Boards of Directors.

# How does political favoritism manifest itself in the management of state-owned companies?

*Analytical Commentary*

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### Boards of Directors' Role in State-Owned Companies

The proximity of state-owned companies to political factors and economic interest in public assets create a favourable environment for corruption, which justifies a rigorous and uniform approach to everything related to state-owned companies. The State may participate directly in the economic life by means of two legal forms of organisation – state-owned enterprise and joint stock company (*hereinafter, the state-owned enterprises and majority state-owned or wholly state-owned joint stock companies will be referred to as state-owned companies, except when a particular legal form is referred to*). Although the activity of state-owned enterprises and joint stock companies is governed by separated laws, the management bodies of these companies are largely structured similarly and share the following elements<sup>1</sup>: board of directors, manager/executive body, audit committee.

Rigorous control mechanisms have to be implemented in management of state-owned companies, since these are often established to provide a public service or to operate in an industry prone to a natural monopoly. The division of state-owned companies into state-owned enterprises and joint stock companies makes the management of public assets more complicated. If the State prefers the joint stock companies as an organisational form, these companies should be managed according to the most stringent principles of transparency and corporate governance, going beyond the legal framework set up for private joint stock companies.

For state-owned companies to be effectively monitored, the natural step would be to apply a single and rigorous standard both to the management of state-owned enterprises and majority state-owned joint stock companies, taking into account the specifics, the objective and the industry in which the enterprise operates. In other words, management procedures, including criteria for appointment of representatives in management bodies and their duties, standards on disclosure of information, etc. should be the same for all state-owned companies. The proximity of these companies to political factors and economic interest in

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<sup>1</sup> The role of the founder of a state-owned enterprises is largely taken over by the general meeting of shareholders in case of joint stock companies.

public assets increase significantly the risk of corruption, which justifies a rigorous and uniform approach to everything related to state-owned companies.

**The main structure by which the State can play an important role in the activity of state-owned companies are the boards of directors.** The purpose of a board of directors is to represent the owner's interests (in this case – of the State) in order to ensure the strategic direction and good operation of the enterprise. The existence of two different approaches, between state-owned enterprises and joint stock companies, creates conditions for perpetuating obscurity in the supervision of these entities. Whereas the Law on joint stock companies has as primary objective to regulate private sector entities, the powers provided to the boards of directors of joint stock companies are narrower than the powers of boards of directors of state-owned enterprises (Table), such elements as setting performance indicators being left at the discretion of joint stock companies. For this reason, given the increased interest in protecting public assets, if the State establishes a joint stock company, its activity should not be limited only to the fulfillment of the applicable legal framework, but should pursue a high level of transparency and corporate governance, also being a role model for private sector entities.

**Table: Legal provisions on board of directors of state-owned enterprises vs board of directors of joint stock companies**

|                                                               | <i>State-owned enterprises</i>                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                  | <i>Joint stock companies</i>                                                                                                                                                                                                                                                                                                                                                                    |
|---------------------------------------------------------------|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Composition                                                   | <ul style="list-style-type: none"> <li>• Uneven number of members; at least 3</li> </ul>                                                                                                                                                                                                                                                                                                                                                                                                                                        | <ul style="list-style-type: none"> <li>• Minimum 3 persons, and for joint stock companies with more than 100 shareholders – minimum 5 persons</li> </ul>                                                                                                                                                                                                                                        |
| Term                                                          | <ul style="list-style-type: none"> <li>• 2 years, eligible for reappointment</li> </ul>                                                                                                                                                                                                                                                                                                                                                                                                                                         | <ul style="list-style-type: none"> <li>• Term provided for in the Statute, maximum 4 years, eligible for reappointment</li> </ul>                                                                                                                                                                                                                                                               |
| Maximum number of boards of directors which it may be part of | <ul style="list-style-type: none"> <li>• 3 boards of state-owned enterprises and 3 boards of municipal enterprises</li> </ul>                                                                                                                                                                                                                                                                                                                                                                                                   | <ul style="list-style-type: none"> <li>• 5 boards of joint stock companies</li> </ul>                                                                                                                                                                                                                                                                                                           |
| Main duties                                                   | <ul style="list-style-type: none"> <li>• Approve the business plan</li> <li>• Set up the performance indicators</li> <li>• Review reports of control bodies and of the auditor</li> <li>• Approve the profit distribution proposal</li> <li>• Select, on a competitive basis, the manager candidate and present it to the founder for appointment</li> <li>• Approve decisions on the manager's salary ceiling</li> <li>• Select the audit entity</li> <li>• Submit to the founder the annual report on its activity</li> </ul> | <ul style="list-style-type: none"> <li>• Approve decisions on the securities issuance (shares, bonds)</li> <li>• Put forward proposals to the general meeting on the payment of dividends and decide upon the use of the reserve fund</li> <li>• Draw up a list of candidates to be elected in the company's management bodies</li> <li>• Approve the payroll accruals for employees</li> </ul> |

Source: Law on state-owned enterprise and municipal enterprise<sup>2</sup> and Law on joint stock companies<sup>3</sup>

<sup>2</sup> Law No 246 of 23.11.2017 on state-owned enterprise and municipal enterprise:  
<http://lex.justice.md/index.php?action=view&view=doc&lang=1&id=373351>

<sup>3</sup> Law No 1134 of 02.04.1997 on joint stock companies:  
<http://lex.justice.md/index.php?action=view&view=doc&lang=1&id=326515>

## Need to Enhance the Professionalism of Boards of Directors

**Currently, the process of appointing members to boards of directors of state-owned companies is unclear and subject to an excessive politicisation risk.** Since boards of directors play a crucial role in strategic management of a company, lack of a clear and transparent mechanism of delegating people in these positions poses a major threat to the good management of public assets. Besides a well-established procedure, an exhaustive list of criteria for the selection of potential candidates for boards of directors should also be in place. According to existing legislation, the founding institution is entitled to delegate persons to boards of directors<sup>4</sup>, without a detailed description of that procedure.

**The adoption of a new law on state-owned enterprise and municipal enterprise tries to partially address a conflict of interests existing in the current architecture.** Until now, the ministries or other administrative authorities – owners of state-owned enterprises, were, as a rule, policymakers for the area in which these enterprises operated. The designation of Public Property Agency as the founder of all state-owned enterprises removes the existing structural conflict. In addition, according to the old law on state-owned enterprise, the majority of boards of directors' members had to be representatives of Ministry of Economy and Ministry of Finance<sup>5</sup>. The exclusion of this provision from the new Law on state-owned enterprise and municipal enterprise is thus welcome. **This step is though insufficient to ensure the quality of members delegated to these boards of directors.** On the other hand, the Law on joint stock companies still requires the inclusion of Government representatives (Ministry of Economy, Ministry of Finance and/or of the body in charge of privatisation of public assets) in the boards of directors of majority state-owned companies<sup>6</sup>. Therefore, a clear selection procedure for boards of directors' members, to be applied to both state-owned enterprises and state-owned joint stock companies, needs to be established.

**Government representatives are appointed in boards of directors of state-owned companies on the basis of political favoritism rather than on competencies.** Considering the fact that the founding institution usually has political representatives in the leadership and considering the lack of procedures for the appointment of members to boards of directors, there is a risk of delegating people who share the leaders' political visions, to the detriment of professional qualities. For instance, in case of the Board of Directors of Banca de Economii, according to the summary of Kroll report, from 'a review of the limited documentation available, it is apparent that in numerous instances, risks were raised to the Board but appeared to have been ignored and the loans were approved'.<sup>7</sup> The lack of action on behalf of the board of directors, representing the interests of the State and implicitly of citizens, is a strong indicator of the fact that certain political interests were promoted through the representatives in the board of directors.

**The risk of political favoritism is exacerbated by the high salaries earned by members of the board of directors for their work.** An analysis of civil servants' earnings, who were delegated to the boards of

<sup>4</sup> Article 8(2) of the Law No 246, <http://lex.justice.md/index.php?action=view&view=doc&lang=1&id=373351>

Article 66(1) of the Law No 1134, <http://lex.justice.md/index.php?action=view&view=doc&lang=1&id=326515>

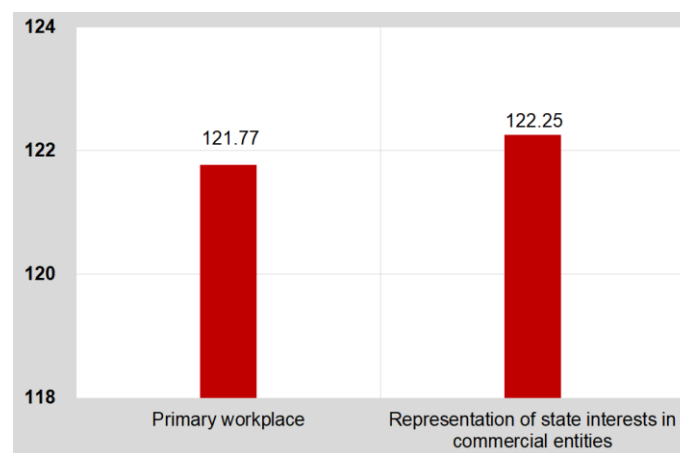
<sup>5</sup> Article 7(2) of the Law No 146, <http://lex.justice.md/index.php?action=view&view=doc&id=311598>

<sup>6</sup> Article 66(2) of the Law No 1134, <http://lex.justice.md/index.php?action=view&view=doc&lang=1&id=326515>

<sup>7</sup> Page 14, Kroll Report, [http://bnm.md/files/Kroll\\_%20Summary%20Report.pdf](http://bnm.md/files/Kroll_%20Summary%20Report.pdf)

directors of largest state-owned companies<sup>8</sup> in 2016, reveals that on average they received greater rewards for representing State interests in commercial companies than for their main activity (Figure 1). This is possible since the civil servants are usually delegated to boards of directors of several enterprises simultaneously. On the other hand, remuneration of boards members in joint stock companies may exceed MDL 150 thousand annually. Therefore, besides the political battles for these positions, the incentives are somewhat distorted, people being motivated to work in the interests of enterprises rather than in their primary role of public policy-making. Moreover, delegation to multiple boards of directors questions the effectiveness of civil servants at their main workplace. Although this measure also has the role of maintaining qualified public service staff by providing them with an additional 'bonus' to the basic salary, the risk of exploiting the system to the detriment of public interest is too big to perpetuate this mechanism.

**Figure 1. Average income of public officials, State representatives in boards of directors during 2016, by sources, MDL thousand**



*Source: author's calculations based on statements of assets and public personal interests on the website [declaratii.ani.md](http://declaratii.ani.md) (within the limits of data availability)*

**More independence and professionalism of the boards of directors can enhance performance of enterprises, reducing the risk of exploiting them in order to obtain political dividends.** The recent trend of member states of Organisation for Economic Co-operation and Development (OECD) is to professionalise boards of directors by providing them independence and protection from politically motivated interventions<sup>9</sup>. In 2002, after a series of corporate scandals, the Sarbanes-Oxley Act was adopted in the United States, which set a rigorous standard for the composition of audit committees of public interest companies, highlighting the importance of attracting independent and qualified individuals to these positions<sup>10</sup>. This paradigm shift contributed to an increase in the quality of boards of directors and, implicitly, to a higher performance of companies.

**Although the local legislative framework does not expressly prohibit delegation of professionals to boards of directors of state-owned companies, this practice has not been implemented so far.** Analyzing the boards

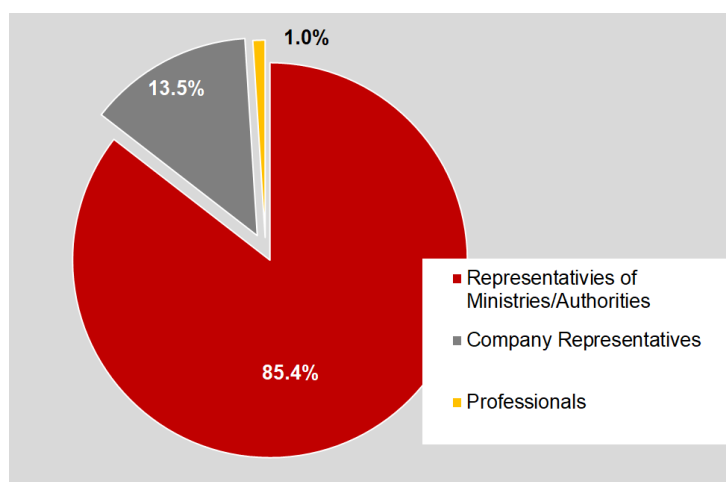
<sup>8</sup> The websites of about 30 state capital companies were analysed. However, a considerable part of the enterprises do not publish the full lists of the boards of directors' members, so obtaining data is a difficult and error-prone process

<sup>9</sup> <http://mof.gov.il/qca/about/documents/oecd-boardsdirectors.pdf>

<sup>10</sup> <https://www.prnewswire.com/news-releases/10-years-later-sarbanes-oxley-act-continues-to-shape-board-governance-164296516.html>

of directors of the largest state-owned companies<sup>11</sup>, we note that an overwhelming share of positions is held by persons delegated by line ministries (Figure 2), the number of positions offered to independent professionals accounting for only 1%. It is crucial to launch a process of attracting professionals to boards of directors and empower audit committees, as revealed by experience of states that succeeded in modernizing state-owned companies, including boards of directors' composition.

**Figure 2. Composition of boards of directors of the largest state-owned companies**



*Source: analysis of the composition of state-owned companies' boards*

## How to decrease corruption in boards of directors?

**The excessive losses generated by state-owned companies denote serious deficiencies in their management.** According to certain estimates, state-owned companies generated cumulative losses of about MDL 1.47 billion<sup>12</sup> during 2013-2016. Although in most cases state-owned companies do not aim at maximising profits, ensuring their sustainability by generating a sufficient revenue flow is crucial in order not to put additional pressure on taxpayers. To this end, the State can strategically supervise and manage companies it owns through boards of directors. Currently, the overwhelming majority of boards of directors' members are representatives of the founding authorities. In the absence of clear selection procedures for boards of directors' members, evidence suggests that most appointments take place on the basis of political criteria. Approval of the new Law on state-owned enterprise and municipal Enterprise and the change in the paradigm by assigning to the Public Property Agency the role of unique founder, which will also delegate representatives to the boards of directors, is welcome. However, the implementation of measures that would reduce the level of corruption in state-owned companies must continue and include:

- Obligation to comply with legislation on disclosure of information. This element continues to be a vulnerable point in the activity of state-owned companies, despite the fact that this commitment was stated in the action plan for implementation of the public administration reform strategy.<sup>13</sup> A

<sup>11</sup> We analysed the composition of the same boards of directors as in the case of salary assessment

<sup>12</sup> <https://expert-grup.org/media/k2/attachments/yantreprinderile-de-stat-La-Punct.-Despre-glurile-negre-ale-economiei-moldoveneuti.pdf>

<sup>13</sup> Action 13 of the Action Plan adopted by the Government Decision No 1351 of 15.12.2016: <http://lex.justice.md/index.php?action=view&view=doc&lang=1&id=368499>

considerable number of companies do not publish the list of persons on their boards, not to mention the reports that must comply with the legislation.

- Remove the provision requiring delegation of representatives of Ministry of Economy and Ministry of Finance to the boards of directors of majority state-owned companies from the Law on joint stock companies.
- Establish a single approach to the boards of directors of all state-owned companies, drawing rigorous criteria and clear procedures for appointing representatives.
- Gradually professionalise boards of directors, attracting private sector managers and finance and accounting specialists to the company's audit committees.
- Ensure an ongoing education of boards of directors' members. Membership often involves complicated processes, such as setting performance indicators and subsequent monitoring of them, approving business plans, presenting proposals for enhancing company efficiency, etc. Without education in business management, it is impossible to ensure quality implementation of these provisions, especially taking into account the high share of civil servants in these positions.