



CYPRUS

September 2023

TECHNICAL ASSISTANCE REPORT – STRENGTHENING THE GOVERNANCE AND OVERSIGHT OF STATE- OWNED ENTERPRISES

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TECHNICAL ASSISTANCE REPORT

CYPRUS

Strengthening the Governance and Oversight
of State-Owned Enterprises

AUGUST 2023

Prepared By

Sybi Hida, Natalie Manuilova, Ricard Frederick, and Sorana Baci

Authoring Departments

Fiscal Affairs Department

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Abbreviations and Acronyms

| | |
|-----------|--|
| CPA | Cyprus Port Authority |
| CYTA | Cyprus Telecommunications Authority |
| CySTAT | Cyprus Statistical Services |
| EAC | Electricity Authority of Cyprus |
| EU | European Union |
| FAD | Fiscal Affairs Department |
| FRBSL | Fiscal Responsibility and Budget Systems Law |
| GFSM 2014 | Government Finance Statistics Manual 2014 |
| KEDIPES | Cyprus Asset Management Company Ltd |
| LMs | Line Ministries |
| MoF | Ministry of Finance |
| OECD | Organisation for Economic Co-operation and Development |
| SOE | State-Owned Enterprise |

Preface

At the request of the Ministry of Finance (MoF) of Cyprus, a team from the IMF's Fiscal Affairs Department (FAD) visited Nicosia during March 22 – 31, 2023, to assist the authorities with strengthening the governance and oversight of state-owned enterprises (SOEs). The mission team was led by Mr. Sybi Hida and included Ms. Natalie Manuilova (both FAD), Ms. Sorana Rodica, and Mr. Richard Frederick (both FAD short-term experts).

The mission team met with the Deputy Minister to the President, Ms. Irene Piki; the Secretary of the Councils of Ministers, Ms. Penelope Papavasilio; and their staff. From the MoF, the team met with the Permanent Secretary, Mr. George Panteli; and the Budget Director, Ms. Melina Catsounotou, and her staff; the Director of Strategy and Coordination, Mr. Kyriakos Kakouris; the Director of Debt Management, Mr. Phaedon Kalozois; and the Director of Financial Services, Ms. Avgi Chrysostomou Lapathiotis. From the Treasury of the Republic, the team met with Mssrs. Marios Hadjidamianou and Aigli Constantinou. From the General Auditor Office, the team met with Mr. Akis Kikas and Ms. Markella Koukkoulli.

From the line ministries and regulatory entities, the mission team met with Mr. George Papageorgiou and Ms. Marina Patera (Ministry of Energy); Mr. Yiannis Nicolaides, Ms. Maria Ionnou, and Ms. Militza Kastellani (Ministry of Transport); Mr. Antonis Economides and Ms. Kiriaki Demetriou (Ministry of Interior); Mss. Christina Zouvani, Katerina Neophytou, and Solonas Karakokkinos (Cyprus Energy Regulatory Authority); Mss. G. Kastanou, M. Michael, and O. Drousiotou (Commission for the Protection of Competition). Also, the team met with Mr. Michalis Persianis, Chairman of Fiscal Council.

From the SOEs, the mission team met with Mr. Adonis Giasemides, Mr. Andreas Ioannides, Mr. Marios Skordellis, and Ms. Monica Christofidou (Electricity Authority of Cyprus); Mr. Michael Ioannides (Chairman), Ms. Maria Hamatsou and Ms. Loukia Mina (Cyprus Telecommunications Authority); Mr. Anthimos Christodoulides, Ms. Maria Ioakim, Mr. Michelle Christensen, and Mr. Stelios Pittakas (Cyprus Ports Authority); Mr. A. Hadjicharalambous, Ms. Fedra Diomedous (Larnaca Sewerage and Drainage Board).

The mission team would like to thank the authorities for the frank and open discussions and excellent cooperation and hospitality during the mission. Particularly, the mission is grateful for the outstanding support from the Budget Director and her team, especially Ms. Evgenia Constantinou, in coordinating the work of the mission.

Executive Summary

Cyprus' government has implemented measures to enhance financial oversight and strengthen the governance of state-owned enterprises (SOEs) over the past decade. Several actions have been taken to strengthen the accountability and governance of public entities. The Fiscal Responsibility and Budget Systems Law of 2014 provides the legal basis for financial oversight of public entities, including SOEs, and assigns clear control functions to the Ministry of Finance (MoF). Additionally, government has issued Ministerial Decisions and circulars aiming at strengthening oversight and fiscal risks management and allocating responsibilities to manage these functions. In 2020, a Public Sector Governance Code was implemented, introducing elements of good governance and accountability for public entities. Furthermore, the MoF has increased its role in monitoring public entities and has developed an analysis of public entities' financial performance as part of its annual fiscal risk statement.

The ongoing reforms have already yielded positive results. Liabilities of public entities have remained stable over the recent years at about 11 percent of GDP, and government guarantees have decreased from 4.5 percent of GDP in 2015 to less than 3 percent in 2021. Public entities accounted for less than 2 percent of total non-performing loans in 2022. In addition, progress has been made in their governance practices. Most of public entities' boards are now non-executive directors, ensuring that executives do not oversee their own actions and mitigating conflicts of interest. Furthermore, to ensure transparent and public candidate selection the Council of Ministers established an independent advisory council in June 2023 that will support the government in selecting and appointing qualified board members to public entities' boards.

Additional measures are needed to strengthen SOEs corporate governance and accountability practices. Currently, the MoF monitors only 58 public entities, leaving out entities such as the Cyprus Asset Management Company and pension funds which are operated by SOEs. Also, the categorization of public entities is based on their legal status and does not consider whether their activities are for commercial or policy purpose.

Establishing and regularly updating a consolidated inventory of public entities is essential to ensure SOE accountability. SOE classification should follow the guidelines provided by the IMF Government Finance Statistics Manual 2014 (GFSM 2014), which aligns with the European System of Accounts 2010 and enables differentiating entities operating in commercial sectors (SOEs) from non-commercial public entities. A unified classification system will facilitate effective monitoring, evaluation, and informed decision-making by the government regarding SOEs. Using the GFSM 2014 criteria and the available information, the mission team has identified 17 SOEs among total of 58 public entities. These SOEs collectively manage assets amounting to about 22.3 percent of the country's GDP in 2021.

Good SOE governance requires a coordinated and sequential approach to reforms. Coordination among various stakeholders and decision makers is paramount and calls for developing and publishing a reform strategy with benchmarks to track progress. The strategy should be based on the Organisation for Economic Co-operation and Development (OECD) Guidelines on Corporate Governance of SOEs (2015). Based on the findings of this report, the government can establish a clear roadmap for SOE governance reform. International experience indicates that a centralized unit or body empowered with oversight

functions over SOEs and responsible for implementing governance reforms is much more informed and practical in delivering results.

Implementing the announced reforms to professionalize SOE board nomination and selection processes is crucial for improving governance in the sector. The government should formalize the institutional structure for SOE board nominations and align its functions with the best standards of governance, and with the entities' operational objectives. The nominations process should be formal, transparent, and guided by merit and operational needs of the SOEs.

A SOE ownership policy should also be developed. This policy could outline the state's ownership rationale and define the roles and responsibilities of the institutions involved in SOE oversight and governance to provide clarity on the objectives and guidelines for effective ownership and management of SOEs. The policy should set clear accountability lines of respective agencies involved in the SOE ownership, governance, and oversight process. Their responsibilities would depend on the chosen ownership model the government will decide.

The MoF should strengthen its capacity to oversee SOE financial performance and their impact on the public finances, monitor their related fiscal risk, and publish reports on their performance. This will require additional staff with expertise to carry out fiscal and financial oversight functions. The MoF could apply IMF Fiscal Affairs Department analytical tools for analyzing the financial performance of SOEs and assessing their fiscal risks. This will enable the MoF to produce periodic SOE reports, including both financial and non-financial information. Publishing comprehensive periodic reports will provide stakeholders with valuable insights into their financial health, performance, and related potential risks.

Table 1. Key Recommendations

| No | Recommendation | Responsible | Timeline |
|---|---|---------------------------------|--------------------------|
| SOE Classification | | | |
| 1 | Conduct an inventory and categorize all public entities according to the IMF GFSM 2014. | Ministry of Finance | December 2023 |
| State Ownership and SOE Governance | | | |
| 2 | Develop an SOE governance reform strategy and an action plan. | Inter-ministerial working group | December 2023 |
| 3 | Establish a formal institutional structure to support the government on SOE board nominations. | Government | December 2023 |
| 4 | Develop an ownership policy that sets the roles and responsibilities of the institutions involved in the oversight and governance of SOEs, including the roles of SOE board and management. | Ministry of Finance | April 2024 |
| 5 | Revise the Code of Public Enterprises in line with the OECD Guidelines 2015. | Ministry of Finance | April 2024 |
| 6 | Establish a centralized ownership function to coordinate the SOEs oversight. | Government | December 2024 |
| SOE Financial Oversight and Transparency | | | |
| 7 | Strengthen capacity of the MoF Budget Directorate to undertake financial oversight and fiscal risks analysis of the SOEs. | Ministry of Finance | December 2023 |
| 8 | Publish annual report on SOE performance. | Ministry of Finance | April 2024 and continues |

I. SOE Landscape and Reforms

A. Overview of public entities

1. **Public entities play a significant role in the Cypriot economy**, executing regulatory functions, implementing policy objectives, and delivering public services on commercial terms, the latter known as state-owned enterprises (SOEs). The Ministry of Finance (MoF) registers 58 public entities and groups them based on their activities and budget transfers they receive. According to the MoF, there are 26 SOEs, 21 policy implementation agencies, and 11 regulatory and other function entities. In line with the 2010 European System of Accounts, the Cyprus Statistical Services (CySTAT) publishes a list of 62 public entities and classifies them as 19 government-controlled entities (or SOEs), 28 semi-government organizations, 8 extra-budgetary funds, and 7 social security funds. While there is no information on financial data for all 62 public entities, as of 2022, MoF reports that 58 entities collectively managed assets equivalent to 30 percent of GDP, with liabilities totaling 11 percent of GDP. They employed about 2 percent of labor force (Figures 1 and 2). The liabilities and economic significance of Cyprus public entities are comparable to other European Union (EU) member states, such as Estonia, Lithuania, and Slovenia.¹

Figure 1. Assets and Liabilities
(2022, Percent of GDP)

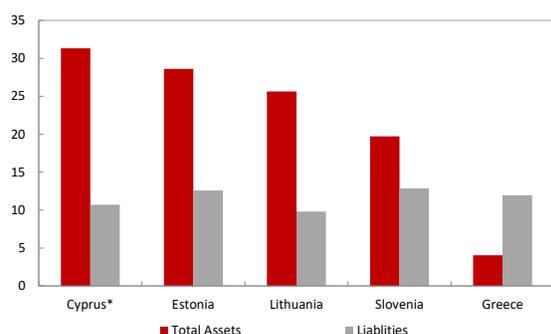
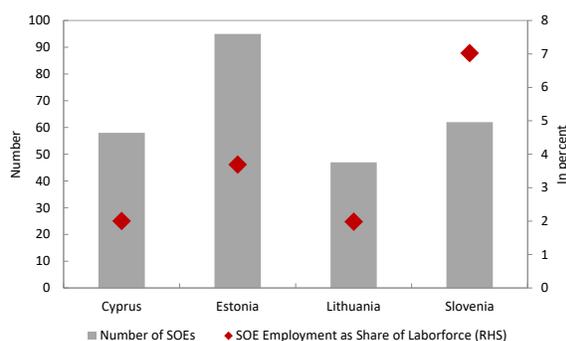


Figure 2. SOEs and Employment
(2022, number and share of labor force)



Source: Country Fiscal Risk Statements

Note: Cyprus data cover all public entities, and only SOEs for other countries.

2. **Other corporations created and administered by SOEs are not included in the published lists.** For example, some SOEs administer pension schemes through pension funds that are entirely controlled by them.² These funds are not reported by the SOEs as they operate off-balance sheet and are owned by the contributors, who are the SOEs' employees. The MoF does not have comprehensive information on the assets and liabilities of these funds.

3. **The Cyprus Asset Management Company Ltd (KEDIPES) is not included in the MoF public entity list.** KEDIPES was established to recover non-performing loans and other assets from the

¹ *Reassessing the role of state-owned enterprises in Central, Eastern, and South Eastern Europe (IMF 2019).*

² *All resident financial corporations controlled by general government units or other public corporations are part of the public financial corporations subsector (GFSM 2014, 2.115)*

liquidated Cyprus Cooperative Bank Ltd. The government is the only shareholder of KEDIPEs. KEDIPEs aims to recover the state support of € 3.6 billion (14 percent of 2022 GDP) for the benefit of Cypriot taxpayers through the management of the assets under its purview. As end 2022, € 880 million (3.5 percent of GDP) have been returned to the State budget. In fact, CySTAT classified KEDIPEs as part of general government in 2018, but KEDIPEs is not monitored by the MoF.³ KEDIPEs' business plan outlines a gradual and complete repayment of the state aid by 2028.

4. Additionally, postal services are directly carried out by the government and is not considered a separate public entity. The responsibility for providing universal postal services lies with the Department of Postal Services (Cyprus Post) of the Ministry of Transport, Communications and Works. This arrangement will continue until 31st December 2027. After this date, the Commissioner of Electronic Communications and Postal Regulation will select a universal postal provider through an open competition process. Separation of postal services from government is a common practice in the EU and developed economies. This separation allows postal providers to operate in competitive markets with operational independence, enabling them to make timely and market-informed decisions while fulfilling specific public service obligations (PSOs), which should be duly compensated by the state budget.

5. SOEs manage the largest assets among public entities, primarily operating in the energy, telecommunications, and water utility sectors. These entities include Electricity Authority of Cyprus (EAC), Cyprus Telecommunication Authority (CyTA), six district sewerage boards, and three regional water boards. There are other large SOEs operate such as Cyprus Port Authority (CPA) in the port services and Housing Finance Corporation (HFC) in the financial sector. Together, these SOEs manage total assets of about 20 percent of GDP.⁴

B. Legal Framework and Recent Reforms

6. Over the past decade, the government has made significant efforts to address challenges within the SOE sector. Starting in 2014 with the implementation of the new Fiscal Responsibility and Budget Systems Law (FRBSL), reforms have been focused on improving financial sustainability of public entities. The FRBSL introduced comprehensive measures aimed at establishing effective and centralized financial oversight of SOEs and assigned clear control functions to the MoF to safeguard public finances. These functions include the review and approval of annual budgets, headcounts, new investments, borrowings, as well as quarterly and annual financial reporting.

7. Five main legal acts and regulations regulate the oversight and governance of the public entities. In 2014, an SOE Bill was submitted to the Parliament; however, due to lack of political consensus, the bill was withdrawn. To fill the legal gap, the government approved alternative legal acts to address the most pressing weaknesses in accountability and governance of public entities. The legal framework governing public entities includes the following:

- The FRBSL 2014 provides the necessary legal foundation for the financial oversight of public entities, including budget operations, borrowing activities, and financial reporting and transparency.

³ <https://kedipes.com.cy/en/management-results/> and <https://www.cystat.gov.cy/en/Announcement?id=53728>

⁴ Mission calculations based on 2021 MOF Fiscal Risk Statement and official GDP data.

- The Decision 2018 establishes provisions for the effective management and accountability of state grants allocated to SOEs.⁵
- The Decision 2019 requires that SOEs develop strategic plans and three-year rolling budget plans, which are submitted to their respective parent ministries and for approval to the MoF.⁶
- The Circular 2020 provides guidelines for identifying and analyzing entity-level risks, along with mechanisms for annual reporting of such risks by all public entities, starting from 2021.
- The of Public Sector Governance Code, implemented in 2020, introduces a governance and accountability framework for public entities.

8. The current legislative framework applies to all public sector entities. However, it lacks a clear definition of an SOE as a commercial entity separate from the government. Furthermore, public entities are treated as extensions of the government, regardless of their objectives and mandates. Best practices, as outlined in the OECD guidelines of 2015, require that SOEs adhere to the highest standard of corporate governance applied to listed companies. These concerns were also mentioned during the 2018 IMF FAD mission, which recommended the adoption of differentiated approach for various types of public entities⁷.

9. The government follows a universal monitoring approach for all public entities. The MoF oversees and monitors all 58 entities, applying identical monitoring requirements irrespective of their specific mandates and economic nature. The FRSBL categorizes public entities in three categories—(i) general government entities, (ii) state-owned organizations, and (iii) state-owned enterprises—based on their legal status. However, it does not consider the nature of their activities to determine their classification. As a result, regulatory agencies, educational institutions, and healthcare facilities are subject to the same monitoring requirements as entities operating in commercial markets.

10. As part of the annual budget preparation and execution process, the MOF plays a crucial role in monitoring the financial performance of public sector entities. The MOF's Directorate of Budget and Fiscal Control collects financial and supplementary data to analyze financial performance and employment data for all public sector entities. Analysis is performed annually, based on the entities' main financial indicators and performance ratios to assess their financial performance as compared to the approved budgets, their reliance on public funding, and to measure risks stemming from their operations. The MOF relies on the entities' financial statements and additional data to produce the annual Fiscal Risk Statement published on the MOF website.

11. The enforcement of the legal framework has been relatively weak. The CoM decisions have been only partially implemented, due to lack of capacity in government and limited SOEs' understanding on their obligations. SOEs currently do not submit the three-year strategic plan to the parent ministry and the MoF. SOEs submit statements on their compliance with the Public Sector Governance Code to the MoF, but no entity is assigned with analyzing these statements or reporting on the implementation of the code.

⁵ Council of Ministers (CoM) Decision No. 86.013, dated October 24, 2018.

⁶ Council of Ministers (CoM) Decision No. 87.226, dated April 9, 2019.

⁷ Cyprus: Value-for-Money Reviews and Oversight of State-Owned Enterprises (IMF, 2018)

12. Cyprus is subject to EU legislation and aspires to the best practices applied by EU peer countries. Responding to the European Council recommendations provided in July 2022, the government is committed to improving SOE governance standards and practices (Box 1). The full implementation of these guidelines is consistent with the recommendations of 2018 IMF FAD mission.

Box 1. European-Council-Recommendations to Improve Cyprus SOE Governance and Accountability

The European Council provided recommended to improve the governance and transparency of public sector entities, and identified the following gaps with the OECD Guidelines:

- Increase transparency of and higher accountability for financial performance and public objectives to increase SOEs' efficiency and effectiveness
- Implement merit-based and transparent process for nominations to SOE management bodies
- Introduce clear separation of the SOE ownership function from the policy-making function carried out by line ministries by delegating ownership function to a dedicated central body
- Open up commercially viable markets where SOEs currently have a dominant position (e.g., in the energy market)

The European Council stated that the above goals are aligned with the objectives of the long-term strategy for Cyprus and the respective action plan. Also, policies aimed at improving SOE governance can be conducive to reducing government debt, while better SOE governance would increase public-sector efficiency, help improve the business environment and increase potential for growth.

Source: Council Recommendation of 12 July 2022 on the 2022 National Reform Programme of Cyprus and delivering a Council opinion on the 2022 Stability Programme of Cyprus (2022/C 334/13)

C. Next Steps

13. First, the authorities need to establish a consolidated inventory of public entities to ensure effective monitoring. The first step is to accurately identify and list all public entities and their relationships with the state. This entails conducting a comprehensive stocktaking exercise that encompasses public entities at both the central and district levels, as well as entities established off-balance sheet by existing SOEs. To create a comprehensive inventory, information on ownership status, shareholder responsibilities, and sector of operation for each public entity should be collected. This exercise should be undertaken at government level and include CySTAT. The MoF can take lead this process or establish an inter-ministerial working group to facilitate the task.

14. Second, the government should adopt a unified classification system for public entities. The IMF Government Finance Statistics Manual 2014 (GFSM 2014) could be used for the classification, which is compatible with the European System of Accounts 2010. The purpose of this classification is to identify SOEs and distinguish them from non-commercial public entities. Drawing on available information, the mission team has identified 17 entities that could be classified as SOEs based on the GFSM 2014 (Box 2). These SOEs, in 2021, managed assets that accounted to about 22.3 percent of

GDP (Figure 3). Their net result (equivalent to profit) was only 1.9 percent of assets or 0.4 percent of GDP, however, the largest SOE was loss making.

Box 2. Definition of SOEs

Although no commonly accepted definition of an SOE (ESA 2010; GFM 2014 2014; OECD 2015) exists, there are some shared elements: (1) the entity has its own, separate legal personality; (2) the entity is at least partially controlled by a government unit; and (3) the entity engages predominantly in commercial or economic activities.

The GFM 2014 provides two basic tests for an SOE.

- *Government control:* Ability to determine the general corporate policy of the corporation. Eight indicators are used to determine if a corporation is controlled by the government, including ownership of the majority of the voting interest, control of the board or other governing body, and control of key committees of the public corporation. A government may exercise significant influence over corporate decisions even when it owns a small number of shares.
- *Market producer:* An entity is classified as a market producer if the value of its sales (excluding both taxes and subsidies not directly linked to the volume or value of the output) averages at least half of the production costs (broadly defined as the sum of the compensation of employees, use of goods and services, consumption of fixed capital, and a return on capital), over a period of at least three years. Also, consumers are free to choose whether to buy, and how much to buy, on the basis of the prices charged.

However, the test for government control and engagement in commercial activities are not easy to apply and involves judgement (GFMS 2014 - paragraph 2.108 and Box 2.2). In sectors such as utilities, nuclear energy production, or weapons production, for example, prices are often difficult to determine or are not strongly linked with production costs (given the presence of quasi-fiscal activities).

Source: Allen, Richard and Miguel Alves. 2016. "How to Improve the Financial Oversight of Public Corporations," How to Notes. Fiscal Policy." Fiscal Affairs Department, International Monetary Fund; IMF Government Finance Statistics Manual 2014, Chapter 2

Table 1. SOEs Proposed for Priority Monitoring by MoF and Financial Result for 2021

| No | State-Owned Enterprises | Total Assets | | Net Result | | Government Guarantees | |
|----|---|--------------|-------|--------------|-------|-----------------------|-------|
| | | Euro million | % GPD | Euro million | % GPD | Euro million | % GPD |
| 1 | Electricity Authority of Cyprus (EAC) | 2,204 | 9.40 | -42 | -0.18 | 195 | 0.83 |
| 2 | Cyprus Telecommunications Authority (Cyta) | 1,048 | 4.47 | 78 | 0.33 | - | - |
| 3 | Sewerage Disposal Board of Limassol – Amathus | 495 | 2.11 | 9 | 0.04 | 117 | 0.50 |
| 4 | Cyprus Port Authority (CPA) | 333 | 1.42 | 12 | 0.05 | - | - |
| 5 | Housing Financing Corporation (HFC) | 305 | 1.30 | 5 | 0.02 | - | - |
| 6 | Sewerage Disposal Board of Nicosia | 238 | 1.02 | 12 | 0.05 | 130 | 0.55 |
| 7 | Sewerage Disposal Board of Larnaca | 195 | 0.83 | 4 | 0.02 | - | - |
| 8 | Sewerage Disposal Board of Paphos | 151 | 0.64 | 1 | 0.00 | 51 | 0.22 |
| 9 | Sewerage Disposal Board of Paralimni | 82 | 0.35 | 4 | 0.02 | 75 | 0.32 |
| 10 | Limassol Water Board | 49 | 0.21 | 5 | 0.02 | - | - |
| 11 | Sewerage Disposal Board of Ayia Napa | 28 | 0.12 | 1 | 0.00 | 20 | 0.09 |
| 12 | Nicosia Water Board | 26 | 0.11 | 4 | 0.02 | - | - |
| 13 | Larnaca Water Board | 22 | 0.09 | 5 | 0.02 | - | - |
| 14 | Cyprus Stock Exchange | 20 | 0.09 | -1 | 0.00 | - | - |
| 15 | Natural Gas Public Company Ltd. | 19 | 0.08 | 5 | 0.02 | - | - |
| 16 | Cyprus Petroleum Storage Company Ltd. | 8 | 0.03 | -1 | 0.00 | - | - |
| 17 | Cyprus Hydrocarbons Company Ltd. | 3 | 0.01 | -1 | 0.00 | - | - |
| | SOE Sector | 5,226 | 22.30 | 100 | 0.43 | 588 | 2.51 |

Source: 2021 Fiscal Risk Statement, MoF

15. A unified classification will help monitor and evaluate SOEs and make informed decisions regarding their management and potential reforms. Proper classification of public sector units ensures the completeness of oversight and monitoring and instills consistency and transparency of fiscal reports across the whole public sector. The classification will further help the MoF assess and manage fiscal risks stemming from public entities. This distinction is critical for the purpose of strengthening public entities' governance practices and accountability mechanisms.

16. Categorization will help the Government to focus reform efforts on strengthening oversight over the largest SOEs that operate in competitive sectors and deliver socially critical services. MOF analyzes all public entities equally, while their contribution and risk to the state budget vary considerably. MOF's oversight can be prioritized based on the size and importance of each entity, as well as its commercial orientation, financial performance, and the size of its liabilities, assigning a priority and risk category for prudent risk management.

17. Efforts are needed to address existing gaps in SOE corporate governance practices, transparency, and accountability. Progress needs to continue to improve corporate governance practices, including professionalizing SOE boards, achieving the right balance of skills and professional expertise at the board level, and introducing linkages between SOE performance and senior management compensation. The latter can be achieved by applying and enforcing entity-level key performance indicators (KPIs) to link SOE's senior management accountability to financial and nonfinancial performance. SOE transparency must be significantly improved by enforcing complete and timely publication of SOEs' audited financial statements on their websites, or via an alternative medium, accessible to public.

18. Establishing a comprehensive and robust governance framework is a critical part of the SOE ownership functions. As the SOE Bill of 2014 failed to be approved by the legislature, partial steps were taken to address board responsibilities for public sector entities, their financial sustainability and accountability. However, the independence of governance and decision making for commercially oriented

SOEs still need to be addressed. Once SOE classification is completed, the following options can bring the legal framework and practices closer to the OECD Guidelines:

- Bring commercial entities—classified according to GFSM 2014 requirements—to the auspices of the Company Law, subjecting them to the same corporate governance, accounting, reporting and audit requirements applicable to the private sector entities. (See OECD Guidelines, Section II.A Rationale for state ownership.)
- Introduce all relevant provisions of the Company Law into the individual entity-level establishment legislation of SOEs, as they relate to the corporate governance, accounting, reporting and audit requirements applicable to the private sector entities.
- Mandate SOEs to develop their own Corporate Governance Codes, based on the Public Sector Governance Code, aligning corporate governance, accounting, reporting and audit requirements with those applicable to the private sector entities.

Recommendations:

Recommendation 1: The government should conduct an inventory of all public entities and categorize them according to the IMF GFSM 2014, with the aim of identifying all entities operating in commercial activities (by December 2023).

Recommendation 2: The Ministry of Finance should revise the legal framework to introduce the definition of SOE, and align corporate governance, financial reporting, and transparency requirements with those applied by the private sector companies applying one of the three options (December 2024).

II. Strengthening State Ownership and SOE Governance

A. The Rationale for State Ownership

19. The legal form of SOEs is mainly that of a statutory enterprise. A statutory company is an enterprise that is established by parliament with defined powers and functions. A statutory enterprise may or may not be required to operate under company law or subject to other laws such as labor, environmental protection, or insolvency law. Internationally, statutory enterprises have different governance practices than companies established under company law. Good practice for SOE governance suggests that they be established under a standard legal form and comply with the governance requirements applying under company law. This puts them on a more equal footing with the private sector (See Section II.C Competitive neutrality below) and requires the application of good governance practices such as, for example, establishing the duty of loyalty and care for board members and subjecting the SOE to reporting requirements that are of the same quality as that expected in the private sector.

20. There is no centralized ownership function⁸ that takes a shareholder perspective on the performance of SOEs, incentivizes good financial performance, or good governance practices. Sectoral ministries take the lead in the governance of the enterprise. In some cases, SOEs are effectively extensions of ministries or government departments with the state being involved in day-to-day decision making and almost daily interactions between the ministry and the CEO.

21. A centralized ownership function exercises shareholder oversight of the SOE sector. A centralized shareholder oversight function typically serves to monitor SOE governance and SOE performance from a shareholder perspective and provides for a clearer separation between the government's role as a policy maker and its role as a shareholder. Ownership functions usually have the capacity to collect and analyze data and publish aggregate reports on the state of the SOE sector. They help the state demonstrate to the public sound stewardship of state assets and accountability for SOE performance. A centralized ownership function may also serve to establish financial and social performance expectations and key performance indicators (KPIs) for SOEs and set them down through a formal performance contracting process. Centralized ownership functions also serve to encourage better SOE governance practices by requiring SOEs to have policies in place (e.g., conflict of interest codes, stakeholder, or environmental policies), provide training, and otherwise strengthen SOE governance. Centralized ownership functions can include advisory functions to the government and ministries and help develop SOE laws and policies such as, for example, sector-wide board member nominations or remuneration policies. Box 3 provides ownership models in OECD countries.

⁸ The OECD Guidelines refer to "ownership entity" as anybody that may provide central monitoring for the state. There is a variety of powers that may accrue to such a central body including legal ownership of the SOE. However, an ownership entity may not necessarily formally own an SOE. For the purposes of this report, in order to avoid potential confusion, the terminology of centralized ownership function is used.

Box 3. Ownership models in OECD countries

According to an analysis conducted by the OECD of national practices, there is a clear continued convergence toward centralization or co-ordination in the state ownership function, which is consistent with the recommendations of the SOE Guidelines. Around half of the reviewed countries vest ownership rights and responsibilities within one single centralized entity.

| Country | Ownership Model |
|---|--|
| Hungary, Israel, Italy, Korea, New Zealand, Norway (with some exceptions), Peru, Sweden | One centralised ownership department holding company or government ministry, exclusively performing the role of ownership. |
| Austria, Chile, Colombia, France, Greece, Iceland, Netherlands | One centralised portfolio including a significant subset of the country's SOEs plus dispersed ownership for the rest |
| Belgium, Turkey | A small number of ownership agencies, holding companies, privatisation agencies or similar bodies owning portfolios of SOEs separately. |
| Costa Rica, Latvia, Lithuania, Philippines, United Kingdom | A coordinating department with non-trivial powers over SOEs formally held by other ministries (and institutions). For example, a co-ordinating department or specialised unit acting in an advisory capacity to shareholding ministries on technical and operational issues, in addition to being responsible for performance monitoring. |
| Brazil, Czech Republic, Estonia, Switzerland | "Dual ownership": two ministries or other high-level public institutions jointly exercise the ownership. This would be the case where different aspects of the ownership functions are allocated to different ministers – e.g. one ministry is responsible for financial performance and another for operations, or each ministry appoints a part of the board of directors. |
| Argentina, Bulgaria, Germany, Japan, Mexico, Ukraine | "Dispersed ownership": a large number of government ministries or other high-level public institutions exercise ownership rights over SOEs (in the absence of a coordinating agency) |

Source: OECD (2020), Organising the State Ownership Function, OECD Publishing, p. 11.
<http://www.oecd.org/corporate/organising-state-ownership-function.pdf>.

22. The government does not produce or publish an aggregate report on the state of the SOE sector. As a consequence, neither the state nor the public are able to form a holistic view of the SOE sector or easily evaluate its performance or identify risks. The development of an annual aggregate report is considered one of the key functions of a centralized ownership function and an important obligation of the state (see next chapter). Such reports serve not only to describe the state of the SOE sector but also to be accountable to the public by demonstrating the state's responsible oversight over the assets that it holds in trust on behalf of the public.

23. There is no formal ownership policy or SOE law. An ownership policy, whether embedded in law or other instrument, is considered to be an essential component of sound SOE governance. Ownership policies take different forms in different countries and vary in content. Internationally, the main elements of an ownership policy can be embedded in an SOE law, a decree, or a policy statement. In some countries, the components of a state's ownership policy are found in different laws. It is, however, preferable to consolidate the main rules that regulate the state's interaction with the SOE in a single document. In general, the purpose of such a policy is to clearly identify the institutions that are involved in SOE governance and set down their functions and decision-making rights. An ownership policy may

specify the need for the implementation of an “ownership rationale” (see below) and a centralized ownership function as described above. An ownership policy is essential to inform the various participants in the governance process of their proper roles and decision-making rights.

Box 4. Ownership Policies and the State’s Role as Owner

According to an analysis conducted by the OECD of national practices, there is a clear continued convergence toward centralization or co-ordination in the state ownership function, which is consistent with the recommendations of the SOE Guidelines. Around half of the reviewed countries vest ownership rights and responsibilities within one single centralized entity.

Governments have diverse approaches to expressing their logic of state enterprise ownership. Some jurisdictions set forth an explicit state ownership policy defining the general objectives of state ownership, while the objectives of state enterprise ownership may be implicit in others. Of the 32 jurisdictions participating in a 2020 inventory conducted by the OECD, 17 jurisdictions reported having explicit ownership policies. State ownership policies in these countries are set out in different ways including in specific legislation (as in Hungary, Korea, Latvia, Lithuania, New Zealand, Philippines); through a government decision, resolution or decree (as in Chile, Estonia, Germany, Norway, Sweden and in Switzerland); via a government policy statements (as in Colombia, Iceland and the Netherlands) or via some combination of these elements (as in the Czech Republic and France).

Regarding the state’s role as an owner, the OECD Guidelines recommend:

- The Government should develop an ownership policy. The policy will specify rationales for ownership, implementation mechanisms and the respective roles of different government offices.
- The exercise of ownership rights should be centralised in a single ownership entity, or, if this is not possible, carried out by a coordinating body. This “ownership entity” should have the capacity and competencies to effectively carry out its duties. Ownership should always be exercised on a whole-of-government basis.
- The government should allow SOEs full operational autonomy to achieve their defined objectives and refrain from intervening in SOE management. The government acts as an active and informed owner, but at arm’s length from the company.

Source: OECD (2020), Organising the State Ownership Function, OECD Publishing, pages 8, 55.
<http://www.oecd.org/corporate/organising-state-ownership-function.pdf>.

24. There is no formal ownership rationale that requires the justification for continued state ownership or defines its criteria. An ownership rationale is a statement that defines the reasons for continued state ownership. It typically calls for regular review of the SOEs in the state portfolio to ensure that the rationale for continued state ownership continues to exist. This process is essential as the nature of competition changes in a dynamic economy. An ownership rationale is typically found in an SOE law or in an ownership policy (Box 4). The ownership rationale can bring a logical consistency to the state’s portfolio of SOEs both by reassessing existing SOEs and by establishing the criteria under which new SOEs may be created. Such a rationale typically establishes conditions such as: market failure (as a result of natural monopoly and/or externalities); strategic significance; or infant industries that the state

wishes to protect or promote for a limited period of time. Cyprus Fiscal Responsibility and Budget Systems Law requires that the creation of new public entities be subject to criteria defined the Ministry of Finance Circular of February 9, 2021. That circular does not, however; a) specify the conditions that apply specifically to the creation of SOEs; b) contain a subsidiarity principle (State ownership of SOEs should exist only where private provision of products and services is not feasible); or c) make the creation of new SOEs conditional to the criteria noted immediately above (such as market failure).

25. The degree to which SOEs have autonomy in decision making and the degree of separation between the state's policy, regulatory and shareholder functions varies considerably from enterprise to enterprise. In some cases, the state simultaneously exercises regulatory and policy functions and is involved in the day-to-day decision making of SOEs. Some SOEs are effectively extensions of ministries as in the case of Cyprus Port Authority (CPA) where the Council of Ministers and the Ministry of Transport may influence tariff setting.⁹ The situation is quite different in the electricity sector where the board of the Electricity Authority of Cyprus (EAC) has broad decision-making autonomy. Ministers can communicate their opinions but cannot force the company to make, for example, an investment. Some enterprises, nevertheless, feel that ministerial opinions carry a weight that cannot be ignored. Regulatory functions are separated in the case of the energy sector where the independent Cyprus Energy Regulatory Authority (CERA) sets electricity tariffs that aim to achieve full cost recovery for EAC. This model appears to be a good example of an effective separation of the state's regulatory and policy roles.

B. Corporate Governance Codes and Standards

26. The existing Code of Public Sector Governance does not adequately address the fundamental requirements of SOE governance. The Code of Public Sector Governance (2018) was developed by the Cyprus Institute of Directors in collaboration with a number of stakeholders including government officials. The Code places emphasis on the role of stakeholders in the SOE. It does not clearly define the distinct roles of shareholders (the owner), boards, and management. Nor does it define the precise duties, roles, responsibilities, or functions of a board or address the issue of independence. While it is an excellent start, it lacks detail and falls short of with internationally accepted good practice.

27. The Public Sector Governance Code is enforced through comply or explain¹⁰, however, compliance reports are not actually read by the authorities and are not made public. This, in addition to the relatively light requirements specified under the Code, limits its impact. Comply or explain has limitations as an implementation tool. Its success is predicated upon the wide disclosure of reports and the presence of interested, informed, and engaged users. Comply or explain is successful where there are sophisticated users, where it is valued as a tool to encourage a flexible application of good practice without having to resort to heavy-handed legislation. It has proven far less effective in countries with strong legalistic traditions or where public appreciation of good governance practices is weak. In

⁹ It may be better to consider CPA part of the government administration, similar to a civil aviation administration, rather than an SOE as all of its commercial activities have been converted into concessions.

¹⁰ Comply or explain is an approach to implementation designed to encourage enterprises to adhere to best practices and standards. When enterprises deviate from a particular governance standard, they are required to justify their decision in a disclosure. The principle acknowledges that enterprises may have valid reasons for not fully complying with certain regulations or standards under certain circumstances.

such countries, a more directive approach may be called for. For Cyprus, it would be recommended to require regular mandatory public disclosure of governance practices compared to the Public Sector Governance Code.

28. Neither the Code nor other formal pronouncements have the explicit goal of complying with the OECD Guidelines for the Governance of SOEs. The OECD Guidelines are the only international standard for SOE governance agreed by many governments and international trade union and business bodies. They present a consensus view on good practice from over 30 member governments. Agreed between OECD member states in 2005 and further refined, the OECD Guidelines guide governments and SOEs in the efficient, transparent, and accountable governance of SOEs. They aim at professionalizing the state as an owner, emulating good practices from private enterprises, enhancing board practices, ensuring transparency and accountability, and encouraging competitive neutrality between public and private enterprise. They do so while taking due account of the special nature of the SOE. Due to their broad international acceptance, the SOE Guidelines constitute a necessary reference point against which to benchmark any country's SOE governance practices. While this report provides a general assessment of the SOE governance practices of Cyprus to the central elements of the OECD guidelines, a more detailed analysis is needed to be carried out by the government.

C. Competitive Neutrality

29. The conditions under which the SOE sector and the private sector compete differ. One of the key precepts of good SOE governance is that SOEs and the private sector should compete on a “level playing field”; that is, the conditions under which they compete should, to the extent possible, be identical. In most countries there are conditions that favor SOEs over the private sector while there are also conditions that act to their detriment. Currently, SOEs are assessed to operate on a sustainable basis and do not request or receive significant financial support from the state. They do, however, benefit from guarantees by the state which promises to make up for cash shortfalls, permits on-lending, and guarantees loans. It also appears that SOEs are not subject to insolvency law.

30. On the other hand, some SOEs report factors that substantively impede their ability to compete. They mention, specifically, limitations on staffing and on investments, political interference in management decision making, and public service obligations (PSOs). Furthermore, the status of many SOE employees as civil servants has important implications for personnel costs and human resource management. In addition, restrictions on some aspects of management decision making, the composition and quality of boards, and the politicization of board member selection were cited by SOE representatives as sources of competitive disadvantage.

31. SOEs do not have a formal dividend policy. Nor are statutory SOEs expected to cover their cost of capital or generate any return to the owner. This suggests that they have an advantage over private sector competitors. SOEs may, on the other hand, be asked to contribute funds to the state budget on an ad-hoc basis. While calls for contributions are uncommon, they do occur as happened with EAC during the Covid-19 crisis. The losses that resulted from the decrease in tariffs mandated by the state were not compensated; full compensation of the costs of PSOs would be considered a good practice. One SOE reported that it was unable to pursue necessary investments projects due to the absence of ability to use its retained earnings.

D. SOE Board

32. There is no entity to collect systematic information on SOE board roles, board composition, or how effectively board's function. The state should be able to have an informed view on the SOE sector, how its SOE board's function, how well they comply with their expected roles, and if boards and governance processes pose risks to the state and the SOEs themselves. An ownership function is typically assigned the task of providing these key insights to the state (See Paragraphs 21 and 22 on the ownership function above).

33. The roles and responsibilities of board members¹¹ are not clearly defined, and there are gaps in their adherence to good international practices. In Cyprus, SOE boards focus on day-to-day decisions, especially on compliance issues. In some cases, procurement and compliance issues were reported to take up to 70 percent of board time. Some SOE boards meet weekly whilst international practice for a private listed company may range between seven to a dozen meetings per year. Few board members have the capacity to oversee the financial reporting, risk management, or control functions of the entity. There is no formal induction or training on the roles and expectations of board members. Good international practices assign to boards the key roles to: review and guide strategy; establish goals and evaluate performance; help select management and conduct succession planning; ensure that an effective control environment exists (including an independent internal audit function); oversee corporate communications and reporting; oversee the remuneration of staff and executives and ensure incentives are in place; develop and oversee implementation of ethics codes and other systems to ensure responsible business conduct, anti-corruption efforts and whistle-blower programs; and ensure the good governance of the enterprise by conducting self-evaluations and developing remedial action plans.

34. The priority is often given to the state's policy goals over the interests of the SOE. Under commonly accepted international practice, the two common duties of board members are loyalty and care to the company and its shareholder(s). The OECD SOE Guidelines and the G20/OECD Principles underscore the duty of board members to act in the interest of the company and its shareholders. In Cyprus, SOE statutes, law and business culture suggest that the duty of board members is mainly to the state and to the achievement of the state's policy goals. In principle, this is consistent with the view that board members act in the shareholder's interest. However, the trade-offs and costs involved in choosing between policy goals versus commercial and financial goals are often unclear and decision making can be to the detriment of the SOE.

35. The proportion of independent board members on SOE boards and the quality of independent judgement could not be established. All members of SOE boards are Non-Executive Directors (NEDs). This is positive as it avoids the situation where executives oversee their own actions. However, feedback from SOE representatives suggests that the degree to which board members actively exercise independent judgement in the interest of the SOE is limited. The understanding amongst board members appears to be that their role is to ensure compliance with the directions of government. Furthermore, it appears that, in some cases, CEOs can act as Chairs of boards. If so, this practice would undermine the capacity of the board to exercise independent oversight over the executive. Under

¹¹ The term "board member" is used rather than "director" to avoid potential confusion as the latter term is used in some countries to refer to an executive in an enterprise, for example, Director General or Director of Operations.

international practice, independence of mind is, arguably, the ultimate protection against the risks and failures one observes in SOEs globally. True independence of mind—above formal independence—has been the goal of many international efforts.

36. Steps are being taken to improve board composition through a new board member nomination body and process which aim to depoliticize selection and ensure that it is merit based.

To date, the selection of board members was made by the Council of Ministers. This process was reportedly vulnerable to politicization. While there is a “fit and proper” testing process once candidates have been selected, the process is not set down in any formal policy or procedure nor is it disclosed to the public. Consequently, board member selection is perceived by the public to be opaque and politically driven. In response to these concerns, the government has suggested the establishment of an independent Advisory Council that aims to propose board members based on merit. There are international examples of independent nominations bodies which may serve as reference points (Box 5). Such bodies should be independent and apolitical, demonstrate impeccable governance themselves, and be supported by a formal and transparent mission. They must also provide appropriate opportunities for governments to express their legitimate policy concerns through the nominations process. Often, they permit the government to make the final decision based on a short list of candidates put together by the independent Advisory Council. Best practice would suggest that the board member selection process aim at finding board members who have the skills and knowledge that would help SOEs to better address their specific challenges.

Box 5. Independent Board Member Nomination Advisory Bodies

An SOE advisory body may play an informal role, providing advice, as requested, to line ministries. But without a systematic structure or process in place, their role and inputs may be minimal. Giving them a more formal role in the process usually yields better results and helps improve the prospects of identifying more qualified and merit-based boards. Advisory or coordinating bodies are assigned a formal role in countries such as India, New Zealand, Sweden, and the United Kingdom. In these cases, they usually prepare short lists of candidates, evaluate and propose candidates, maintain a database of potential candidates with different terms of reference, and keep records of board memberships and directors’ terms. A special panel or expert committee may also be created to provide supplementary advice for board nominations.

Corporate Governance of State-Owned Enterprises: A Toolkit, The World Bank, p 173

37. A practical challenge is to find sufficient board talent given the small population of the country. The main approach to addressing this concern in Cyprus will likely be to broaden the pool of candidates to consider. At present, board member positions are not open to public expressions of interest. Further, there may be merit in using search consultants to find board talent. It may, in addition, be possible to attract foreign talents to board positions. With respect to board member term limits, international practice in private enterprise suggests that two 3-year terms strike a good balance between the need to give board members time to gain experience and the need for fresh thinking. In Cyprus, some SOEs set board member terms at 30 months with the possibility of one single renewal. The government may therefore wish to lengthen term limits or allow a 3rd term if board talent is scarce.

38. The remuneration of SOE board members is so low that other incentives, such as the ability to influence decision making, serve to attract board members. There is no harmonized board member remuneration policy though, at present, board members of the larger SOEs receive an attendance fee of approximately EUR 100 per meeting. This level of remuneration is set to approximate the pay level of a Permanent Secretary of a Ministry but provides little incentive for individuals with skills to participate on SOE boards. Low remuneration may also have contributed to a recent trend of board member resignations. It is not uncommon for countries to try to minimize board attendance fees. However, the practice may dissuade candidates and incentivize existing boards to have a greater number of meetings to increase their income.

39. Boards do not conduct annual self-evaluations of their own governance practices, nor do they develop governance improvement plans. In other countries, such board evaluations lead to the development of board improvement plans that are checked and reviewed on a regular basis to measure progress. Board evaluations can also be useful to understand the skills needed on the board and help the board member selection process identify optimally suited talent (Box 6).

Box 6. Board Evaluations

Governments are increasingly encouraging board evaluations – a long-time and commonplace practice in private companies – as a way of maximizing board performance and minimizing risk. Board evaluations help form a clearer view of the board’s overall functioning, the desirable attributes that the board should possess and, in so doing, help identify any needs that could be addressed through future nominations.

Evaluation practices vary from informal evaluations conducted by the Chair to formal self- evaluations, to formal evaluations conducted by external experts and facilitators. Evaluations may concern individual directors and/or boards as a whole. For example, Brazil’s Ministry of Planning requires SOE boards to conduct annual self-evaluations based on a detailed questionnaire and to share the results of the self-evaluation with the Ministry. Chile’s ownership agency coordinates the performance reviews for all SOE boards of directors but outsources much of the evaluation work to corporate governance centers. Israel, in 2015, developed a structured process of board evaluation including a system for self-evaluations. The evaluation focuses on the board as a group as well as individual directors. In Poland, the Ministry of Treasury periodically evaluates supervisory boards of enterprises within the ministry’s portfolio, based on documentation prepared by boards of directors. As for the SOEs with public policy objectives which are under the supervision of sectoral ministries, an evaluation is made by the appropriate ministry. SOE boards in Switzerland are evaluated against strategic goals that are set every four years. SOE boards are assessed as a whole, and feedback is provided to the Chair.

Source: OECD (2018), *Ownership and Governance of State-Owned Enterprises: A Compendium of National Practices*, OECD Publishing, pp 71-73.

E. Transparency

40. SOEs regularly publish their financial statements but gaps remain. For major Cypriot SOEs, financial reports are produced under International Financial Reporting Standards (IFRS) while audit is conducted using International Standards on Auditing (ISA). This corresponds well with internationally accepted practice. However, no information is available regarding the percentage of audited financial statements that received qualified (negative) or unqualified (positive) opinions from their independent external auditors. Repeated qualified opinions are usually a sign of significant weaknesses in the reporting processes and in the governance of the SOE. In future, an assessment of audit opinions could easily be done to ascertain the quality of SOE financial reports. Apart from auditors' opinions, concerns have been raised by professional accounting and audit bodies regarding the capacity of accountants within SOEs to produce IFRS compliant statements.

41. The Auditor General (AG) fulfills the responsibility of appointing the external auditor for SOEs, a responsibility which is, normally, carried out by the SOE board. Under good practice, this responsibility is typically exercised by the audit committee of the board. Positive features of Cyprus's approach are that it may shield the external auditor from any potential conflict of interest with management or the board and result in cost savings through the centralized procurement of audit services. However, SOEs representatives expressed concerns about the quality of the services provided because of the pressure to reduce fees. Cyprus's approach has reportedly resulted in delays in hiring external auditors as well as delays in the approval of financial reports since the AG manages the external auditor and approves the results of each audit. Another factor to consider is that the hiring of the independent external auditor by the AG means that the auditor may perceive that they owe their duty to the AG and not the company. The central role of the AG in the external audit also removes one of the classic roles from boards and their audit committees potentially making them less accountable for the oversight of the control and reporting environment.

42. The completion and audit of annual financial reports is not timely. While the government does not formally track timeliness of reporting, it appears that, in practice, the audited financial reports of SOEs are available 9 months or more after the end of the financial year. In some cases, a year or more can pass. For example, the Cyprus Port Authority (CPA) has not published audited reports since 2016. It is worth bearing in mind that financial information has a time value. As time passes, the value of the information goes down. Outdated information has little if any utility in alerting the owner to potential financial problems. In the case of the CPA, this may be explained, in part, by the fact that it has effectively ceased commercial activities due to subcontracting of its operations out to concessions. Despite the possible justification in that case, the timeliness of audited financial reports remains a concern for the SOE sector as a whole.

43. Aside from the largest SOEs, the function of the internal audit within SOEs is poorly understood. Typically, the internal audit function should be independent of management and have the right to set its audit plan for the year based on its own assessment of risks. The internal audit function within the SOE is also supposed to have direct and unfettered access to the board, ideally, to an audit committee fully staffed by independent board members with a good understanding of financial reporting and controls. In practice, in Cyprus, the internal audit function is often used by boards on an ad-hoc basis to verify compliance with transactions that may come to a board member's attention. It is, thus, used as a

means of transaction checking versus an assurance that the controls of the enterprise are functioning optimally and as a service to contain risks.

44. There is no uniform disclosure of a comprehensive set of governance-related information on SOE websites. The result is that accountability to the public may be limited. Website disclosure is increasingly considered the norm both for private and state-owned enterprises. The OECD recommends that SOEs publish information on their ownership structure and other relevant information which might be disclosed in an annual report or on the company website.¹² Some countries make the disclosure of some governance data mandatory on websites. Mandatory disclosures for SOEs exist in a diverse set of countries including Brazil, Costa Rica, Czech Republic, Korea, Latvia, Lithuania, New Zealand, and Panama, amongst others. Typical disclosures could include (in addition to basic information on the enterprise): relevant legislation; governance structure; board membership including CVs; ethics, conflict of interest and other policies; governance codes and compliance therewith; whistleblower information, and financial reports.

F. Performance Planning and Evaluation

45. While MoF actively engages in budget monitoring, there is no performance monitoring of SOEs. The difference between the two is that budget monitoring alerts the state to differences in spending behavior. Budgets are typically produced on a cash basis and are particularly useful when trying to assess the immediate impact of an SOE's operations on the state budget. Performance monitoring, on the other hand, shows: a) the financial and operational health of the SOE; b) potential problems with cash flow (e.g., the collection of receivables); c) risks due to the capital structure; and d) the long-term financial sustainability of the enterprise. Performance monitoring relies on financial reports produced on an accrual basis (thus taking into account financial impacts over time). Analysis of budgets is typically a straightforward process that shows budget variances while the analysis of a financial reports requires a deep understanding of ratios, KPIs, accounting assumptions and more. While the true financial analysis of SOEs holds the promise of providing important financial insights, skilled financial analysts are not always active in state administrations. In some countries, a financial analysis function is located in the centralized ownership function. Some examples are Canada, France, Latvia, Norway, Sweden and the UK. (See paragraphs 21 and 22 above on the ownership function).

46. Cyprus does not use performance contracts, statements of corporate intent, letters of expectations or other performance contracting tools to establish the goals of SOEs or to assist in the monitoring of SOE performance. High-level expectations are communicated to SOEs through 3-year plans and the general objectives of the government but not through a formal and transparent goal-setting process. The state does not establish any KPIs for financial performance or for the achievement of PSOs. Consequently, it is difficult to guide boards and SOEs towards explicit objectives or hold them accountable for performance. Furthermore, the PSOs of SOEs are not contracted explicitly. The corollary is that the costs of the PSOs that SOEs provide are not always well understood.

¹² OECD (2020), Transparency and Disclosure Practices of State-Owned Enterprises and their Owners, OECD Publishing, p. 23. <http://www.oecd.org/corporate/transparency-disclosure-practices-soes.pdf>.

G. Next Steps

47. Good SOE governance works as a system. Many different conditions need to be in place for it to work well. The following list of recommendations is divided into two areas, *priority measures* and *supporting measures*. The priority measures are selected based on their anticipated impact but also as a function of their relative ease of implementation. Reformers should not lose sight of the supporting measures which can enhance the overall effect of governance reform. These can be pursued at the same time as priority measures though their completion may be less urgent. These recommendations relate specifically to SOEs under the ownership of the central government, but they will likely need to be adapted to match the capacity of municipal enterprises and smaller SOEs.

48. The government should develop an SOE governance reform strategy and an action plan. These may serve to guide and coordinate different players and their actions and establish a benchmark against which to track progress. The reform strategy should aim to achieve as its outcome the practices described in the OECD Guidelines for the Corporate Governance of SOEs. Practically, the government should use the OECD benchmark to do a gap analysis and then develop an action plan to close the gaps. The implementation of the reform strategy should be assigned to a specially created working group on SOE reform. Such a working group may benefit from the inclusion of key stakeholders (MoF, main line ministries, representatives of SOEs, the Office of the President) and have some degree of independence from government.

49. The strategy should aim to professionalize board member nominations. The creation of an Advisory Council to depoliticize the board member selection process is a positive step. However, the government should formalize the institutional structure for board nominations and ensure the body's independence and that the Advisory Council itself follow the best standards of governance. (See Annex 1: Appointing qualified board members to SOEs.) The nominations process should be formalized and made public. Appointments need to be guided by merit and respond to the operational needs of the SOE as determined by SOE board evaluations where available. The nominations process should occur in an independent and transparent fashion. The pool of potential nominees should be open to the public and international experts. The use of search firms should also be considered if opportune.

50. An ownership policy should be developed to support the SOE sector. The government should consider developing a formal document that describes the roles and responsibilities of the institutions involved in the oversight and governance of SOEs. It should also contain a discussion of the state's ownership rationale. In doing so, it should draw upon the extensive knowledge and guidance of both the OECD, IMF, and the World Bank who have developed useful tools. Given its past experience, Cyprus may opt for a less formal approach in the form of a policy document rather than a law. What is essential is that the different roles and decision-making powers of different institutions be clearly defined.

51. Board roles and decision-making powers should be clarified and strengthened. As part of the above strategy and benchmarking process, the government should review and revise the responsibilities of SOE boards. It should provide capacity building for board members, top executives, and government officials on good governance practices so that all parties involved in SOE governance develop a shared understanding of their roles and their decision-making authorities. Board roles should be defined as distinct from management and the owners. Both boards and owners should be discouraged from micro-managing and interfering in the decisions that are rightly taken by executives. This should also

help ensure the accountability of executives to owners by preventing them from shirking (handing over decision-making to boards or owners). A clear definition of the distinct roles of boards, management, and the state as owner should be established in an ownership policy.

52. The Code on Public enterprises should be revised. Its recommendations should be more explicitly aligned with the OECD Guidelines. Its implementation should be changed from comply or explain to a mandatory explanation of practice. A report on the SOE's governance compared to the Code should be published annually on the SOE's website.

53. Performance contracting and performance monitoring should be introduced. The government should develop and implement a system for establishing and monitoring the achievement of financial and non-financial performance objectives. It is recommended to develop statements of corporate intent (SCIs) that focus on high-level outcomes. They should include both financial and non-financial objectives. KPIs should be used to track SOE performance and health. They should also include PSOs and make explicit who is to pay for the cost of PSOs.

54. The reporting of audited financial statements by SOEs should correspond to best practice in the private sector. The public disclosure of audited financial reports should be mandatory within 5 months of fiscal year end. Current legal requirements that only require submission to the registrar of companies within 12 months of the closing of the balance sheet are insufficient.

55. A centralized ownership function or coordinating body should be established. It should be placed within one of the central ministries or as a separate entity under the Council of Ministers and tasked with monitoring SOE performance and reporting in aggregate on the SOE sector. This body should have the capacity to conduct financial analysis. The ownership function should have the explicit goal of enhancing SOE governance and may be tasked with implementing the reform strategy proposed above. For example, Seychelles has created a separate entity to monitor and evaluate the overall performance of public enterprise.¹³

56. Measures to enhance board autonomy and independence should be introduced. Cyprus should provide greater autonomy and independence to SOE boards while at the same time increasing their accountability for high-level agreed outcomes by introducing performance contracting. The level of direct control of SOEs by ministers and ministerial representatives should be reduced as performance contracting is introduced. As a preliminary step, it is essential to define the proper roles of boards versus owners versus managers (see above). Micro-management and political interference should be restricted. Cyprus should also develop rules that mandate dismissal of board members only for cause. This can serve to protect boards from undue political interference and encourage the level of independent judgement amongst board members.

57. Annual board evaluations should be conducted both to develop remedial action plans and to measure progress. Boards should be required to conduct self-evaluations (ideally, assisted by external experts) to help identify gaps in board practices, identify their needs and improve their

¹³ <https://www.pemc.sc/>

composition, governance, and operations. Board evaluations should lead to the development of remedial action plans against which to measure progress.

58. Additional supporting measures should be undertaken in parallel or after realization of some of the above measures.

- *Mandate minimum disclosure requirements for SOEs by centralized oversight function:* SOEs should emulate the disclosure of a private company listed on a stock exchange. The state should insist on receiving the same quality of information that is typically provided to private shareholders. Amongst others, SOEs need to report on financial, non-financial, governance, environmental and stakeholder indicators. They should also provide information on foreseeable future risks. Governance disclosure should include the identity and CVs of board members (with information on potential conflicts of interest), and governance practices and policies including nominations, conflict of interest, whistleblower, and ethics policies. The remuneration policy applicable to top executives and board members should also be disclosed. ESG (Environmental, Social and Governance) reporting is increasingly expected.
- *Introduce aggregate reporting on SOEs:* The ownership entity, once established, should develop an annual aggregate report on the SOE sector. It should have the capacity to take a shareholder/financial perspective on SOE performance and report, in the aggregate, both on financial targets as well as PSOs. The aggregate report should be made public including on the ownership entity's website.
- *Enhance competitive neutrality:* Efforts need to be made to create more equal conditions for competition between the private and public sectors.
- *Separation of the CEO and Chair function:* It is recommended to separate the functions of CEO and Chair of the board in SOEs where the two roles are combined to strengthen the board's capacity to oversee the executive function of the SOE and ensure greater independence of oversight.
- *Rationalize board member remuneration:* Cyprus should review current SOE board member remuneration and develop a uniform remuneration policy that is aligned with good international practice. The analysis should address, among other things, the appropriateness of fees, the appropriate mix of fixed honoraria versus per meeting fees, the extent to which fees may need to vary to be consistent with market conditions, and potential changes required to legislation.
- *Corporatization and legal transformation of SOEs:* Convert statutory enterprises into standard corporate legal forms. SOEs should be subject to company law and adopt private sector governance practices. If it is not feasible to change the legal identity of statutory enterprises, then they should be subjected to company law to the extent possible.

Recommendations

Recommendation 3: The government should develop an SOE governance reform strategy and an action plan (by December 2023).

Recommendation 4: The government should establish a formal institutional structure to support the government on SOE board nominations. This will enable the depoliticization of board nominations and facilitate the implementation of the highest governance standards (By December 2023).

Recommendation 5: The government should develop an ownership policy that sets the roles and responsibilities of the institutions involved in the oversight and governance of SOEs, including the roles of SOE board and management (by April 2024).

Recommendation 6: The government should revise the Code of Public Enterprises in line with the OECD Guidelines 2015 (April 2024).

Recommendation 7: The government should establish a centralized ownership function to coordinate the SOEs oversight (December 2024)

Recommendation 8: The MoF or the oversight body should produce templates to be used for self-evaluations by the SOE boards (December 2024).

III. Strengthening financial oversight of the SOE Sector

A. Fiscal Risks from SOEs

59. Identifying and managing fiscal risks arising from SOEs could help reduce budget costs and avoid disruption to public services. These risks can originate from direct budget costs related to lower dividends and taxes paid by profitable SOEs, budget transfers to cover loss-making activities, materialization of contingent liabilities associated with explicit government guarantees on SOE debt, as well as periodic injections required to bail-out loss-making entities. Financial difficulties in SOEs may also result in the non-delivery of core public services such as the provision of water, electricity, and/or public transportation. Given these risks, governments should ensure these SOEs are well managed and that such risks are mitigated.¹⁴

60. The central government of Cyprus faces fiscal risks arising from SOEs, despite their generally healthy financial performance. The profitability of SOEs was affected by the pandemic shock, resulting in lower earnings before interest, tax, and amortization (EBITA) in 2020 and 2021, albeit remaining above 5 percent of the sector's assets (Figure 3). However, some SOEs experienced negative returns (Table 1 in Section I). As usual, the effect of the shocks could extend beyond the incurrence period and therefore require continuous monitoring of performance. On the positive side, government guarantees provided to SOEs decreased from 4.5 percent of GDP in 2015 to less than 3 percent in 2021 (Figure 4). These guarantees—without risk-based fees—typically support loans for significant development projects. The risk of default on guaranteed loans is relatively low; SOEs accounted for only 1.9 percent of total non-performing loans as of March 31, 2022. Still, there are other risks not reflected in the SOEs' financial data that would require continuous monitoring.

Figure 3. Profitability of the SOE Sector, (2015-2021, in percent of GDP and Million Euro)

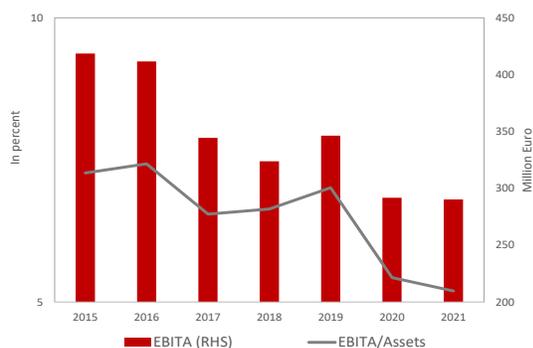
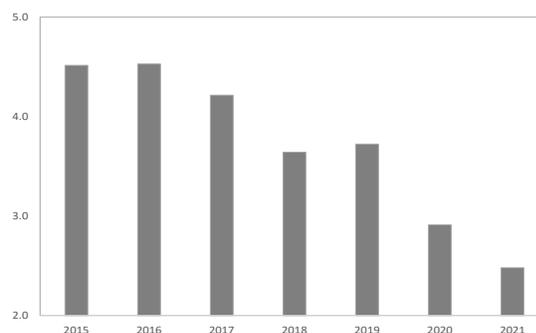


Figure 4. Government Guarantees to the SOE Sector, (2015-2021, percent of GDP)

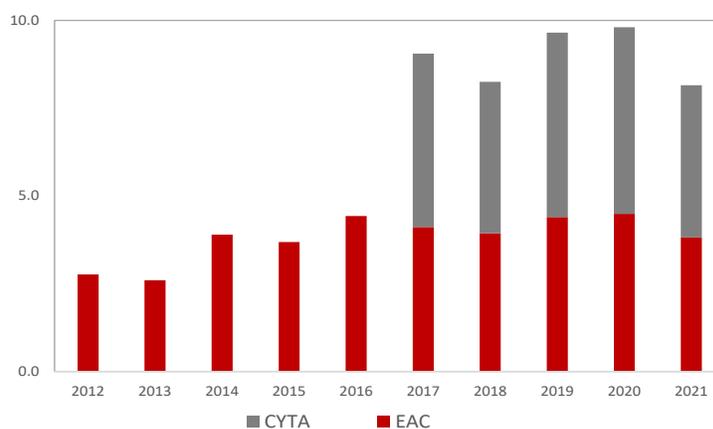


Source: Source: Fiscal Risk Statements, MOF
 Note: Data refer to table entities operating in commercial activities (SOEs)

¹⁴ For a detailed analysis on fiscal risks from SOEs see Baum, A., P. Medas, A. Soler and M. Sy .2020: "Managing Fiscal Risks from State-Owned Enterprises", Working Paper, International Monetary Fund, Washington DC.

61. Pension obligations for SOE employees are a potential risk. Unfunded pension obligations make up a large share of SOEs' liabilities. The pension funds are defined benefit schemes and are highly sensitive to changes in market interest rates. For instance, in 2021, CYTA and EAC pension obligations amounted to above 8 percent of GDP (Figure 5) with unfunded liabilities of 2.7 percent of GDP. The market sensitivity of pension obligations creates significant risks to the financial health of many SOEs. The MoF does not have yet a comprehensive assessment of the unfunded liabilities for all SOEs. Furthermore, SOEs contribute to various other defined contribution plans, the assets of which are held in separate trustee-administered funds (or pension schemes administered by SOEs and its employees) and not reported in the SOE financial statements. SOEs also do not oversee these funds as they operate as stand-alone entities, but the issue could raise in cases their financial assets do not cover ongoing liabilities.

Figure 5. Estimated Pension Liabilities of CYTA and EAC (2012-2021, in percent of GDP)



Source: Data EAC and CYTA Annual Reports
 Note: No data available for EAC during 2012-2016

62. Greenhouses gas emission allowances costs present a financial risk to SOEs. In 2021, the cost of EAC's greenhouse gas emission allowances increased by €90.5 million compared to €7.6 million in 2020, due to increase in the price per emission allowances and slight increase in the number of allowances purchased during the year. The purchase of emission allowances commenced in 2020 following the European Commission's decision to discontinue the previously granted free rights to the EAC.¹⁵ In 2019, the country's per capita emissions stood at 11.2 tCO₂e, exceeding the EU average by 3.3 tCO₂e above, and the share of renewable energy reached 13.8 percent. The country's 2030 target of a 22.9 percent share is focused on changes in the heating, cooling, and electricity sectors¹⁶. In the absence of a steady progress towards a more efficient and green economy, the greenhouses gas emission allowances cost will remain high.

¹⁵ EAC Annual Report 2020 - <https://www.eac.com.cy/EN/EAC/FinancialInformation/Pages/AnnualReports.aspx>

¹⁶ BRIEFING EU progress on climate action – Climate action in Cyprus: Latest state of play - [https://www.europarl.europa.eu/RegData/etudes/BRIE/2021/696195/EPRS_BRI\(2021\)696195_EN.pdf](https://www.europarl.europa.eu/RegData/etudes/BRIE/2021/696195/EPRS_BRI(2021)696195_EN.pdf)

63. Government interventions and weak financial oversight pose vulnerabilities for SOEs.

These weaknesses are driven by the following:

- *Uncompensated quasi-fiscal activities.* These include operations undertaken in pursuit of a public policy objective that remain partially or fully uncompensated and worsen the SOE' financial position relative to the strictly commercial profit maximizing level. These includes charging less than the commercial (cost recovery) price for the provision of goods and services; paying certain suppliers (e.g., domestic farmers) above the commercial price; or employing more staff than needed. An example could be electricity supply by the ECA to the uncontrolled territory of Cyprus, or subsidized tariffs provided to consumers during COVID-19 pandemic. There is currently no comprehensive information or estimated cost for the SOEs of these obligations.
- *Excessive dividends (or tax extraction).* Retained profits are one of the main sources of capital for SOEs. Excessive dividends are another form of quasi-fiscal activity, which arise when governments collect funds more than the distributable income of the accounting year, normally because of sales of assets or payments out of accumulated reserves, that weaken the financial health of the SOE.
- *Arrears among SOEs and other government units.* Cross arrears (unpaid bills) among SOEs, which tend to be associated with persistent mismanagement or unresolved legacy issues, have direct impact on financial performance of SOEs.
- *Inadequate central oversight.* Weak monitoring of SOEs can lead to higher risk-taking behavior from SOEs, resulting in inefficiency and poor financial performance. Inadequate oversight may introduce a risk of moral hazard in managing state assets potentially leading to expectation of government bailout. A typical case of weak oversight is South Africa energy company, Eskom, which has been unable to provide uninterrupted electricity. Following a series of blackouts in early 2023, the government was forced to provide a debt relief package of about 4 percent of GDP.
- *Political interference on SOE corporate governance.* The SOE boards and management may lack the necessary mix of skills, knowledge, and experience to ensure efficient management and sound internal controls.

B. Next Steps

64. The MoF monitors public sector entities and regularly reports on their performance and risks. The MoF's Directorate of Budget and Fiscal Control collects financial and supplementary data for all public sector entities and prepares annual report that summarize their financial performance and include employment data. Analysis is conducted based on the entities' key financial indicators and performance ratios to evaluate their financial performance in comparison to the approved budgets and assess the risks associated with their operations. These analyses are included in the annual fiscal risk statement that is published on the MOF website.

65. However, financial oversight and fiscal risks analysis should be strengthened with specific focus on SOEs. While it is important to oversee all public entities, it is crucial to allocate resources and efforts to enhancing financial oversight and analyzing fiscal risks specifically for SOEs. The analysis should incorporate a broader range of financial ratios that are aligned with key performance indicators and can be used to estimate potential future risks. This comprehensive approach will provide a more holistic view of the SOEs' financial health and potential costs for the budget. In prioritizing oversight

activities, it is advisable to consider factors such as the size and importance of each SOE, its financial performance, and the magnitude of its liabilities. For important and high-risk assessed SOEs, the monitoring could be more frequent, for example on quarterly basis.

66. The initial step in establishing financial oversight functions for SOEs is assigning a dedicated team and building a financial dataset for all SOEs. Based on experiences from other countries, it is recommended to form a specialized three-staff team (with financial expertise) with the Budget Department to undertake financial analysis. The unit will focus only on financial oversight—financial performance and fiscal risk analysis—and not involved ownership functions: board nominations and other governance related issues. Also, it is essential to complete the classification of public entities and build a dataset with financial data and non-financial information for SOEs. The Budget Department already possesses sufficient data collected for the preparation of the public entity section included in the annual fiscal risk statement, however, additional information is required for deeper analysis. The primary responsibilities of the team will include the following:

- Analyzing the historical financial performance of SOEs and making comparisons with relevant companies to gain insights into their financial situation.
- Conducting scenario analyses and engaging in discussions with SOEs regarding their three-year strategic plans and budgets. This will allow for a comprehensive understanding of the SOEs' performance and their financial targets.
- Compiling an annual report that provides an aggregated overview of the performance, financial status, and risk profile of all SOEs.

67. The mission team presented to the authorities two FAD analytical tools for fiscal risk analysis: the SOE Health Check and the SOE Forecasting and Stress Test. These tools have been developed by FAD and applied by several countries for financial oversight and fiscal risks analysis. They are built in Microsoft Excel and publicly available (including user guidelines) on the IMF website¹⁷. The tools provide a headline view of SOE financial strength according to common metrics, but further in-depth analysis is required to understand the underlying drivers of the SOEs poor performance and to inform remedial actions.

68. The SOE Health Check tool would usefully supplement the existing tools currently being used by MoF. The SOE Health Check tool assesses fiscal risks emanating from SOE both at individual company and overall sector level over time in various ways; some of which include the following:

- Identifying risks across the entire portfolio of SOEs for the most recent year across multiple profitability, liquidity, and solvency metrics.
- Providing an overview of the aggregate picture of the SOE sector with breakdown by sectors as well as identification of the largest and potentially riskiest SOEs.
- Undertaking detailed single company level assessments, including comparable summarized financial statement, financial ratio calculations, and risks profiling.

69. The tool minimizes data collection and manipulation required for a portfolio of SOEs. Data input is limited to key financial information on each SOE, with the template automatically calculating ratios

¹⁷ <https://www.imf.org/en/Topics/fiscal-policies/Fiscal-Risks>

for a range of financial vulnerability indicators and classifying them according to different risk thresholds. It provides a range of outputs to assist in the assessment of the financial performance of SOEs in the sector as whole. The template can accommodate up to 15 years of financial data for up to 40 SOEs.

70. The tool allows for a significant degree of flexibility. The tool is not limited to historical analysis and can also conduct a forward-looking analysis of the risk profiles of companies if the user inputs forecasted financial data. These forecasts are particularly valuable in terms of informing the medium-term budget process. A second tool is available to develop projections and to undertake scenario and sensitivity analysis and stress tests: the SOE Forecasting and Stress Test tool. Further, users can customize the risk analysis to reflect country or industry specific characteristics by altering the risk thresholds.

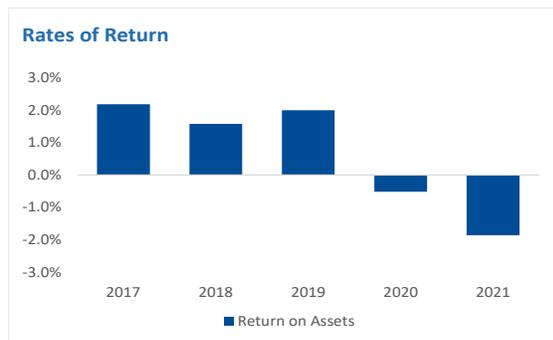
71. The SOE Health Check Tool was presented to the authorities. The tool has been applied to 2 SOEs (EAC, CYTA) using financial data compiled from SOE’s own published annual financial statements. A training session was provided to two Budget Directorate staff, and Box 7 provides a snapshot of outputs generated by the tool.

Box 7. Illustration of the SOE Health Check Tool Outputs for EAC

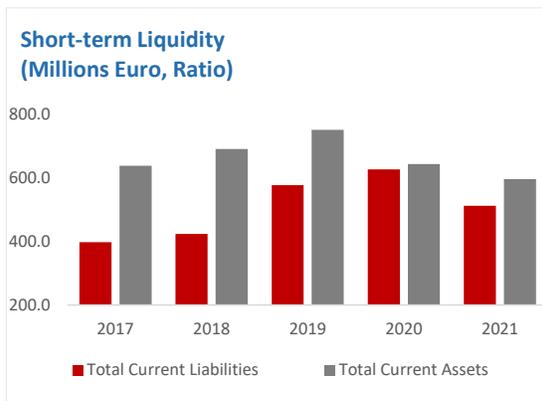
Steep reduction in operating profit



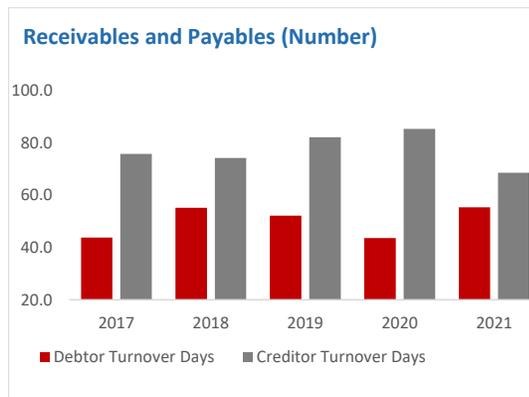
with negative rate of return on assets,



worsening liquidity,



and longer time to pay suppliers.



Source: EAC Financial Statements and IMF staff

72. The SOE Forecasting and Stress Test provides a framework to assess financial and fiscal risks from non-financial SOEs by combining backward-and forward-looking analysis.¹⁸ It can be used for all SOEs, but depending on capacity constraints, it can most usefully focus on larger ones or those posing significant risks. The template combines a benchmarking of the SOE's financial indicators to assess the relative performance of the company and identify main vulnerabilities; and a forward-looking analysis of the impact of different scenarios on the SOE and public finances (Figure 6). There are two main scenarios illustrating shocks of different nature, size, and length: a baseline (no change in policy) and a stress scenario (a negative macro shock). The tool quantifies the financial performance of the SOE, projects its outstanding debt stock and its impact on public finances over a six-year horizon under both scenarios. The results can help inform the approval of SOEs' financial plans and risk mitigation measures around budget preparation.

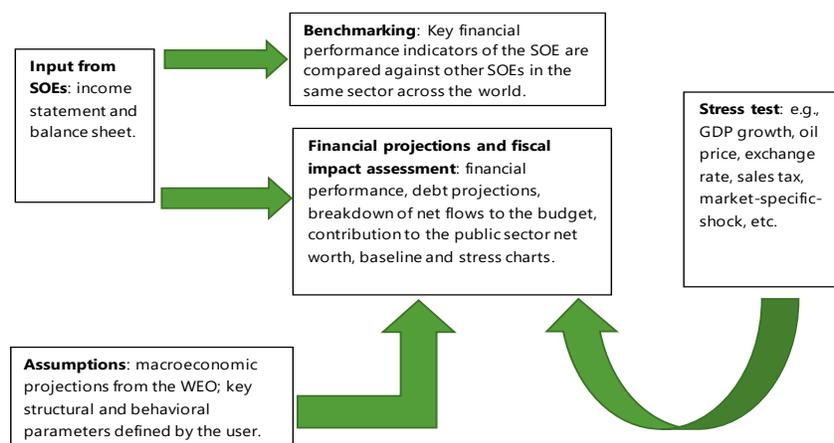
73. The benchmarking module provides the backward-looking elements of the analysis. It compares some key financial and economic ratios of the company with a broad set of SOEs all over the world operating in the same sector. The benchmarks are calculated as the median, top 75th and bottom 25th percentiles of the distribution for each indicator across all countries by sub-sector. The rationale behind this approach is that financial ratios can greatly vary across productive sectors, reflecting different technologies, demand characteristics and commercial channels. Consequently, it is important to assess the financial soundness of SOEs in relative terms, considering the specificities of their own sectors.

74. Benchmarking SOEs helps better understand their relative performance and vulnerabilities and identify possible risks. The focus is on financial indicators, including on profitability and productivity. The benchmarking indicates potential weaknesses if an SOE performs worse than its sectoral peers in other countries. Additional analysis might be required to understand the drivers of its performance. For example, if labor costs are significantly higher than in other SOEs, it could reflect mismanagement or imposed employment policies. Financial benchmarks can also be useful for governments to help set goals and expectation regarding the financial performance of the SOE.

75. The stress testing module is the forward-looking component of the template (Figure 5). It projects the SOE's three main financial statements—income, balance sheet, and cash flow—over a 6-year horizon, synthesizes them in a set of financial and economic ratios (measuring profitability, liquidity, solvency, and productivity) and quantifies the consequences of this performance on the fiscal accounts. Financial projections are done in two scenarios: baseline and stress. Projections in the balance sheet are based on a set of central assumptions, which can be considered the most likely given the available information. The stress scenario captures several negative macroeconomic shocks, which could be taken from exiting macroeconomic stress scenarios used for macro-fiscal purposes. In this context, the tool seeks to determine the resilience of the SOE to more adverse economic conditions, and its specific contribution to the fiscal outcomes in the stress scenario.

¹⁸ How to Assess Fiscal Risks from State-Owned Enterprises: [Benchmarking and Stress Testing](#)

Figure 6. Mechanics of the SOE Forecasting and Stress Test Tool (Illustrative)



Source: How to Assess Risks from State-Owned Enterprises: Benchmarking and Stress Testing

76. Ensuring timely, comprehensive financial and nonfinancial reporting, from SOEs is crucial for the effectiveness of oversight. In addition to the annual financial statements that should be publicly available, SOEs should regularly submit periodic information to the MoF. This will enable the team to develop a thorough understating of each SOE’s operations. This requirement should encompass a range of data, including the three-year strategic plans and any information that may have a material impact during the accounting year. Since 2019, SOEs have been mandated to prepare a three-year budget within their respective strategic plans. The strategic plans will help the MoF team and SOEs to set performance targets and align them with SOEs objectives. While annual financial statements could be produced with delay, it is essential that SOEs, particularly those deemed macro-critical and risky, provide required information to the MoF team on a more frequent basis. Such regular reporting helps ensure proactive monitoring and enhances the ability to identify and timely address emerging issues.

77. Analysis and financial performance of the SOE sector should be published as part of the budget documentation to ensure transparency and accountability. EU countries and most other countries in Europe publish annual reports on the SOE sector as part of the budget documents or separately. For instance, in France the annual aggregate report of the Shareholding Agency is included in the budget draft law presented to the legislative. Estonia publishes the SOE annual report simultaneously with its submission to parliament. In Sweden, the SOE annual report is reviewed by a parliamentary committee, which formulates its opinion and can instruct the government to take specific actions. Although the formats and content may vary, countries aim to publish comprehensive annual reports that encompass both financial and non-financial information. Lithuania has implemented SOE transparency requirements and publishes annual reports (Box 8). Annex 2 provides an outline of a good SOE monitoring report, which can be used as a reference.

Box 8. Lithuania's Transparency Guidelines for State-Owned Enterprises and Annual Reports

The Government has set out guidelines for the transparency of SOEs in accordance to achieve openness, active ownership, and good governance. The guidelines prescribe a framework of corporate reporting applicable to all Lithuanian SOEs that puts SOEs on an equal footing with listed companies and is consistent with the OECD Guidelines. Consolidated reports for the SOE sector are published quarterly, within three months of the end of the period, and a consolidated annual report is presented no later than April 30. The transparency guidelines require individual SOEs to present the following information in their 6-month interim and annual reports:

- Business strategy, financial and nonfinancial targets, opportunities and threats
- Assessment of performance relative to targets
- Dividend policy
- Description of significant events during the financial year
- Description of services or products
- Description of major customer groups
- Description of investment of fixed assets and future investment plans
- Analysis of annual labor costs
- Description of social policy obligations
- Information about compliance with transparency guidelines

Source: Governance Coordination Center of the Republic of Lithuania: Annual Review, State-owned Enterprises in Lithuania, 2021/2022. https://governance.lt/wp-content/uploads/2022/11/VKC-VVI-Metine-Ataskaita_2022_EN_WEB_08.pdf

Recommendations

Recommendation 9: The MoF should strengthen capacity of the Budget Directorate either by creating a separate unit or assigning a team of 3 staff to undertake financial oversight and fiscal risks analysis of the SOEs (December 2023)

Recommendation 10: The Budget Directorate to consider should using the SOE Health and Check and Stress Test Tools to analyze financial performance of SOEs (December 2024).

Recommendation 11: The MoF should prepare and publish an annual SOE performance report (April 2024 and continues).

Annex 1. Appointing Qualified Board Members to SOEs

The mission team was asked specifically to provide feedback on the establishment of the Advisory Council that Cyprus has proposed to strengthen the board member nominations process. Cyprus's proposal to establish an Advisory Council has the potential to improve the composition and the quality of SOE boards and also to serve as a flagship initiative to provide visibility and impetus to subsequent reforms. As such, it is crucial that its establishment be well thought out and that its governance model be above reproach. It is also important that the Advisory Council be accountable and act transparently.

While the literature on similar bodies is limited, some key principles can be used to guide its establishment. Arguably the most important is that the nominations process be shielded from ad hoc political intervention. The nominations body should operate under a formal mandate that clearly establishes its own governance. Its mission should be formally set down and strive to put in place a competitive and transparent recruitment process that avoids ad hoc interventions or deviation from written procedures. Nominations commissions should aim to preserve the independence of the nominations process. The process may also benefit from a regular audit. A nominations body may play an informal role and provide a simple "opinion" on candidates. However, giving it a more formal role may ensure that its views are taken seriously. This may be more effective in achieving the goal of building independent, high-quality boards.

Recommendations with respect to an Advisory Council:

- Create public awareness and use the Advisory Council as a model for good governance:
 - Demonstrate leadership by applying best governance practices for the Advisory Council
 - Ensure that the Advisory Council is constituted by individuals of stature that are independent-minded and beyond reproach
 - Establish the Advisory Council as a tool to reduce undue politicization of boards, conflicts of interest and corruption
 - Use the establishment to inform the public of the state's commitment to strong and accountable SOE governance and demonstrate to the public the quality of the government's stewardship
- Formalize the governance of the Advisory Council:
 - Ensure the independence of the Advisory Council
 - Establish the mission (to nominate the best available talent for SOEs with the goal of creating the context for the best possible financial and social performance of SOEs)
 - Define who can participate on the Advisory Council and what criteria they must fulfill

- Formalize the search and nominations process:
 - Ensure merit-based selection of candidates and the de-politicization of board member selection
 - Advisory Council Secretariat analyzes candidacies without any bias or external influence
 - Respond to the business needs of SOEs for board talent by consulting with the SOE
 - Establish education, skills and experience criteria for board candidates
 - Adopt a formal definition of independence
 - Have gender diversification goals
 - Open the pool of potential candidates to the public
 - Consider foreign talent
 - Permit the use of search consultants
 - Interviews should be built into the evaluation process
 - Advisory Council develops a short list based on objective criteria
 - Government entities must nominate candidates through the process (except where they already have a formal right to nominate)
 - CoM must choose from the short list provided by the Advisory Council (Government may not bypass or circumvent process though it may nominate candidates at the beginning on an equal footing with other candidates)
 - No preference should be given to government nominees during the establishment of the initial short list
- Be transparent about the Advisory Council's governance and nominations process. Create a website to manage the process and ensure transparency. Items to put on the Advisory Council website:
 - Advisory Council governance
 - Nominations process and procedures
 - Upcoming open positions and calls for expression of interest
 - Government expectations of board members
 - Use website interface to collect data, allow candidates to upload profiles with supporting information and use the database to manage the evaluation based to the maximum extent on formal objective criteria

Annex 2. Suggested Content for Annual Performance Report on the SOE Sector

A sample structure for an annual aggregated report follows:

1. Overview of State Ownership

- Summary of state ownership framework
- Key objectives for SOEs (including performance targets)
- Dividend Policy

2. Overview of Compliance with Governance Framework

- Requirements to produce Business/Strategic Plans
- Requirements for Board Structure and Composition
- Board Selection Process
- Board remuneration policy and outcomes (average remuneration of executives by sector)
- Transparency requirements for SOEs (reporting, accounting, audit, requirements)

3. Overview of Financial Results for the SOE Sector

- Summary of key performance aggregates of the sector and comparison to previous year
- Aggregated financial statements for the SOE sector
 - Profit and loss and balance sheet aggregates
 - Key financial performance indicators for profitability, liquidity, and solvency
 - Explanation of the factors impacting on the financial results (including details of any one-off factors or valuation of assets/liabilities)

4. Overview of Financial Results by Sector or SOE

- a) Industry Sector Overview
 - Vision and strategy with ownership in that sector
 - Key developments/events
 - Key summary indicators e.g. turnover and employment
- b) Summary of financial outcomes and key financial indicators
 - Aggregate sector financial statements (including income statement and balance sheet for each sector)
 - Key financial performance indicators for profitability (e.g. operating profit, earnings before interest and tax, return on equity etc.), liquidity (e.g. current or liquidity ratio), and solvency (e.g. interest coverage ratio, debt to equity ratio).
 - Explanation of the factors impacting on the financial results
 - Gap analysis with private sector (market value, return on equity, capital structure and operational efficiency).
 - Strategic view on potential performance improvement and value optimization
- c) Brief overview of the performance of major SOEs in each sector
 - Financial outcomes and performance
 - Operations details (business overview, key transactions, products, markets etc.).
 - Market, objectives and achievements and goals
 - Management (top management details).

4. State Policy Obligations of SOEs

- a) Summary of the major government functions assigned by the state to SOEs to implement social and policy objectives.

- b) Discussion and quantification of the impact of undertaking these quasi-fiscal activities on SOE financial position, and details of any compensation made to SOEs for undertaking these functions (by sector and/or by entities engaged in significant quasi-fiscal activities such as heating and utility companies).

5. Summary of planned reforms to SOE sector

- a) Summary of ongoing and planned reforms
- b) Progress against achieving reform outcomes

Annex A: List of SOEs

- SOE name, turnover, employment, share of state ownership

Two useful sources of guidance that go into greater detail on the publication for aggregated reports are:

OECD (2022), Monitoring the Performance of State-Owned Enterprises: Good Practice Guide for Annual Aggregate Reporting, OECD Publishing. www.oecd.org/corporate/monitoring-performance-state-owned-enterprises.htm.

World Bank (2021), State Owned Enterprises Annual Report (Prototype) 2021, World Bank Group. <http://documents.worldbank.org/curated/en/099400103082230263/P1754710c2fdaa07094e40427ee33953eb>