

Government and enterprise



Government as best in class shareholder

Featuring the point of
view of 12,000 citizens
in 24 countries

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This study was carried out by Ernst & Young, under the direction of Alessandro Cenderello and Remi Demont with the participation of Mariafrancesca Miele, Catherine Darphin and the collaboration of SDA Bocconi School of Management.

Government and enterprise



Government and enterprise is a series of studies and initiatives examining various facets and aspects of governments' relationships with enterprise. We open the series with this study which focuses on state-owned enterprises, where the aim is to delve deeper into the issue of government ownership, understanding how the state operates in this particular role.

Upcoming initiatives in the series will continue to develop the *government and enterprise* theme, delving deeper into what governments (national and local) own, what they co-deliver in partnership with the private sector, and where they regulate provision from the market.



Past and future state-owned enterprises



Over the past two decades, policy-makers in many countries have considered state-owned enterprises (SOEs) to be fundamentally flawed, doomed by their provenance to underperform the private sector. Indeed, in some respects, the analysis was correct in terms of it being measured through the bottom line. Traditional governance structures and vague missions have tended to make it difficult for SOEs to do anything but underperform. However, by paying careful attention to the structure and the mission, an SOE's parentage doesn't have to be a fatal defect. In this study, we show that the performance of a government enterprise can match or even exceed private company performance, provided its organizational structure and supporting regulatory structure are carefully engineered.

In practical case studies, interviews with a variety of SOE experts, and a survey of 12,000 citizens in 24 countries, we found that SOEs:

- ▶ Continue to perform a vital economic and social role in many countries
- ▶ Tend to be well regarded by citizens for high levels of service and quality
- ▶ Can become much more efficient if their governance is improved

The results make fascinating reading and we hope you will enjoy it.

Philippe Peuch-Lestrade

Global Government & Public
Sector Leader

Alessandro Cenderello

Global Government & Public
Sector Markets Leader

Foreword



Executive summary

- ▶ **SOEs are - and will remain - key players in the global economy**

The recent global economic crisis renewed government awareness of the crucial and strategic role SOEs still play in many national economies.

An SOE's relevance is and will remain lower* in countries where the state traditionally plays a tertiary role (e.g., in the UK and in the US) in comparison to other countries where the state is still important as an entrepreneur or business decision-maker. In all countries, however, SOEs will remain a key bulwark defending strategic industries and guaranteeing the adequacy of infrastructure, such as electricity, power and communication grids, basic networks and transport.

* Outside the specific context of the financial crisis and economic turmoil in cases where states have been particularly active in funding private companies

However, despite the renewed appreciation of the role the state can play in driving stable growth in a volatile world, SOEs still need to be reinvented to better suit the times. They can exist no longer simply to guarantee employment or low prices, as these factors might be more efficiently ensured with effective regulation. Many also need to become more efficient. The good news, however, is that the situation is not as bad as it is often reputed to be. In countries where SOEs are more present, their importance is perceived and fully supported by the public. The stereotype that all SOEs are “useless” and should be privatized is not the perception of the majority in most countries with a significant SOE sector, nor is it grounded in the performance data.

- ▶ **SOEs need to reframe their corporate governance models**

Contrary to the common opinion that sees SOEs as inefficient and bureaucratic, this study found that these traits are not a peculiar and distinctive feature of their ownership structure. In reality, the inefficiency of SOEs is strictly related to the characteristics of their corporate governance model.

If this is true, these organizations should rethink their rules of governance. In particular, charters should be renewed so as to:

1. Protect the interests of all the stakeholders (including customers, minority shareholders, society, etc.) and guarantee the autonomous economic development of the firm.
2. Appoint competent and skillful board members in a transparent, skill-based nomination process.
3. Guarantee the autonomy of the boards but still allow governments to exert authority at a strategic level through regular board evaluation mechanisms.
4. Create other processes that promote accountability and transparency.

- ▶ **Successful cases show that SOEs can generate high value when they focus on their mission and strategy, their innovation policies and their corporate social responsibility.**

SOEs are fundamentally different from private companies. They tend to have different missions and goals, different organizational cultures and different corporate governance mechanisms. Unlike private sector executives, SOE strategists tend to value economic and social goals equally, which gives them a greater willingness to make long-term investments and a greater degree of openness to the needs of different stakeholders. However, politicization is a threat for many SOEs. In many cases, politics unduly influence the appointment of the boards, HRM policies, the choice of which economic investments to develop, the structure of accountability, and the communication of results. SOEs can become key players only if corporate governance models are reframed so that the state might act as an informed, accountable and active owner.

The global voice of governments and enterprises



Countries surveyed: 12,000 citizens interviewed from a total of 24 countries

Robert Boutin,
Director CSR, Canada Post,
talks about **corporate social responsibility** – Canada

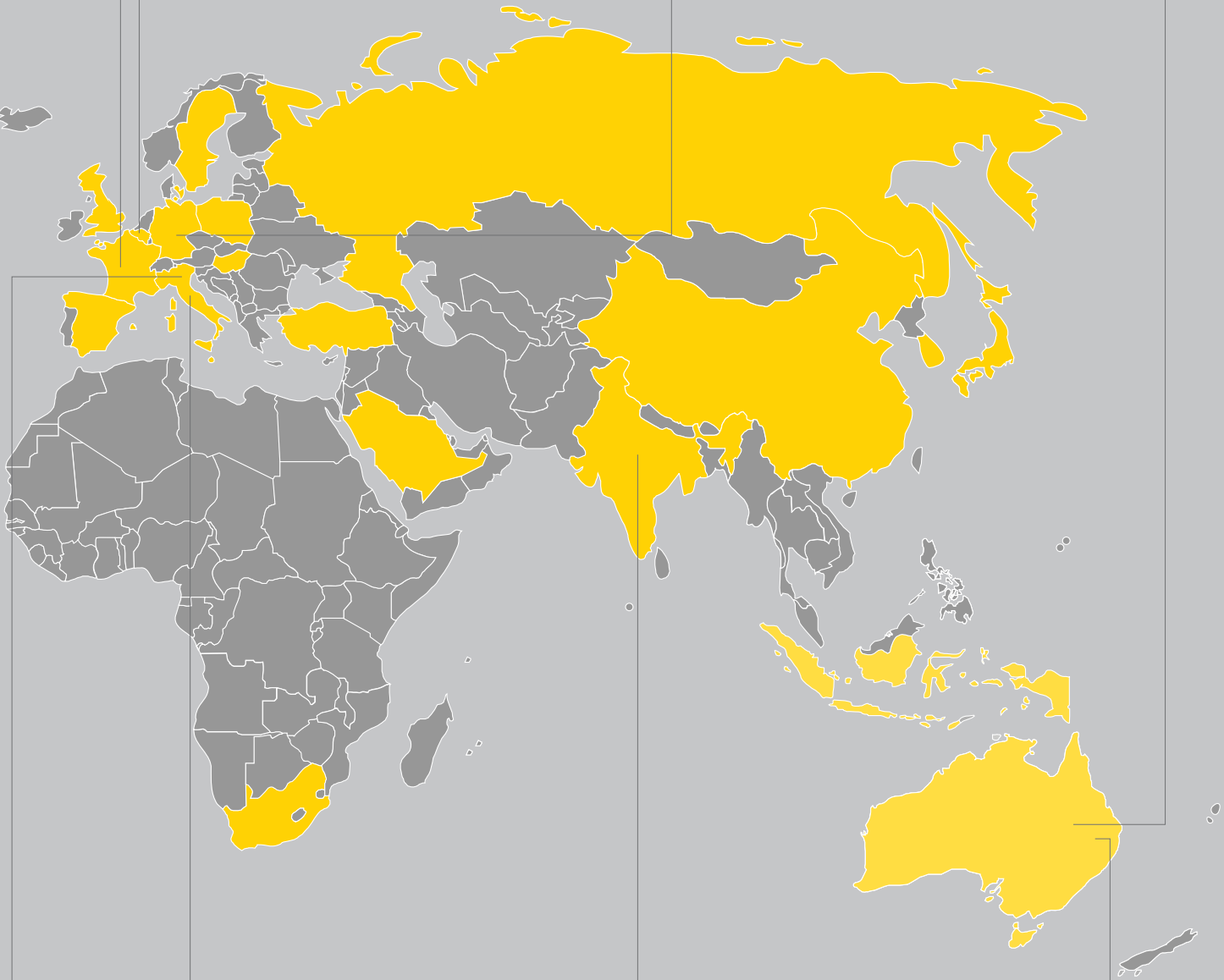
Mauro Roberto Pacheco de Lima, CFO of Infraero,
talks about **corporate social responsibility** – Brazil

Bruno Chaintron,
Former, Director of
development,
Groupe La Poste, talks
about **innovation** – France

Academic view -
Professor Geert Bouckaert
Leuven University – Belgium

Jörg Kämer,
Senior Vice-President,
Sustainability and
Corporate Compliance,
Fraport AG, talks about
governance – Germany

Michael Braham,
Non-Executive Director,
Sydney Ports
Corporation, talks
about **strategy** –
Australia



Sergio Biganzoli,
CFO of
AgustaWestland,
talks about
innovation – Italy

Academic view -
Professor Robert Grant
Bocconi University – Italy

Director of **Rites
Limited**, talks about
governance – India

Academic view -
Professor Vikas Kumar
Sydney University – Australia

The state of the state-owned enterprise

State ownership today

Twenty years after the privatization boom began, state-owned enterprises (SOEs) remain a large part of the world economy and, in some respects, more relevant than ever. In this era of volatility and change, citizens and policy-makers in many countries are once again appreciating the virtues of the SOE – its steadiness, commitment to stakeholders and ability to make long-term strategic investments. In this fast-paced world of private global investment, billions in capital can shift in and out of companies in microseconds. Although private capital allocation works well in many respects, some analysts now argue that the experience of the mixed economies in today's fast-growing BRIC markets suggests that efficient, well-governed SOEs can provide a sturdy trellis on which to grow an economy.

Governments become shareholders for many reasons, according to the Organization for Economic Co-operation and Development (OECD). Through public ownership, the state can sustain sectors of long-term strategic or even national security interest that are presently uneconomical for private investment. The SOE structure also enables the state to launch industries where start-up costs are significant but private sector returns and property rights uncertain. For sunset industries too, the SOE can control a disruptive decline in an obsolete industry sector, such as an outmoded shipbuilding, steel-making, or coal-mining sector, where direct subsidies are not possible and private ownership is no longer viable. SOEs are also often used as an insurer of last resort against catastrophic risks, such as natural disasters in the agricultural sector.

Governments also often find SOEs a useful way to pursue social goals, such as greater equality and social stability. SOEs may serve as a conduit for subsidies that can sell certain kinds of goods. On other occasions, governments create SOEs to build the economy of an underdeveloped region.

Finally, some governments launch businesses in order to protect newborn sectors. As the regulator, the state is well positioned to control the entrance of competitors, impose monopoly prices, and then re-invest the profit.

SOEs in developed countries tend to be involved most often in strategic industrial sectors, such as hydroelectric power, oil, gas and coal, post and telecommunication systems, the main systems of transportation (both rail and air) and, to a lesser extent, financial services.

In developing countries, SOEs are even more heterogeneous, and the state may be as entrepreneurial as any conglomerate.

Top five sectors in which world's largest SOEs operate*

By number of companies

1. Energy
2. Transportation
3. Telecommunication
4. Manufacturing
5. Oil and gas

By total assets

1. Energy
2. Oil and gas
3. Manufacturing
4. Telecommunication
5. Transportation

In the 90s, World Bank analysts rhapsodized that they had found SOEs that “operate a casino in Ghana, bake cookies in Egypt and assemble watches in India.”

* Data for this research has been collected from the largest database of listed companies worldwide (BdvOsiris), selecting only companies for which the state was indicated as the controlling shareholder. For 2009, this procedure identified 266 SOEs, from which we excluded banks, insurances and other financial institutions. The final population included the 157 largest SOEs worldwide, representing 46 different countries.

Role of the state and ownership models

In many countries, the government retains a large political hand in how its SOEs operate. Ministers or other government leaders direct the choice of the chairmen and the CEOs of large SOEs, even if the board is often officially in charge of nominations. In Mexico, for example, ministries direct the appointment and removal of senior executives up to two levels below the CEO, and rules concerning board composition may mandate state representatives on SOE boards be civil servants from particular entities or ministries.

One of the unique challenges facing SOEs is clarifying the role of government as shareholder as opposed to its representation on the board of directors and its role as policy-maker. For example, the influence of state representation can be limited to the nomination of the CEO, or can be extended to the nomination process of the board members, from a given percentage to almost the entire board. Few countries have set up a clearly defined or structured process for the nomination of SOE board members. In only a few cases, an independent nominating committee is at work, and the majority of SOEs tend to have at least one or two state representatives, irrespective of the size of the state's share.

To secure greater independence for themselves, SOE boards might take inspiration from successful governance practices in private companies that have enhanced their board effectiveness. Having said that, the objectives of SOEs are broader than those of private companies in the sense that state presence entails specific commitments such as those previously mentioned (regional economic development, welfare, etc.) .

Among these practices, the development of board internal processes, with board development initiatives, seminars and workshops has proven a very effective way to build capable teams and help enhance cohesion between state and non-state representatives. Finally, among the most successful practices in private corporations, regular board evaluations can represent an important tool to monitor board development and improve operational transparency. Regular board evaluations are widely recommended as a means of monitoring the performance of the board, and increasing the sense of personal responsibility by individual directors for the firm's financial result.

This lack of clarity in the government's role is not only true at board level. It also seems to be true in terms of shareholder rights. The "one share one vote" principle pursued in the Anglo-Saxon countries does not prevail in Germanic or Latin countries.

SOE boards might take inspiration from successful governance practices in private companies albeit not forgetting that their mission is broader.

This has some unfortunate consequences. Often, the typical block-holding nature of the state as owner of SOEs makes it easier to undervalue the rights of minority shareholders, and more difficult for management to steer a new course when an SOE underperforms or goes bankrupt.

Academic view

Lack of political influence is the first driver of SOE success.

Professor Robert Grant
Bocconi University

Robert Grant is Full Professor of Strategic Management. Previous faculty positions include Georgetown University, London Business School, City University, California Polytechnic, UCLA, University of British Columbia, and University of St. Andrews (Scotland).

What are the key factors that government should pay attention to in order to control its SOEs?

I want to separate two groups of SOEs:

- ▶ SOEs offering commercial services (e.g., energy): in this case, government should avoid any political interference as these companies run the risk of becoming insolvent. The governance should be a shield against the political interference.
- ▶ SOEs offering public services (e.g., transportation, railways): although there is a political agenda for price, supply, etc., it is important to reduce political influence. The difference is that in this case SOEs are monopolists, they do not risk bankruptcy, but customers will pay more for low-quality services.

How should governments organize the ownership functions?

Government should appoint an independent and competent board. The key question is: is the government ready to nominate a technocratic board and avoid nominating a political board? Partial privatization and listing the company on the financial market may help. Listing provides a barrier against the state's intervention. Another important condition is if government allows competition in the market or it supports SOEs with the creation of a monopoly. Market forces are an important driver for SOEs' efficiency.

SOEs are relevant players in the world economy: what are the main drivers of success for this type of firm?

The first driver is the lack of political influence. SOEs should fulfil commercial goals and the maximization of shareholders' value. Sometimes they also have national economic goals. At the same time, they should avoid pursuing political goals. The second driver is the company culture. It should be based on a tradition of excellence, on an entrepreneurial force and on a strong technological core. The sense of purpose and identity should create a shield against the risk of political intervention.

Do you think that SOEs will be important players in the economy also in the future?

Yes, for many reasons:

- ▶ The economic development of China, a country that has a large proportion of SOEs,
- ▶ The rise of sovereign funds that are buying stakes in many companies around the world,
- ▶ The recurrent crises in many capitalistic countries are pushing some governments to nationalize and to buy back private companies (e.g., see US with banking and car industries). Crises seem to be ongoing features of our economies.



The state has to make sure there is a relevant interest in its share from major players.

Professor Geert Bouckaert
Leuven University

Geert Bouckaert is the Director of the Institute of Public Management of the Katholieke Universiteit Leuven.

What are the key factors that government should pay attention to in order to control its SOEs?

I think that government might control its SOEs by focusing its attention on drafting good contracts, on appointing excellent people in boards (they should be independent and driven by the common good) and on having good internal audit.

How should governments organize the ownership functions?

It is difficult to generalize. The state has to hold at least 51% of the shares and it has to make sure that there is a relevant interest from major players for the other 49%.

SOEs are relevant players in the world economy: what are the main drivers of success for this type of firm?

The main driver for SOE success is to focus on strategic and on innovative functions in society.

Do you think that SOEs will be important players in the economy also in the future?

SOEs will remain important in the world economy. This is partly due to the fact that public monopolies will exist in the future. However, monopolies should be limited in time when the innovation has gone, when there are no more excessive risks, when infant industry features disappear, or when the strategic rationale for a state in a particular industry has gone.



Dual model isn't unique

The most traditional form of SOE organization is the “decentralized” or “sector ministry model,” in which an SOE falls under the responsibility of sector ministries. More recently, the “dual model” was the most common organizational structure. Under the dual model, a sector ministry and a central ministry or entity, usually the finance ministry, shared responsibility. In Europe, the dual model still characterizes Greece, Italy, Switzerland, Turkey and some countries such as Germany which is transitioning toward this model.

It also used to be common in Asian countries such as China or in Latin American countries. Its main disadvantages consist in a multi-principal agency problem, amplified by the fact that many enterprises are not regulated by strong governance arrangements and respect of law. Such problems could be particularly strong at the sub-national level: for instance, one critical vulnerability of the existing governance framework is the ambiguous nature of the relationship between the local government and development agents.

Now a centralized model is emerging, in which ownership responsibility is centralized under one main ministry. Initially organized as a way to prepare SOEs for the auction block, this portfolio approach has also proven to be a convenient way to manage SOEs on an ongoing basis. In the Netherlands, for example, the Ministry of Finance took on the ownership function in the late 1990s, while centralization has been undertaken more recently in Sweden.

The British have created the “Shareholder Executive,” with the aim of providing a more centralized and consistent approach toward the government ownership function. In a few countries, a centralized agency for state shareholdings has been established, usually reporting directly to the Ministry of Finance, as in the case of France, where the “APE” (Agence des Participations d’Etat) was created at the beginning of 2004.

Now a centralized model is emerging, in which ownership responsibility is centralized under one main ministry.

The French APE still answers to the Ministry of Finance, but enjoys more autonomy than a normal department or office within the ministry. The Russian federation has also adopted a centralized model, and most SOEs are put under the responsibility of the “Federal Agency for State Property Management” (Rosimushchestvo).

The BRIC experience

The BRIC experience is worth dwelling on as it is representative of ways in which SOEs present themselves as key tools for the economic development of a country. Therefore, given the particularly strategic role of SOEs, it becomes even more important for issues of governance and ownership to be appropriately addressed.

Brazil's privatizations followed a path that limited some of the political risk of privatization by granting concessions rather than a permanent transfer of the asset. Beginning in the early 1990s, SOEs were transferred to the private sector, but the Government sold only controlling blocks of these companies instead of a dispersed sale of shares on the market. This option was wise in two ways: first, investors paid significant premiums to buy controlling shares. Second, Brazilian privatization left SOE ownership in the hands of capable, sophisticated investors, both foreign firms and consortia of local businesses and funds. However, the stability of this new governance structure (jointly controlled firms with local partners) has yet to be tested. As in so many other markets, one of Brazil's next big challenges is to establish a regulatory framework that will facilitate the protection of SOEs' minority shareholders.

Russia, in spite of the state's pervasive role in company asset acquisition, performs well in some regulatory areas related to barriers to entry, including regulatory and administrative opacity and system of licensing and permits. However, its performance is less strong in terms of protection of property rights and minority shareholders' interests.

In the context of India, "ownership" and "management" of SOEs should not necessarily be seen as one.

Professor Vikas Kumar
Sydney University

Vikas Kumar has lived and worked in India, US and Italy and has an understanding of the cultural and institutional similarities as well as differences across these major countries of the world.

The contribution of SOEs within the Indian economy has declined in the post-economic reform era as a result of the slow, albeit consistent, inclination of subsequent governments in India since 1991 toward increased privatization.

However, in the context of India, "ownership" and "management" of SOEs should not necessarily be seen as one. At least for some SOEs in key sectors (e.g., "navratnas"), the management is extremely professional and autonomous, which has had significant positive implications on their performance.

Academic view

India has moved away from its former "dirigist model" to become a market-based economy, thanks to fundamental legislative reforms begun in the early 1990s and renewed in the 2000s. Deregulated SOEs

have lifted the Indian economy on to a significantly higher growth path, helping to reduce poverty. In service sectors where government regulation has been eased - such as communications, insurance, asset management and information technology - output has grown rapidly, especially in exports of information technology-enabled services. In those infrastructure sectors opened to competition, such as telecoms and civil aviation, the private sector has proven to be extremely effective in generating phenomenal growth. Reducing barriers to competition and improving corporate governance of SOEs has also been a key policy objective. The latest rankings of the *Global Competitiveness Report 2009-2010* placed India 36th in the "protection of minority shareholders' interests" and 27th in the "strength of auditing and reporting standards."



China has made enormous progress in developing the modern legal and regulatory foundation for the market economy and this influences their

SOEs as well. The nine years since China's entry into the World Trade Organization in 2001 have been especially productive for economic reforms: the country's private sector is now the largest ownership segment. In this process, the enhancement of corporate governance standards, especially for listed SOEs, has assumed a key role in financial development and enterprise reform, as part of China's campaign to "grasp the large and let go the small." However, more work remains to strengthen the protection of Chinese minority investors.





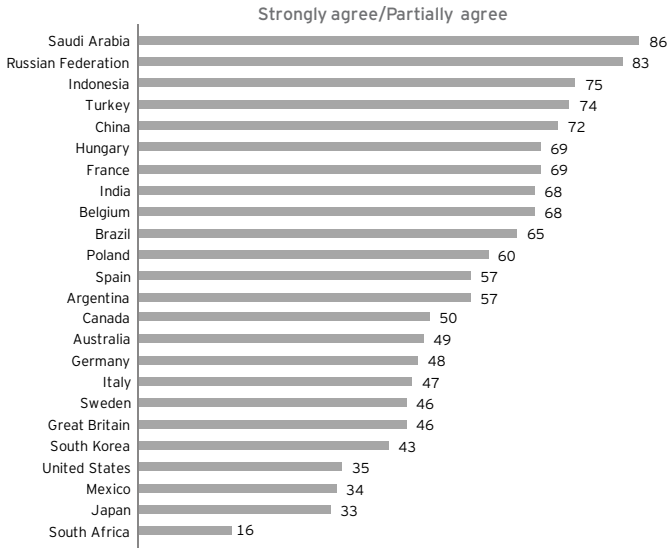


Government as a shareholder - what do citizens think?

Since the 1980s, conventional wisdom has held that the private sector is always more efficient and that governments should therefore place as much of the economy as possible into private hands. Today, the idea that the private sector model is always and everywhere the best way to create wealth, now seems doubtful to many policy-makers - especially as several of the most vocal proponents of the idea belong to investment banks that now, temporarily at least, have been rescued with state investments. Indeed, this idea was deeply reinforced due to the crisis, when citizens were obliged to devote their taxes to enabling private corporations to survive. Furthermore, many of the fastest-growing economies - particularly China - have shown that SOEs can be a powerful engine for economic growth and social change. Other clues can be found not in economic statistics but in the perception of over 12,000 citizens in 24 countries we surveyed, who reported they had largely positive feelings about the state-owned companies of their own countries. The depth of their positive feeling suggests that citizens see a special value in SOEs.

State control and big industries - who believes in it?

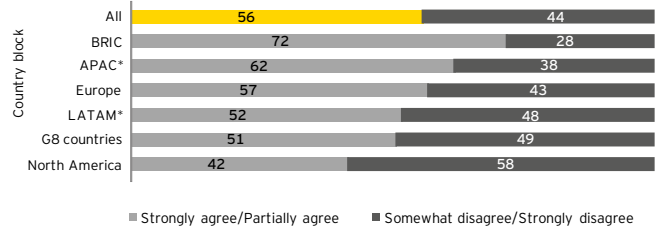
It is in [country's] interest that our big industries should be controlled by the government.



Source: Ipsos MORI/Ernst & Young, Government & Public Sector Centre, 2010
Shown: percentage of respondents

Citizens consider government control strategically valuable. As previously mentioned (p. 9-10), SOE prevalence in a country (in terms of share of GDP and share of investment) is less for high-income and middle-income countries, as opposed to LDCs. Interestingly, all surveyed countries where the majority of respondents deemed government control for their country's big industries undesirable are either high-income or middle-income countries and (with the exception of South Africa) OECD members.

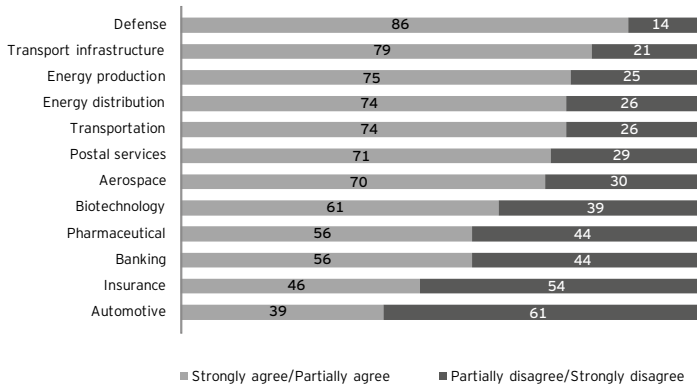
Furthermore, the significant 30% difference in opinion that exists between BRIC respondents and North American respondents is coherent with the divergent general economic vision and market models of these two country groups. The results for North America are in line with the market-oriented model, where state involvement in industry is generally avoided; conversely, the BRIC response is coherent with the more interventionist model, where the government is seen as a potential sturdy trellis to foster the development of an economy.



Source: Ipsos MORI/Ernst & Young, Government & Public Sector Centre, 2010
Shown: percentage of respondents
*: APAC = Asia-Pacific
LATAM = Latin America

State control - it's a sector thing

The central/federal government should be the owner of enterprises operating in the sectors shown below



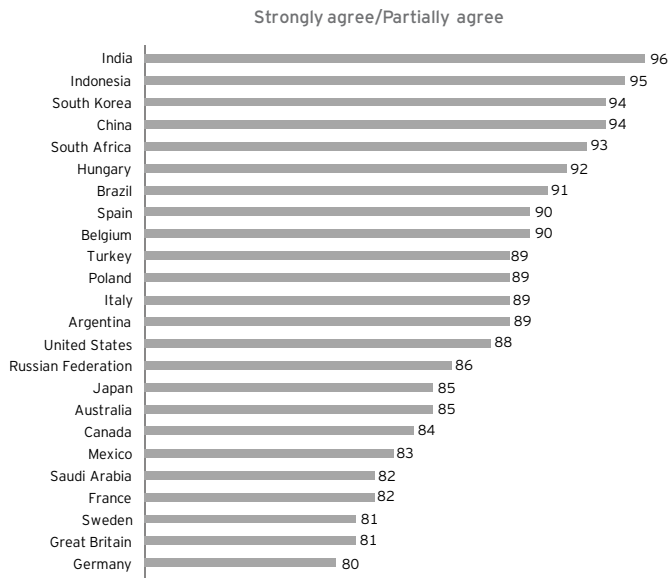
Source: Ernst & Young, Government & Public Sector Centre, 2010
Shown: percentage of respondents

That defense should be the most-voted sector for state involvement is hardly a surprise. Moreover, in citizens' opinion, states should continue to operate in sectors where the quality of the service provided is perceived to be more important than concerns about cost-efficiencies - e.g., transportation and infrastructure, both of which score among the highest percentages.

Notably, respondents showed considerably less agreement on state participation in sectors hard hit by the global financial crisis such as insurance and automotive, suggesting that government involvement is seen as no more than temporary. Nevertheless, for the banking sector, the majority of countries do consider government holding as a must.

Politics reign supreme

SOEs are too much influenced by politics



Source: Ernst & Young, Government & Public Sector Centre, 2010
Shown: percentage of respondents

There is a fairly homogeneous tendency to believe SOEs are firmly under political thumbs. Interestingly, this is true the world over, with only limited variance: on the low side, 80% of Germans believe in political influence, while on the high side, 96% of Indians perceive SOEs to be under political control. Such conceptions pose an additional challenge for SOE reformers who would like to see governments develop more independent governance structures for SOEs.

SOEs: balancing quality and efficiency

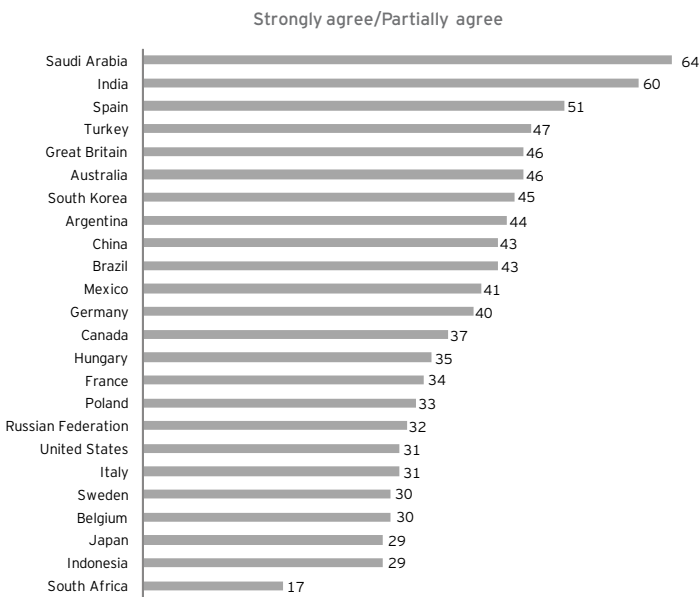
As previously mentioned (p. 8-9 and p. 19), SOEs have an unusual link with the concepts of cost-efficiency and service quality, where both do not necessarily have to be present at the same time (i.e., there are cases where the quality of the service provided by an SOE is more important than the efficiency of its structure and operations). India is particularly representative of this relationship, as its citizens mostly believe that SOEs deliver better services, albeit not as efficiently in comparison to private firms.

Globally, citizen perception is largely homogeneous and supports the stereotype that SOEs are fundamentally flawed compared with private companies: a consistent minority (that

rests between 44% and 34%) of citizens thinks that SOEs exceed private firms in the quality of service delivery. Similarly, a consistent majority of citizens (ranging from 77% to 64%) believes that SOEs are less efficient. South Africa, Indonesia and Japan also reflect this opinion.

The presence of the stereotype is not unexpected - however, it is interesting that there is a much more marked difference in opinion at an individual country level that contradicts the stereotype: there is a 47% gap separating those with the least and the most positive opinion of SOE service quality, and a 40% difference existing between the countries with the lowest and the highest opinion of SOE efficiency.

SOEs deliver better services than private firms

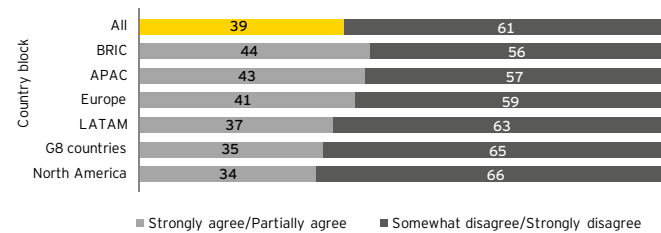


Source: Ernst & Young, Government & Public Sector Centre, 2010
Shown: percentage of respondents

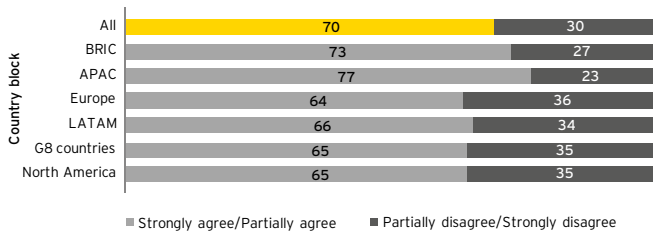
SOEs are less efficient than private firms.



Source: Ernst & Young, Government & Public Sector Centre, 2010
Shown: percentage of respondents



Source: Ernst & Young, Government & Public Sector Centre, 2010
Shown: percentage of respondents



Source: Ernst & Young, Government & Public Sector Centre, 2010
Shown: percentage of respondents

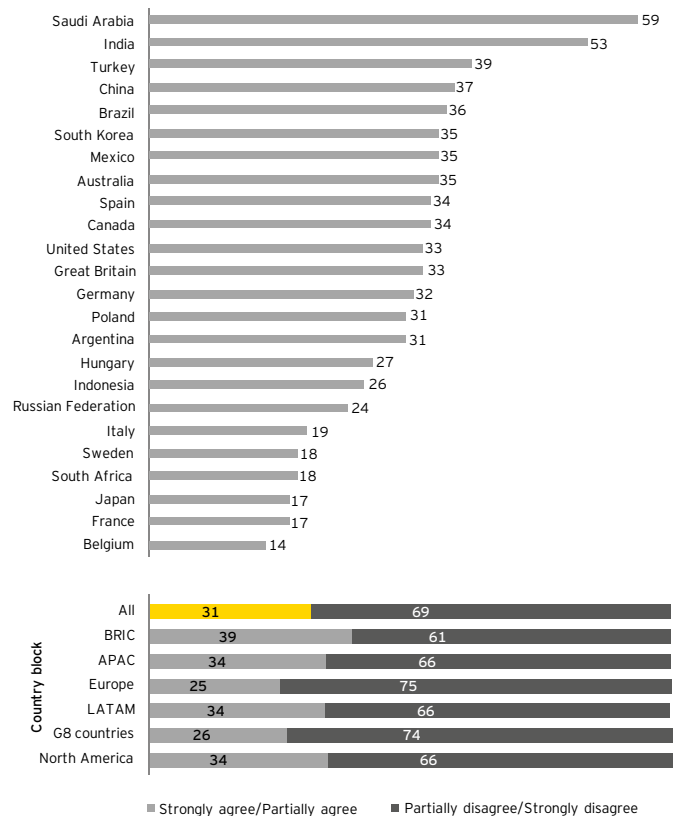
Manager ineptitude: a pervasive belief

It has been argued that SOEs are often inefficient because their managers have little or no incentive to pursue profitability for their enterprises: easy access to government subsidies and government-guaranteed loans effectively remove the threat of bankruptcy as a check on inefficiency. Indeed, it seems that SOE manager inefficiency is a pervasive belief, both at a global level and at individual country level.

Interestingly, however, for the two countries where the perception of service quality of SOEs is unusually positive (India and Saudi Arabia), a majority believes that managers in SOEs are better than in private firms. In particular, the Indian “navratnas” and their professional and autonomous management (as described by Prof. Vikas Kumar) seem to receive positive recognition by citizens.

However, there are also critical voices, sometimes in the same market. For example, only 17% of French citizens consider SOE managers to be better than those in private firms, despite their mainly positive feelings about SOE efficiency.

Managers in SOEs are better than in private firms.



Source: Ernst & Young, Government & Public Sector Centre, 2010
Shown: percentage of respondents

Perception, fact, and leverage

This survey found a gap between what citizens perceive about the quality and efficiency of their own SOEs and the general reputation of SOEs for inefficiency. At the same time, however, the citizens we surveyed sensed that politics play an important role in the operation of SOEs. For managers seeking greater independence and control, this perception that SOE quality and efficiency are being held back by politics is crucial. It could constitute an unusual opportunity to drive new policies that create the greater degree of transparency and independence that SOEs need to improve their performance, in the same way that earlier perceptions of SOE incompetence helped to drive the movement towards privatization.





Four pillars for SOE success

State-owned enterprises should be viewed as different from private companies. Some of the dissimilarities are quite positive, including their reputation for quality, their tendency to make long-term investments and their concern with achieving social as well as financial goals. Other qualities are comparable and can be benchmarked, particularly their relative level of efficiency, the quality of management and their susceptibility to political influence.

The SOE looks both towards the corporate future, in its regard for stakeholders and sense of social responsibility, and back toward a less efficient, patriarchal past. Can an SOE manager nurture the forward-looking aspects of state ownership, while avoiding the tendency for inefficiency that sometimes gives state-owned companies a bad name? Or are they all part and parcel of the same model?

We suggest that these positive and negative aspects are not linked and that, in fact, it is possible to combine the positive parts of a publicly owned heritage while leaving the other aspects behind.

We now focus on four key factors or pillars: **governance, strategy, innovation and corporate social responsibility**. Improvements in how the SOE handles each of these four components can lead to tremendous overall gains in achievement for the company.

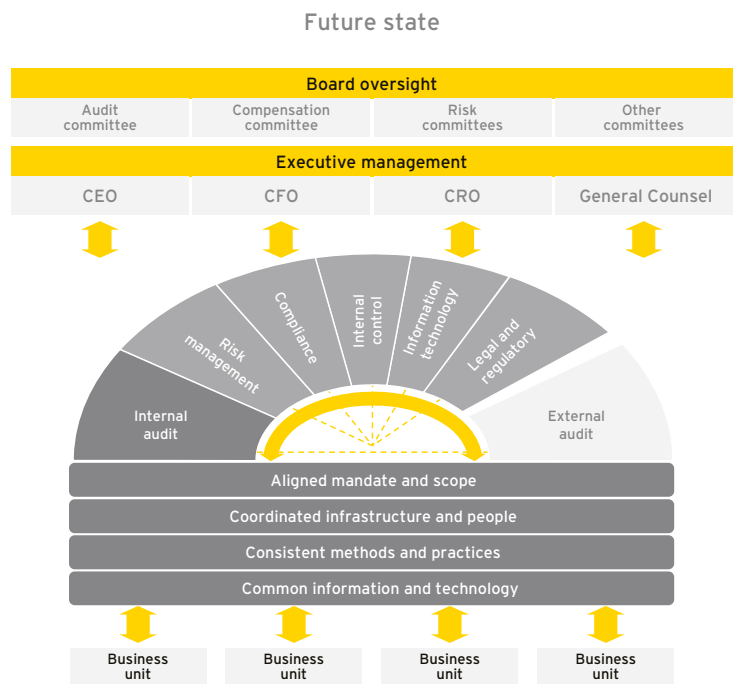
Gover

Although there are some important differences between management of an SOE and management of a private enterprise in connection with the special purpose of every SOE, the way private sector boards have triggered the enhancement of their own effectiveness and independence may provide some clues to SOE managers about how to improve SOE management. For example, the development of better internal processes, including board development initiatives, seminars, and workshops, have been shown to be effective tools for building better management teams.

Board evaluations have also been shown to be an effective tool to monitor board development and raise governance transparency. These kinds of regular board evaluations are widely recommended as a means of monitoring board performance. Such evaluations are especially useful if they can clarify the responsibility of individual directors for the firm's financial results. The OECD has also long suggested that governments create independent boards to monitor the performance of their SOEs.

Some countries have had some luck with performance agreements, either with top executives or between a government agency and the SOE. In either case, whether organization wide or between a senior executive and the government, the aim is to specify certain performance goals and service thresholds. Performance agreements can be useful tools, but the World Bank cautions that they are subject to certain risks. The biggest among these is that the government, under political pressure or budgetary pressure, reneges on its end of the contract, creating skepticism within the SOE about future agreements.

Beware of one-size-fits-all theories of governance for the SOE. As some policy theorists say, the best governance solution for any particular company will depend on the market structure of the industry in which the company operates and the state of development in the country.



Publications

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Interview

On track to deliver

Director of RITES Limited

India's rail system is one of the largest and busiest networks in the world. Transporting up to 20 million passengers and 2 million tons of freight a day, the system is operated by Indian Railways, a department owned and controlled by the Indian Government.

A core component of India's rail network is Rites Ltd, a multi-disciplinary consultancy organization in the fields of transport, infrastructure and related technologies.

We spoke to one of the Rites Ltd directors about its priorities and relationship with the Government.

"The state's involvement is limited to the extent of a formal Memorandum of Understanding (MOU) that is signed each year," he says. "This covers broad performance parameters and financial targets. The strategic and operational aspects of our business are left to the company management. Only in rare circumstances does the ministry extend its influence into the operational decisions of the company."

What about the strategic objectives of Rites? "While most are common, some are a higher priority to the state and some a higher priority to the business. For example, most financial and operational issues are of common interest, the business may look to drive technological advancement and image building, while the Government may seek the kind of projects that foster the Government's development agenda. There are formal mechanisms in place to ensure the independence of board members. "While these mechanisms are

not absolute, and in different situations vary in their degree, they empower the board while ensuring that there is the appropriate independence in place," he says.

"The Public Enterprises Selection Board (PESB) is responsible for the selection of directors and independent board members. While this is a transparent and formal process, the influence of the state is a possibility because the process of selection and the PESB itself are.

"On most issues, the board, together with the managing director, debate until a consensus is reached. Any issue on which there is no unanimity is put to a vote."

There is also a formal risk assessment unit within the organization, which intervenes prior to any new project. "This is the critical point at which we can meet and mitigate risk. The two focus areas are projects undertaken overseas and projects which are new in type, and that we have not done before. Every single new project must be approved by this unit, but they lay special emphasis on analyzing the risks involved in these two types of projects."

Interview

Changes of this scale would probably not have been possible at such speed under 100% state ownership.

Jörg Kämer, Fraport AG,
Senior Vice President, Sustainability and
Corporate Compliance



Gover

Fraport AG, which operates Europe's third-busiest airport and has interests in 12 others worldwide, has transformed itself from a regional company with public owners to a publicly listed global enterprise, mainly through a 2001 IPO that ultimately put 48% of the company into the hands of private investors. This partial privatization was Germany's first successful airport listing.

The funds raised in the IPO laid part of the financial base for both capacity expansion at Frankfurt Airport and international growth. Jörg Kämer, Senior Vice President in charge of sustainability and corporate compliance, says the governance rules required of listed companies as well as the capital markets themselves were the drivers of deep shifts in strategy, structure and company culture.

The shift from state administration to stakeholder-oriented management is not unusual for public infrastructure SOEs in Germany. But the IPO set off a

much broader reorientation. For one, the IPO led to changes in governance, such as the appointment of new, private shareholder representatives to the supervisory board, a restructuring of supervisory board committees and the stricter transparency and accounting rules that apply to listed companies. Second, and perhaps more crucial, was the discipline imposed by capital markets; Kämer says there was now an "equity story" the company had to live up to on a daily basis, or be immediately punished by analysts and investors. "We decorated the bride and now she had to perform," he says of the push toward profitability and transparency induced by the public listing.

With the express support of Fraport's public majority owners, the newly listed company was restructured, creating separate business segments that must individually meet profit goals. Poor performers such as cargo handling were split off and shares in a nearby regional airport sold. The company also switched its primary accounting system from the

German standard to the more investor-friendly IFRS, which made disclosure faster and more transparent. A new risk management system across the entire company gives top executives immediate notice if any of their targets might not be met.

"Changes of this scale would probably not have been possible at such speed under 100% state ownership," says Kämer.

He also says that majority state ownership continues to have benefits. Although there is no formal guarantee, the backing of government shareholders holds down the cost of finance, for both the acquisition of other airports as well as investment in the Frankfurt hub itself. With the completion of another runway in 2011 and a new terminal by around 2016, some €7 billion in investments will boost Frankfurt's capacity by approximately half, laying the groundwork for future growth that should make both public and private shareholders happy.

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In large business organizations, strategic thinking is imperative. This is even more true for SOEs, which play a game where the goal posts are often much less evident.

The first step in establishing a strategy is determining the mission. Most authorities say, sensibly enough, that a company's mission should be clearly articulated, easy to understand and communicate, and represent an over-arching guide to the corporation's conduct. If the mission statement is successful, it can become a kind of prime directive that helps steer business operations, the daily language of managers, employees and even outside stakeholders.

There are some factors that can hinder following this step. For example, SOEs may lack the same sense of direction as for-profit companies, where the threat of bankruptcy provides a degree of focus to even the most static firm.

Nevertheless, waves of privatization and budget cutting, increased competition, and an increasing need for states to minimize losses in businesses they control, have led to greater efforts in defining the mission. If properly done, a mission statement that articulates the values and the embedded culture in the

organization encourages a shift toward an approach that is more customer oriented, driven by the satisfaction of customer needs. The shift toward customer orientation is particularly challenging for SOEs. First, it often means overcoming a long-time tendency to ignore customers as key drivers of value. Second, it is sometimes necessary to create a sense of crisis or urgency that makes the need for change clear - not always easy to do in, for example, a government monopoly with strong employment guarantees.

The second step is a plan. A typical strategic plan includes goals the company seeks to achieve over the planning period with regard to both quantitative targets (e.g., targets for revenue growth, cost reduction, operating profit and return to shareholders) and qualitative targets. Due to the increasing turbulence in the business environment, strategic plans today have become less formal

and more flexible. Many companies focus less on long-term goals and more on general issues of strategic direction. Planning horizons have also shortened (two to five years is now the typical planning period). To emulate their successes, SOEs will need to develop a culture of strategic thinking which establishes objectives and plots paths to achieve them.



Source: *Planning for growth*, Ernst & Young 2010

Interview

A strategic balance

Michael Braham
Non-Executive Director
Sydney Ports Corporation

Sydney Ports Corporation owns and manages Sydney's ports infrastructure both for Sydney Harbour and Botany Bay. As a state owned corporation, wholly owned by the New South Wales Government, Sydney Ports has to balance the strategic needs of state development with its financial objectives.

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Summary of the implications for strategy and business evolution:

Strategy and business evolution	
Implications	
Optimize operational flexibility	<ul style="list-style-type: none"> ▶ Gain flexibility within the operating model. ▶ Create more flexibility in internal processes.
Optimize market reach	<ul style="list-style-type: none"> ▶ Evaluate the effectiveness of your business units. ▶ Establish or revise innovation processes.
Re-evaluate the business model	<ul style="list-style-type: none"> ▶ Redefine and shape the company's unique selling proposition (USP) to give services/products a real difference to appeal to your target audience(s). ▶ Concentrate on your core business rather than on diversification. ▶ Execute core operations flawlessly. ▶ Adjust your strategic platform based on your revised business model.
Accelerate decision-making and execution	<ul style="list-style-type: none"> ▶ Evaluate and revise decision-making processes. ▶ Expand or establish program management capabilities. ▶ Reduce time to market. ▶ Redesign and tighten up your performance management system. ▶ Make planning a continuous process and not a yearly event.
Strengthen management talent	<ul style="list-style-type: none"> ▶ Identify future leaders and develop their potential at an early stage.
Optimize capital availability and deployment	<ul style="list-style-type: none"> ▶ Align capital structure to the future operating model for the business. ▶ Allocate capital when needed and not as part of the yearly budget process.
Revitalize risk management	<ul style="list-style-type: none"> ▶ Re-evaluate risk appetite and risk tolerance. ▶ Develop emergency plans for the most likely and most impactful strategic risks. ▶ Develop and communicate a common risk language and risk appetite.
Strengthen stakeholder confidence	<ul style="list-style-type: none"> ▶ Develop a stakeholder engagement plan.

Source: *Planning for growth*, Ernst & Young 2010

"We are here to develop efficient and effective ports - financial performance is just one side of that story," says Michael Braham.

Efficiency is critical, given the port's pivotal role in Australia's export industries. Shifting to a more service - orientated approach has seen Sydney Ports redesigning processes to make life

easier for its customers, including for truck drivers who are front-line users of port services. It is also working to shift more freight to rail, taking heavy vehicles off the road and reducing congestion and traffic noise for nearby residents.

Sydney Ports is in the process of expanding Port Botany - AUD1 billion project that will help meet the future

needs of the state. A 10-year Statement of Corporate Intent has allowed the organization to plan for such major investments but, given projected future growth in NSW and across Australia, the board is now considering an even longer planning horizon.

Interview

Operational excellence, customer relations and sustainability.

Mauro Roberto Pacheco de Lima, CFO of Infraero

Infraero is a Brazilian Government corporation created in 1970 and responsible for airport operations and commercial management. It operates 67 airports, 81 air navigation stations and 32 international freight terminals, which account for 97% of the regular air traffic in Brazil. The main challenge for the sector is the lack of a more robust regulatory framework. Studies show that Brazilian costs are not competitive, while at the same time revenues are lower, and this decreases profitability. The result is that the company's attempt to be self-sufficient has become an ongoing challenge.

In recent years, Infraero has developed various initiatives to put its business strategy into practice. Today, Infraero is focused on 20 strategic objectives. We have taken three key themes: operational excellence (guaranteeing that demand is met), customer relations and sustainability. The consolidation target for strategic planning is 2014.

Each strategic objective has indicators that include targets; we are generating identifiable results indicators so as to develop our internal assessment at a later stage. The ticket, the leased square meter, the level of satisfaction and other factors are among the measures used by the sector all over the world.

Infraero also aims to be as innovative as possible, utilizing best practices in this sector from around the world. We are also seeking to implement the best corporate governance practices countersigned by the Brazilian Institute of Corporate Governance (IBGC) so that we may attract investors to the company in the future. The company has to develop its financial management practices to prepare for new accounting standards and new controls and management tools also have to be implemented. Studies are also being carried out to define Infraero's new business model.

Sustainability is also crucial to our culture and operations. We have our Ethics Committee, our Code of Ethics as well as the Sustainability Committee. We also have targets to promote the reduction of the company's impact on the environment. These help shape our actions and behavior both now, and in the future.

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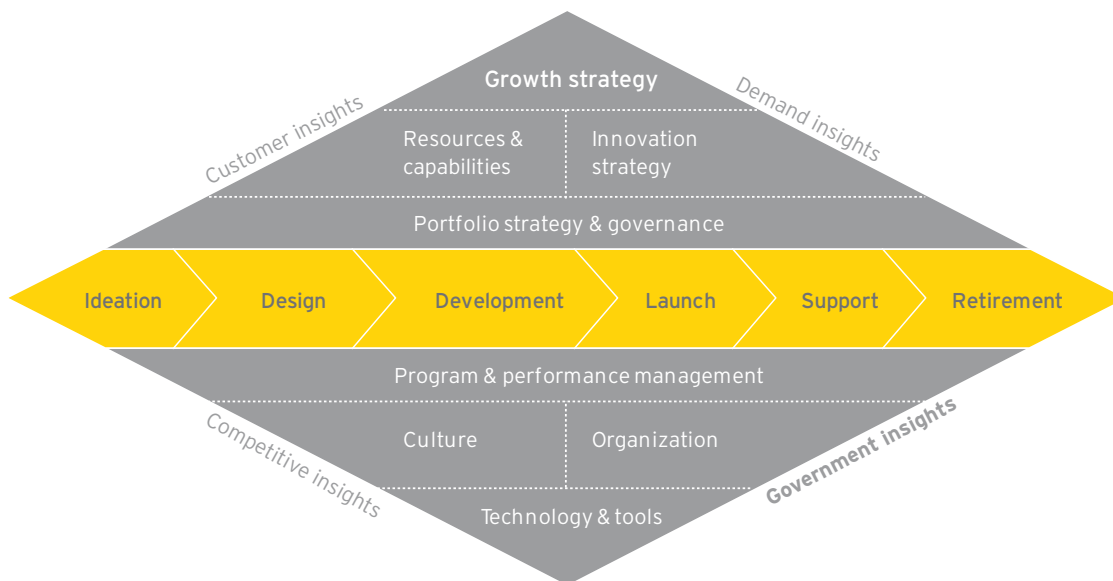
What we observe is that no practice is as venerated in business today as innovation. Over the past 30 years, the world has changed dramatically, as one important invention followed another, creating profound alterations in corporate and national fortunes.

Government often acts as an important agent of innovation. For example, it has the capacity to direct public investments at the kind of basic research for which the return is far from certain. Nanotechnology and biotechnology, for example, have both been helped immeasurably by government support of research. Or, it may act as a market-maker: in energy, for instance, long-term commitments to feed-in tariffs have made all the difference in building the alternative energy industry, and are a major reason that cloudy Germany has become a major leader in solar energy. Government can also be pivotal for facilitating major technological change: policy-makers played a profound role in inventing the internet - first as a military communications tool, then as a medium for academic exchange, and finally, for the rest of society.

In spite of the obvious involvement of governments in SOEs, the stereotype would not seem to lead to perceiving them as “innovative” environments: more than most companies, SOEs often tend toward conservatism. Seniority will often prevail over meritocracy. Customer focus and a civil-service mentality may make it difficult to adopt new ideas, especially as the upside is frequently not nearly as clear as the possible downside. However, given the existing involvement and aptitude of governments to stimulate innovation, the associated inference is that there is space for this to be extended to SOEs. In specific terms, one of the most important characteristics of governments is their ability to make long-term investments; if they were to focus these on their own “property,” i.e., SOEs, it would create opportunities for innovation (e.g., for research and development). In a more general sense, the experience that government already has in acting as an agent for innovation can only benefit SOEs - they have the necessary skills, knowledge and resources, all the right cards to become leaders through innovation.

Our observations lead us to the conclusion that the success of innovation depends largely on it being embedded in a company’s operating model and its talent management strategy, including also a human resource approach that features dedicated roles adequately supported by management bodies and designated funds.

Product innovation and lifecycle management framework



novation

Interview

It's not just about strategy and technology, but also about human resources and people's behaviors.

Bruno Chaintron, Groupe La Poste, Former Director International Development, La Poste Global Mail.

With many experts predicting that mail could decline by 30% by 2015, the worldwide postal industry has no choice but to innovate. In France, Groupe La Poste has adopted an ambitious and aggressive project called "Reinventing mail by 2015" with innovation at its core: 17 programmes, three dimensions (development, performance and life at work) and a single goal: becoming among the leading media for managing customer relationships.

Innovation, in the form of strategic business model innovation, technology driven innovation and human resources (HR) innovation, is being deployed to help Groupe La Poste overcome the global mail decline.

New strategic business models can be, and should be, created in the postal industry to build niches of growth. This involves redefining the value proposition (what we offer to customers) and the value constellation (the network of partners that cooperate to deliver the full value). For instance, although the

international mail industry worldwide has declined more rapidly than the domestic mail industry, La Poste international mail activities have successfully achieved higher than industry growth by focusing on an innovative business model: arbitrage of international mail. The key is to provide customers with the best possible database of transportation and distribution solutions worldwide in order to optimize the expected price to quality ratio.

Technology is also exploited for the countless possibilities that it offers, either to improve the customer relationship, introduce process efficiencies or to create new services. For instance, through XAnge, a private equity firm sponsored by La Poste, investments have been directed at innovative companies that open up further pathways to opportunity. An example of this is Mobile Tag, which provides a 2D barcode management platform for mobile phones, where scanning the barcode activates an internet link that redirects you to new value creation sources.

Effectively leveraging any of these sources of innovation requires a rethinking of internal HR processes. It is crucial that postal companies learn how to best support those individuals who are seeking to innovate and carry these new programs through. They also need to match these individuals with the most promising innovation opportunities and the supporting environment required to make things truly happen.

New guidelines have to be set up to make all companies - not just in the postal industry - more entrepreneurial. And it's not just about strategy and technology, but also about HR and people's behaviors.

Interview

Ensuring a role of pure entrepreneur

Sergio Biganzoli, CFO of AgustaWestland

AgustaWestland is the Anglo-Italian helicopter company owned by Finmeccanica, the Italian conglomerate controlled by the Italian government (with about 33% of shares), which represents the largest hi-tech industrial group based in Italy working in the fields of defense, aerospace, security, automation, transport and energy.

The mission of AgustaWestland is to maintain its leader position as a total capabilities provider in the vertical lift market – for both military and commercial operators around the world – through its rotorcraft systems design, development, production and integration expertise, its experience in the training business, and its customer-focused integrated operational support solutions.

Ad hoc joint ventures have been launched, some related to specific multination program like the NH90 helicopter model with Germany, France and the Netherlands and more recently with India, Russia, and China. Part of AgustaWestland's strategy has also been to focus on its core activities both local and global levels. It has also reinforced strong partnerships with a number of other leading aerospace and defense industrial suppliers in order to deliver mutually beneficial programs.

Like all companies that are part of Finmeccanica Group, reviews on an annual basis its strategic plan which extends over a 15-year period. Its plan is most likely witnessing a down-swing in Western economies while it considers

emerging markets to be not only those of the Far East but some bordering the Mediterranean as well such as Turkey. AgustaWestland wants to maintain its competitive advantage by continuing to invest in the sector's core industrial components without losing sight of the process of globalization and stated market leadership ambitions.

AgustaWestland's values and culture lie directly with the people who work for the company. We recall with pride that –when the company went through a very difficult period during the financial crisis of the nineties- a culture of efficiency and effectiveness was spontaneously created and this culture has helped to make us a winner in the global market.

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Knowing how to create a virtuous relationship with the stakeholder – a public shareholder – and ensuring a role of pure entrepreneur that is completely removed from politics and dependent solely on the market creates competitive advantage.



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Corporate social

In recent years, more and more corporate thinkers have begun to see their mission as a dual one: not only to generate profits for the company, but to create social and ecological gains for the national society.

SOEs have a natural lead when it comes to corporate social responsibility (CSR). Often set up from the start by governments acting with a public purpose in mind, SOEs appear to have some inherent advantages in seeing and seizing opportunities to promote the social and environmental good. Certainly, SOEs all over the world, in developed and developing countries alike, have found ways to make themselves not just valuable companies in their market, but invaluable partners in their society, often much more than their privately owned cousins.

One recent survey of 300 companies operating in China, for example, found that on a 100-point scale foreign companies rated 12.1 points, domestic private companies averaged 17.9 points, while Chinese SOEs rated 30.6. In some places, they are also showing leadership in encouraging CSR excellence in their domestic market: in 2009, the Institute for the Accountancy Profession in Sweden and the Swedish Association of Auditors named two state-owned companies' sustainability reports as the best submitted for the year in both the large and small categories.

Encouraging CSR in an SOE may be slightly easier than with a private company. First, because the orientation of a state-owned company tends to be geared more towards service. Second, the relationship with the state makes it easier to compel activity. There are a number of ways in which governments have helped SOEs to develop greater CSR capacities:

- ▶ **Require the development of a formal CSR function.** In China, the Government now requires SOEs to develop a department that can monitor and manage CSR.
- ▶ **Frame the engagement.** In Indonesia, SOEs are encouraged to build community development programmes, individuals, or institutions, and partnership development programs, such as loans to cooperatives or farmers. Guidelines limit support of community-development programs to a maximum of three years. Partnership development can be more open-ended, but may continue only as long as the project is economically justifiable. Loans need a sponsor to guarantee their return.
- ▶ **Require regular CSR reports.** Sweden requires state-owned companies to file annual reports on their CSR activities based on the Global Reporting Initiative (GRI) guidelines, in the same way it mandates CSR reports from private Swedish companies. "Working with sustainability issues is more important than ever, and reporting drives that work," said Maud Olofsson, the Minister for Enterprise and Energy, in a 2009 speech.
- ▶ **Mandate good deeds.** Indian policy-makers are also reportedly considering a requirement that up to 5% of the net profits of every SOE be set aside for CSR projects. "There is no escaping from CSR, which will no longer be a photo opportunity for the chairman," said Bhaskar Chatterjee, Department of Public Enterprises.

Three pillars of CSR



Source: *Corporate Social Responsibility*, Ernst & Young 2008

al responsibility

Interview

It is all about embedding it in the day-to-day activities of all employees.

Robert Boutin,
Director CSR of Canada Post

Canada Post, as a government-owned corporation, has been concerned about its social responsibilities for years. It has established a committee of the Board of Directors responsible for CSR, created a specific CSR team, and implemented a management committee responsible for promoting and supporting CSR initiatives across all departments.

The CSR management committee discusses strategies, shares best practices, identifies and implements action plans, discusses progress accomplished and raises the profile of the CSR program across the organization. As Robert Boutin, Director CSR, says: "Committee members act as change agents in their respective groups."

The CSR program has three main areas of focus:

Employees: Priority is on employee health and safety and engagement. "In 2009, we have achieved our highest employee engagement score ever and have also reduced work-related accidents by 22% last year by making safety a top priority," says Boutin.

Environment: Canada Post has taken action to reduce its greenhouse gas emissions and has comprehensive recycling and sustainability programs. "These activities are not only good for the environment, they are also contributing to the profitability of the corporation," explains Boutin.

Community: The corporation supports literacy programs and has a foundation that raises money for mental health.

At Canada Post, CSR is not only about specific actions, it is all about embedding it in the day-to-day activities of all employees.

A key component is the measurement and reporting of its accomplishments. As Boutin points out: "At Canada Post, we believe that what gets measured gets done." It publishes an annual report on CSR that provides comparisons with targets, prior year results and target for the upcoming year.



Conclusion

SOEs differ from private business firms both for their role in the society and in the economy of different countries and due to how they go about pursuing their competitive advantage. This review elaborates on this uniqueness, highlighting the variety of SOE corporate governance structures and also identifying positive feelings in citizen perceptions of SOEs, as well as drawing out and focusing on the main factors of success (the four pillars) that can differentiate SOEs from private firms.

We can conclude that the governance structure and the strategy of each SOE should be based on an idea of excellence along several dimensions, including steering free of politicization and keeping to their broader mission, which includes a wider set of factors such as regional development and welfare. SOEs should also be innovative organizations, making the most of the experience that government already has in acting as an agent for innovation and embedding this feature in the operating model of SOEs, including reviewing HR policies so that they are based on a more meritocratic approach, rather than a bureaucratic one.

All companies - and particularly SOEs - should avoid being successful thanks to the externalization of costs to stakeholders such as the employees, the suppliers, or the collectivity at large. SOEs should be the leading actors of change, setting the bar for companies in terms of the fulfillment of the triple bottom line, therefore paying attention to the economic, the social and the environmental bottom line at the same time.

It seems that SOEs are not doomed to fundamental flaws and perpetual underperformance. There is evidence, also sustained by citizens' views, that SOEs can be successful, that there is further scope for this to improve, and that they play a key role in society and in the global economy. Choosing private over public is not as straightforward a decision as stereotypes might imply - indeed, the choice is not even necessary. What we need is to make the most of the best from both worlds.

Contacts

Global Government & Public Sector Center (GPS Center)

Philippe Peuch-Lestrade

GPS Leader
Paris, France
+33 1 46 93 72 62
philippe.peuch-lestrade@fr.ey.com

Alessandro Cenderello

GPS Markets
Rome, Italy
+39 066 7535 531
alessandro.cenderello@it.ey.com

Craig Baker

GPS Advisory
London, UK
+44 (0)20 7951 2626
cbaker@uk.ey.com

Area contacts

Uschi Schreiber

Oceania
Sydney, Australia
+61 2 8295 6706
uschi.schreiber@au.ey.com

Nobukazu Kato

Japan
Tokyo, Japan
+81 3 3503 1137
kato-nbkz@shinnihon.or.jp

Val Lyons

Americas
Washington DC, USA
+1 703 747 0466
val.lyons@ey.com

Mildred Tan

Far East
Singapore
+65 6309 8200
mildred.tan@sg.ey.com



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