

THE QUALITY OF SOES' ANNUAL FINANCIAL STATEMENTS. A CRITICAL ANALYSIS OF THE OECD GUIDELINES

Margherita Smarra^{*}, Marco Sorrentino^{**}

^{*} University of Molise, Campobasso, Italy

^{**} Pegaso Telematic University, Napoli, Italy



How to cite: Smarra, M., & Sorrentino, M. (2021). **Received:** 20.10.2021
The quality of SOEs' annual financial statements: A critical analysis of the OECD guidelines. **Accepted:** 26.10.2021
In K. M. Hogan, & A. Kostyuk (Eds.), *Corporate Enterprises, Disclosure, Transparency, Quality, Financial Reporting* (pp. 69–77). **Keywords:** State-Owned
<https://doi.org/10.22495/cgfcisrp11> **JEL Classification:** M4
DOI: 10.22495/cgfcisrp11

Copyright © 2021 The Authors

Abstract

National and international accounting literature and established accountancy laws now agree that the nature of invested resources, and — above all — pursued objectives, can modify the accountability of state-owned enterprises (SOEs). This accountability is characterised as being of public interest, and the efficacy of the statutory accounts model derived from the chosen business plan is consequently reduced. Based upon this hypothesis, the present work proposes an evaluation of the mandatory accounting regulations for Italian state-owned enterprises via an evaluation of compliance with the OECD guidelines of November 2015 regarding “disclosure and transparency”. Although the work substantially evidences compliance with the majority of OECD recommendations, it also highlights a concentration of *non-compliance* in areas regarding company performance statements.

1. INTRODUCTION

With around eight thousand operational organisations reaching 13% of the total turnover of active companies, almost a million employees, over five thousand local administrations included in the share hold base and a ubiquitous presence in the provision of local services, public-owned companies have assumed a primary role in the economic, social and

political life of the country (ISTAT, 2020). The economic stability of traditional stakeholders such as employees and suppliers, the quality of life of numerous citizens, the economic balance of participating administrations and, more generally, the level of efficiency and efficacy of a large part of public spending depends upon their performance and seamless functionality. This context generates a multitude of legitimate inquiry exigencies, spread between organisations that are extraneous to the direct management of the companies for which they are *reporting entities*, and, as described unanimously in accounting literature, must draw up their balance sheets while adhering to the highest qualitative standards, even when this results in a notable increase in production costs (Ball, 1988; McCahey & Ramsay, 1989).

On the basis of this premise, the present work proposes to evaluate the quality of the regulations disciplining mandatory accounting procedures within the Italian public administration system. These regulations are derived from the specifications of an adopted business plan because these companies do not lose their status as private enterprises despite the fact that their capital is augmented by grants from public organisations but, as has been clarified by the recently issued unified code, are still regulated under the civil code of justice. These same regulations have been developed based on suppositions that are not always valid when massive use of public resources preceded by the general interest in the final results of a business plan significantly modify accounting practices and generate stronger and wider-ranging cognitive exigencies (Capalbo & Palumbo, 2013). The subject has not escaped the attention of the OECD, which has confronted the problems of state-owned enterprise (SOEs) on numerous occasions, by formulating specific Governance recommendations (OECD, 2005), and by commissioning direct studies to analyse and evaluate the entity of the phenomenon (Christiansen, 2011; Kowalski, Büge, Sztajerowska, & Egeland, 2013; OECD, 2014). Finally, an entire section of the latest *Guidelines on Corporate Governance of State-Owned Enterprises* (OECD, 2015) has been dedicated to disclosure and transparency and in 2020 OECD has published a report about national approaches towards implementation of Chapter VI of the *OECD Guidelines on Corporate Governance of State-Owned Enterprises* (OECD, 2020).

Table 1. OECD guidelines on disclosure and transparency

<i>Balance sheet minimum content</i>
<ul style="list-style-type: none"> • A clear statement to the public of enterprise objectives and their fulfilment. • Enterprise financial and operating results, including where relevant, the costs and funding arrangements pertaining to public policy objectives. • Indication of any material or financial aid received from public sources. • Any material foreseeable risk factors and measures taken to manage such risks. • The remuneration of board members and key executives. • Board member selection process. • Any financial assistance, including guarantees, received from the state at a local or national level, and the correlated entities. • Any relevant issues relating to employees and other stakeholders. • The governance, ownership and voting structure of the enterprise, including: <ul style="list-style-type: none"> ◦ the content of any corporate governance code or policy and implementation; ◦ processes.
<i>Audit regulations</i>
<ul style="list-style-type: none"> • Annual financial statements should be subject to an independent external audit based on high-quality standards.
<i>Data publication</i>
<ul style="list-style-type: none"> • Information limits conceded to small businesses may not be extended to companies providing public services. • The report must be compiled annually with recourse to intensive web-based communications in order to facilitate information access by all parties.

Source: OECD (2015).

Although OECD guidelines are not mandatory for member states, they certainly represent the *best practice* that each country should respect in order to guarantee the usefulness of SOE financial statements at various government levels, and for public administrations in general.

As for other methodologies used within the OECD environment, the level of compliance will be stated based on its collocation in one of five distinct levels:

Table 2. The level of compliance

Compliant	No difference
Largely compliant	Little differences
Partially compliant	Moderate differences
Non-compliant	Significant differences
Not applicable	Not applicable to a country’s specific legal, environmental or institutional structure

2. OECD GUIDELINES ON BALANCE SHEET MINIMUM CONTENT

The proposed guidelines may be usefully grouped into two specific areas:

- performance;
- governance.

2.1. Performance area

A clear statement of enterprise objectives and their fulfilment

The actual structure of a company's financial statement is principally aimed at measuring *performance* as related to the earning of profits for the company owners. When objectives change, however, and above all when they assume policy-making importance, a system centred on earnings and capital measurement is no longer sufficient to measure overall company performance (Pallot, 1992; Airoldi, Brunetti, & Coda, 2005; Marchi, 2011). In Italy, state-owned enterprises are not founded as profit-making organisations because they are intended as producers of goods and services that are strictly necessary to achieve the institutional objectives of the partners (Art. 4, d.lgs 175/2016). The demonstration of an economic result, therefore, although important for an evaluation of a capability to operate autonomously, is insufficient to demonstrate management of economic conditions and notably reduces profits — and consequently the quality of accounting. It would be better to establish dedicated indicators to verify the fulfilment of specific company objectives, but to this end — as recommended by the OECD — such objectives must be clearly stated in the annual report.

Enterprise financial and operating results, including where relevant, the costs and funding arrangements pertaining to public policy objectives

Fulfilment of specific public interest objectives imposed by political reasoning may mean forcing the adoption of decisions that lack a degree of economic rationality regarding the costs-earnings dynamics of a specific company. Specifying the costs necessary for the pursuit of these objectives would have the merit of isolating economic and financial performance from expenses devolved from social and/or policy decisions already defined by economics doctrine as inappropriate burdens that constitute “policy conditions than cannot be reasonably introduced into private company management and which entail specific public shareholder expenditures for state-owned enterprises” (Saraceno, 1981, p. 35).

Financial assistance, including guarantees, received from the state at a local or national level, and the correlated entities

OECD requests that SOE financial statements include a clear and exact presentation of all the agreements existing between the company and public administration, including guarantees, subsidies or other incentives, and any form of commitment assumed by the state in relation to company obligations. Adequate information is also required in relation to any form of public-private partnership, with particular regard to those pertaining to the creation of infrastructure and the provision of public services.

2.2. Governance representation area

Any material foreseeable risk factors and measures taken to manage such risks

This recommendation stems from the awareness that state-owned enterprises are very often subject to ambitious strategies corrupted by the presence of non-business targets. The pursuit of these objectives may expose significant risks that become even more intense for companies such as utility suppliers that operate in sectors subject to wide-ranging regulatory and economic changes. For these reasons, the OECD requires representation of *financial and operational risks*, and those risks related to the environment, safety at work, and tax dynamics.

Remuneration of board members and key executives

From the OECD perspective, the urgency for in-depth disclosure of administrator royalties is linked to the risk that lack of information may result in a backlash for public ownership. The OECD, therefore, requires that state-owned enterprises fall fully into line with listed companies by clearly representing both remuneration details and the procedures followed for their determination.

Board member selection process

Clear representation of the procedures followed for the selection of managers in state-owned enterprises is one of the ways in which to avoid the risk of choices being made, or perceived as being made, solely on the basis of company policy decisions.

Any financial assistance, including guarantees, received from the state at a local or national level, and the correlated entities

State-owned enterprises often establish numerous transactions with the internal capital holders. The OECD requires an indication of every government transaction, at both central and local level, while civil legislation only considers transactions with administrations having a stake in company capital.

Any relevant issues relating to employees and other stakeholders

In many cases, state-owned enterprises have been true reserves within which, thanks to decentralised contracting, certain classes of workers — or more often executives — have been guaranteed completely favourable conditions compared to those existing in the rest of the public sector to which they ultimately belong.

The information requested by the OECD recommendations is however more extensive than those required by Law Decree 33/2013, as they also comprise the modes of employee participation in social organizations and education and training programs as well as other particulars relating to relations with other stakeholders such as creditors, suppliers and the local community.

The governance, ownership and voting structure of the enterprise, including the content of any corporate governance code or policy and implementation processes

The public nature of the resources used by these companies certainly increases the ethical dimension of business activities and requires that the verification of legal compliance is recognized as a priority step.

3. OECD RECOMMENDATIONS FOR AUDIT

The OECD requires that state-owned enterprises, or at least the larger of these companies, are always subject to an external audit carried out on the basis of international auditing standards and specifies that this review cannot be replaced by other forms of control exercised by the state also through *supreme audit institutions* (e.g., Government Audit Office).

4. OECD GUIDELINES REGARDING PUBLICATION OF ANNUAL BALANCE SHEET

Information limits conceded to small businesses may not be extended to companies providing public services.

In general, literature and practices are unanimous in believing that the imposition of an obligation to draw up a high-quality balance sheet in *full compliance* with all accounting principles (General Purpose Financial Statements) can be justified only for *reporting entities*, i.e., those entities consisting of *dependent users*, or external subjects interested in the fate of the company, which have no tools outside of the budget that allows them to be informed. It follows that, where there are sufficient reasons to believe that certain bodies should not qualify as reporting entities, the granting of forms of differential reporting allowing budget production costs to be reduced must be sanctioned (Carsberg, Page, Sindall, & Waring, 1985; McCahey & Ramsay, 1989; Faux & Wise, 2004; Sorrentino, 2012). In a public shareholder company or in a company that pursues public objectives, the presence of *dependent users* is endemic and smaller-sized businesses are certainly not excluded. For this reason, it seems absolutely out of place that similar simplifications are granted to public companies because of size considerations (Capalbo, 2012), and the position expressed by the OECD totally excluding the possibility of extending any form of differential reporting to public-owned enterprises that pursue goals of social or public significance.

The report must be compiled annually with recourse to intensive web-based communications in order to facilitate information access by all parties.

5. CONCLUSION

The analysis carried out highlights how Italian legislation is not far off the mark from the indications provided by the international organization.

Table 3. Synopsis of Italian government compliance with the OECD recommendations on disclosure and transparency

<i>Balance sheet minimum content</i>	<i>Level of compliance</i>
<i>Performance area</i>	
A clear statement to the public of enterprise objectives and their fulfilment	Non-compliant
Enterprise financial and operating results, including where relevant, the costs and funding arrangements pertaining to public policy objectives	Non-compliant
Indication of any material or financial aid received from public sources	Partially compliant
<i>Governance area</i>	
Any material foreseeable risk factors and measures taken to manage such risks	Compliant
The remuneration of board members and key executives	Compliant
Board member selection process	Non-compliant
Any financial assistance, including guarantees, received from the state at a local or national level, and the correlated entities	Largely compliant
Any relevant issues relating to employees and other stakeholders	Partially compliant
The governance, ownership and voting structure of the enterprise, including the content of any corporate governance code or policy and implementation processes	Largely compliant
<i>Audit regulations</i>	
Annual financial statements should be subject to an independent external audit based on high-quality standards	Compliant
<i>Data publication</i>	
Information limits conceded to small businesses may not be extended to companies providing public services	Non-compliant
The report must be compiled annually with recourse to intensive web-based communications in order to facilitate information access by all parties	Largely compliant

The positive results achieved in the areas of governance, control and publicising must no doubt be largely due to subsequent interventions with which the government, first with Law Decree 33/2013 and then Law Decree 175/2016, has integrated the guidelines into the civil code of law.

There is a concern, however, regarding the concentration of non-compliance in the performance measurement area. A company that respects all applicable regulations and ensures operations are completely legal but is not capable of achieving its assigned objectives may damage public resources to a greater extent than that caused by individual acts of corruption and/or embezzlement.

REFERENCES

1. Airoidi, G., Brunetti, G., & Coda, V. (2005). *Corso di economia aziendale*. Bologna, Italy: Il Mulino.
2. Airoidi, G., Gnan, L., & Montemerlo, D. (1998). Strutture proprietarie, complessità gestionale e sistemi di governance nelle piccole e medie imprese. In G. Airoidi, & G. Forestieri (Eds.), *Corporate governance: Analisi e prospettive del caso italiano*. Milan, Italy: Etas Libri.
3. Ball, I. (1988). *Definition of the reporting entity*. Caulfield, Australia: Australian Accounting Research Foundation.
4. Capalbo, F. (2012). Il contrasto tra accountability pubblica e rendicontazione in stile privatistico nelle società partecipate dalle pubbliche amministrazioni. In F. Capalbo (Ed.), *L'applicazione della contabilità economica nel settore pubblico: Aspettative, risultati e criticità* (pp. 129–152). Turin, Italy: Giappichelli. Retrieved from https://www.researchgate.net/publication/278533089_Il_contrasto_tra_accountability_pubblica_e_rendicontazione_in_stile_privatistico_nelle_societa_partecipate_dalle_pubbliche_amministrazioni
5. Capalbo, F., & Palumbo, R. (2013). The imperfect match of public accountability of state-owned enterprises and private-sector-type financial reporting: The case of Italy. *Australasian Accounting Business and Finance Journal*, 7(4), 37–50. <https://doi.org/10.14453/aabfj.v7i4.4>
6. Capalbo, F., Frino, A., Mollica, V., & Palumbo, R. (2014). Accrual-based earnings management in state owned companies: Implications for transnational accounting regulation. *Accounting, Auditing & Accountability Journal*, 27(6), 1026–1040. <https://doi.org/10.1108/AAAJ-06-2014-1744>
7. Carsberg, B., Page, M., Sindall, A. J., & Waring, I. (1985). *Small company financial reporting*. Prentice Hall/ICAEW.
8. Christiansen, H. (2011). *The size and composition of the SOE sector in OECD countries* (OECD Corporate Governance Working Paper No. 5). Retrieved from <http://esadepublic.esade.edu/media/getAnnex/48512721.pdf>
9. Demartini, P. (1999). *La comunicazione economico-finanziaria delle PMI*. Retrieved from <https://view.officeapps.live.com/op/view.aspx?src=http%3A%2F%2Fwww2.econ.univpm.it%2Faidea%2F18121999%2Fdemartin.i.doc&wdOrigin=BROWSELINK>
10. Faux, J., & Wise, V. (2004). Differential reporting policy in a changing financial environment. In *Proceedings of International Business Research Conference 2004* (pp. 1–10). Retrieved from <https://dro.deakin.edu.au/eserv/DU:30024304/wise-differentialreporting-2004.pdf>
11. Italian National Institute of Statistics (ISTAT). (2020). *Le partecipate pubbliche in Italia: Anno 2017*. Retrieved from <https://www.istat.it/it/files/2020/02/Report-partecipate-pubbliche-2017.pdf>
12. Kowalski, P., Büge, M., Sztajerowska, M., & Egeland, M. (2013). *State-owned enterprises: Trade effects and policy implications*. Paris, France: OECD Publishing.
13. Marchi, L. (2011). Integrazione pubblico-privato su metodologie e strumenti di controllo gestionale. *Management Control*, 2, 5–8. <https://doi.org/10.3280/MACO2011-002001>
14. McCahey, J. E., & Ramsay, A. L. (1989). *Differential reporting: Nature of the accounting standards overload problem and a proposal for its resolution* (Australian Accounting Research Foundation Discussion Paper No. 13).

15. OECD. (2005). *OECD guidelines on corporate governance of state-owned enterprises*. <https://doi.org/10.1787/9789264009431-en>
16. OECD. (2014). *The size and sectoral distribution of SOEs in OECS and partners countries*. <https://doi.org/10.1787/9789264215610-en>
17. OECD. (2015). *OECD guidelines on corporate governance of state-owned enterprises*. <https://doi.org/10.1787/9789264244160-en>
18. OECD. (2020). *Transparency and disclosure practices of state-owned enterprises and their owners: Implementing the OECD guidelines on corporate governance of state-owned enterprises*. Retrieved from <https://www.oecd.org/corporate/transparency-disclosure-practices-soes.pdf>
19. Pallot, J. (1992). Elements of a theoretical framework for public sector accounting. *Accounting, Auditing & Accountability Journal*, 5(1). <https://doi.org/10.1108/09513579210008244>
20. Saraceno, P. (1981). Il sistema delle partecipazioni statali. *Economia e Politica Industriale*, 29.
21. Sorrentino, M. (2012). *Il costo di adeguamento ai principi contabili: Dall'esperienza anglosassone all'implementazione degli IAS/IFRS in Italia*. Rome, Italy: Aracne.