TECHNICAL ASSISTANCE

TO THE

PEOPLE’S REPUBLIC OF CHINA

FOR

IMPROVING CORPORATE GOVERNANCE AND FINANCIAL PERFORMANCE OF STATE-OWNED ENTERPRISES

September 2002
CURRENCY EQUIVALENTS
(as of 10 September 2002)

Currency Unit — Yuan (CNY)
CNY1.00 = $0.1208
$1.00 = CNY8.2769

On 1 January 1994, the dual exchange rate system of the People’s Republic of China was unified. The exchange rate of the yuan is now determined under a managed floating exchange rate system.

ABBREVIATIONS

ADB — Asian Development Bank
BOD — board of directors
CSRC — China Securities Regulatory Commission
EPES — enterprise performance evaluation system
GDP — gross domestic product
MOF — Ministry of Finance
PRC — People’s Republic of China
SAOC — state asset operating corporation
SHC — state holding company
SOCB — state-owned commercial bank
SOE — state-owned enterprise
TA — technical assistance

NOTES

(i) The fiscal year of the Government ends on 31 December.

(ii) In this report, “$” refers to US dollars.
I. INTRODUCTION

1. The Government of the People’s Republic of China (PRC) has been implementing reforms and restructuring of state-owned enterprises (SOEs) for over two decades. As a part of this, the Government has instituted a system to evaluate SOE performance. During the 2001 country programming mission of the Asian Development Bank (ADB), the Government requested ADB to provide technical assistance (TA) support to expand and refine the evaluation approaches in line with international best practices on corporate governance and financial performance evaluation. ADB and the Government reached an understanding on the objectives, scope, cost, financing, and implementation arrangements of the proposed TA during a Fact-Finding mission in June-July 2002. The TA framework is provided in Appendix 1.

II. ISSUES

2. The PRC has over 7 million enterprises, of which over 300,000 are SOEs with more than 51% of the shares held by municipal, provincial, or central governments. Of these, 40,000 SOEs are in the industry sector. While SOEs were the backbone of the PRC’s economy during the period of central planning, their role has declined substantially during the last two decades. As a result, the contribution of the SOEs to gross domestic product (GDP) fell from 58% in 1980 to 37% in 2000 in line with the decline in the share of the SOEs in gross industrial output from 37% in 1994 to 25% by 2000. However, SOEs continue to account for 55% of employment, 56% of value added, and over two-thirds of the fixed assets of the industry sector.

3. Relative to private enterprises, the overall financial performance of SOEs has been weak due to (i) poor internal management that lacks professionalism and is subject to political interference; (ii) soft budget constraints, with subsidies given through the budget and loans directed through state-owned commercial banks (SOCBs); (iii) over employment and the associated heavy social welfare responsibilities and low economic efficiency; (iv) high leveraging; and (v) the lack of regard for nurturing competitiveness. Recognizing the problems, the Government initiated SOE reforms in 1978. Initially, emphasis was placed on decentralization and gradual reduction of Government support for working capital, although SOCBs continued to finance SOEs, irrespective of commercial considerations.

4. In the second phase of reforms, the Government adopted a contract responsibility system in the late 1980s, under which contracts were negotiated between SOE managers and the government supervising agencies. This, however, did not lead to any tangible changes as the local governments continued to interfere in enterprise-level decision-making. Following this, the Government initiated more substantive reforms of SOEs, which began in the mid-1990s. In the first phase, the Government initiated divestment of state shares and retrenchments in smaller SOEs, under its zhua da fang xiao policy to “keep the large SOEs and let the smaller ones go.” In 1997, the process of corporatization started, by transforming SOEs into limited liability companies under the Company Law, and establishing a two-tier board structure. The Government also started encouraging mergers and acquisitions as a means of SOE reforms. Another key policy measure taken was to use the proceeds from divestment and restructuring of SOEs to finance the burgeoning social security needs.

5. The experimental and step-by-step approach to SOE reforms, however, has not led to any fundamental changes in property rights in many cases. The formation of state asset operating corporations (SAOCs) and the state holding companies (SHCs), and the overall

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1 The TA was first listed in the ADB Business Opportunities in July 2002.
corporatization process have led to a degree of autonomy and decentralization. However, these measures have had only limited impact on overall financial and operational performance. The separation of the state from the management, without changes to property rights, and the unwillingness to cede state ownership, led to a proliferation of various government departments controlling the SOEs, which in turn has led to the problem of “too many owners” exercising de facto property rights, but without bearing any residual risks.

6. In addition to weak internal and external controls, and lack of transparency, accountability, and disclosure, SOEs also lack appropriate managerial incentives. Although managerial compensation has increased in relation to that of workers, and increasingly managers are appointed by the enterprises rather than by the controlling government departments, managerial positions in SOEs are not fully contestable. Appointment decisions are made on considerations other than merit in more than 80% of the SOEs. The remuneration systems are fixed and sufficiently constrained as the government departments or SOE boards cannot determine executive compensation in a free manner, based on financial and operational performance. As a result, the enterprise management or its supervisors do not have sufficient incentives to ensure efficiency in the use of state assets.

7. The poor operational and financial performance of SOEs over the years has led to deterioration in the portfolio quality of the SOCBs that lent to SOEs. SOEs account for more than half of the outstanding credit of SOCBs, equivalent to 128% of GDP. While SOCBs have failed to influence efficient performance in SOEs, nor have the financial markets had a significant effect on governance and internal control structures in corporatized SOEs, given the gradual process of divestment of state shares. Over 95% of the 1,000 enterprises listed in the Shanghai and Shenzhen stock exchanges are SOEs, and over 70% of the shares issued are nontradable and held directly or indirectly by the state. The state exerts significant corporate control over SOEs and no clear incentive structure has evolved even in listed SOEs. Given the concerns over the weak corporate governance norms in all enterprises, in 2001 the State Economic and Trade Commission (SETC) and the China Securities Regulatory Commission (CSRC) formulated separate codes of conduct in relation to corporate governance for the listed enterprises and SOEs. No assessment has been made to verify compliance of SOEs with these codes.

8. SOEs continue to receive support from the Government for capital investments. For instance, the Government’s measures to provide funds for technical innovation in the aftermath of the Asian financial crisis to support the failing SOEs, partly resulted in the rise in the share of SOEs in industrial sector value-added from 47% in 1997 to 58% in 1998. The Government also launched a 3-year SOE bail out program at the end of 1998, to help the weak large and medium-sized SOEs and encouraged debt-to-equity swaps to transfer their long-standing SOCB debts now held by asset management companies. However, delays in SOE reforms have affected the efficiency and profitability of SOEs’ investments. The ratio of value added to fixed assets has steadily declined from 60% in 1994 to 37% by 2000, and operating profits have declined from 13% of the total assets in 1994 to 10% by 2000. Over the same period, the private sector enterprises have maintained their value added at one-to-one against fixed assets, and increased the operating profits from around 15% to 17% of total assets.

9. The Ministry of Finance (MOF), as a representative of the state in the SOEs, has undertaken significant measures to evaluate and monitor SOE performance over the last few years. MOF’s enterprise performance evaluation system (EPES) targets about 3,800 large and medium-sized SOEs that are directly under central Government control. These enterprises are organized into 170 groups that are vertically controlled by SAOCs or SHCs. Their combined
value added amounts to over $150 billion, or about 15% of GDP. The EPES operates on the basis of two indexes. The overall financial position of the SOEs is assigned 80% weight, and the other qualitative factors including management qualifications and formulation of development strategies, among others, are assigned 20% weight. MOF has applied the EPES to different subgroups of the 170 groups of SOEs over the last 3 years. Its current pilot program includes 24 SOE groups with around 550 individual SOEs.

10. While the EPES attempts to quantify and compare the relative performance of SOEs, it has been used primarily as a data gathering and reporting tool. Its financial index does not include any provisions for verifying the quality of financial information or cross-checking the indicators and ratios that are submitted by the SOEs. The qualitative part of the index is based on a random survey of employees in SOEs, but many of the indicators are subjective. Uniform weights are assigned to different indicators across industry groups, without due regard to inter-industry differences. Further, while the sources of financing SOEs' growth are changing and their competitiveness is being tested by more efficient private enterprises and the globalization challenges resulting from accession to the World Trade Organization, there have been minimal efforts on evaluating corporate and financial governance practices in SOEs. The most significant weakness is the lack of any established linkage between the EPES outcomes and how the Government formulates its SOE policies and restructuring options. While a basic evaluation system is in place, there is a lack of capacity to upgrade EPES to capture complex financial indicators or integrate best practices of corporate and financial governance assessments. As a result, policy and regulatory responses have not been optimal, as demonstrated by the continuing weaknesses in SOEs. Because of these shortcomings, the Government has requested for TA support in this area.

III. THE TECHNICAL ASSISTANCE

A. Purpose and Output

11. The TA aims to improve the financial performance and corporate governance practices in SOEs in the PRC. The purpose of the TA is to (i) strengthen the EPES methodology by incorporating international practices on operational and financial performance analysis, and assessment of corporate governance norms, and (ii) formulate efficient methods to link evaluation outcomes with appropriate incentives to enhance productivity. The outputs of the TA will include (a) an improved EPES, (b) a corporate governance rating system, and (c) recommendations to design sound incentive structures.

B. Methodology and Key Activities

12. The TA will

(i) strengthen the EPES and its applications by

(a) improving the quality and reliability of the data gathered; and modifying the EPES to integrate best practices adopted in large enterprises and conglomerates in advanced countries, and evaluation methods followed by large institutional investors in formulating their investment strategies; and

(b) designing a public information dissemination program to disclose the EPES results to the wider public on an ongoing basis;
(ii) **strenthen oversight of SOEs by**

(a) evaluating progress with regard to the corporatization of the SAOCs and their underlying SHCs;

(b) examining the corporate governance norms that apply at present to the SAOCs, SHCs, and SOEs, and assessing their level of compliance with these norms, with focus on their performance and operational practices including (i) nomination and selection of boards of directors (BODs) and management, and the structure of BODs and management bodies and their relative rights and responsibilities; (ii) level of separation between governmental oversight and day-to-day enterprise management; (iii) incentive structures for BODs and management; and (iv) adherence to financial governance principles including accounting, auditing, transparency, and disclosure provisions; and

(c) assessing adherence of central-level SHCs and SOEs with the recently adopted codes of corporate governance conduct for SOEs and listed companies;

(iii) **develop a corporate rating system by**

(a) based on the above, (i) formulating a corporate and financial governance rating system, (ii) translating this into an effective system for monitoring and evaluating performance in all of the above areas that are not covered at present, and (iii) embedding the rating system in the EPES;

(b) initiating a pilot program for at least 25 significant SOEs listed on the stock exchanges to introduce the enhanced EPES, to benchmark and compare corporate governance and financial performance in listed SOEs with that of unlisted SAOCs, SHCs, and SOEs;

(c) designing an appropriate system to determine incentives as well as disincentives based EPES outcomes;

(d) designing a permanent interface between MOF and the People’s Bank of China to share EPES outcomes, to enable the latter to coordinate a well-articulated strategy to deal with current and future nonperforming loans in the banking sector, and, similarly between MOF and CSRC to facilitate effective enforcement of existing legislation; and

(e) implementing the enhanced EPES in the 24 pilot groups of SAOCs that are monitored by MOF, and classifying SAOCs and SHCs into grades based on performance outcomes and the scale and size of enterprises, to facilitate effective remedial measures to address constraints;

(iv) **build capacity for improving corporate governance by**

(a) training a core group of selected officials on modern methods adopted by large enterprises, conglomerates, and institutional investors in developed
economies to assess financial performance and corporate governance norms; and

(b) preparing a comprehensive report outlining recommendations to the State Council to enhance SOE efficiency, with focus on (i) strengthening policy, institutional, legal and regulatory frameworks governing SOEs; and (ii) improving overall governance, within the provisions of the Company Law and other relevant legislation.

B. Cost and Financing

13. The total cost of the TA is estimated at $630,000 equivalent, of which $372,000 is the foreign exchange cost and $258,000 equivalent is the local currency cost. The Government has requested ADB to finance $500,000 equivalent, covering the entire foreign exchange cost and $128,000 equivalent of the local currency cost. The Government will finance the equivalent of $130,000, through the provision of counterpart and workshop facilities. The TA will be financed on a grant basis from the ADB-funded TA Special Fund. Appendix 2 presents the detailed cost estimates.

C. Implementation Arrangements

14. ADB will select and engage a firm using the quality-and-cost-based selection method and a simplified technical proposal in accordance with the Guidelines on the Use of Consultants and other arrangements for the selection and engagement of domestic consultants, to provide for a total of 26 person-months (9 person-months for international consultants and the rest for domestic consultants). Consultants will have expertise in SOE governance, and enterprise performance evaluation and financial analysis. The outline terms of reference for consulting services are presented in Appendix 3.

15. The International Department of MOF will be the Executing Agency for the TA, and will be responsible for all the interagency coordination issues. The Statistics and Evaluation Department of the MOF will be the Implementing Agency for the TA and will be responsible for all the technical implementation issues. MOF will form a project planning and coordination committee, comprising representatives at appropriate levels from State Economic and Trade Commission, CSRC, State Large Enterprises Working Committee, State Development Planning Commission, National Bureau of Statistics, and Ministry of Labor and Social Security. The executing and implementing agencies will organize monthly consultative meetings with the identified agencies, an interim workshop, and a final dissemination workshop followed by tripartite discussions of the findings with ADB. The Government will nominate officials who hold appropriate and sound qualifications and experience in enterprise financial and corporate performance analysis for the training component. Appendix 4 presents further details. The officials will submit a detailed training report on lessons learned and how they plan to incorporate those into their work program. The TA will be implemented over a period of 10 months from the date of commencement of its services.

IV. THE PRESIDENT’S DECISION

16. The President, acting under the authority delegated by the Board, has approved the provision of technical assistance not exceeding the equivalent of $500,000 on a grant basis to the Government of the People’s Republic of China for Improving Corporate Governance and Financial Performance of State-Owned Enterprises, and hereby reports this action to the Board.
## TECHNICAL ASSISTANCE FRAMEWORK

<table>
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<tr>
<th>Design Summary</th>
<th>Performance Indicators/Targets</th>
<th>Monitoring Mechanisms</th>
<th>Assumptions and Risks</th>
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<tr>
<td><strong>Goal</strong></td>
<td>At least 25% improvement in return on equity and return on assets in listed SOEs</td>
<td>Published reports</td>
<td>Political willingness to divest state shareholdings, introduce major board-level changes in large SOE groups, and penalize poorly performing SOEs</td>
</tr>
<tr>
<td></td>
<td>Divestment of the nontradable shares in listed SOEs expedited</td>
<td>Consultations with the Government and related SOE monitoring agencies</td>
<td></td>
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<tr>
<td></td>
<td>Board members and management appointed in line with legislation in all listed SOEs</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Purpose</strong></td>
<td>Revised EPES in place</td>
<td>Review missions</td>
<td>SHC level willingness to cooperate in the implementation of enhanced EPES</td>
</tr>
<tr>
<td></td>
<td>EPES outcomes fully available for at least 40% of the individual SOEs in the current pilot group of 24 state holding companies</td>
<td>EPES reports</td>
<td>Government’s commitment in implementing the enhanced EPES and formulating effective management polices to improve governance in SOEs</td>
</tr>
<tr>
<td></td>
<td>Report to the State Council</td>
<td>Final recommendations to the State Council</td>
<td></td>
</tr>
<tr>
<td><strong>Outputs</strong></td>
<td>Initial revision to be completed within 2 months of technical assistance inception</td>
<td>EPES methodology published through guidelines</td>
<td>Commitment of the Ministry of Finance and other relevant agencies to collaborate and share information from their oversight territories</td>
</tr>
<tr>
<td>1. Revised EPES, based on a review of the current methodology</td>
<td>Design of the corporate governance rating system available</td>
<td>Evaluation outcomes in the initial set of SOE groups</td>
<td></td>
</tr>
<tr>
<td>2. Corporate governance rating system</td>
<td>Enhanced EPES available within 4 months of TA</td>
<td>Reports published</td>
<td>Willingness of SOE groups to participate</td>
</tr>
<tr>
<td>3. Enhanced EPES with the corporate rating process embedded</td>
<td>Enhanced EPES available within 4 months of TA</td>
<td>Consultations with</td>
<td></td>
</tr>
<tr>
<td>4. Enhanced public information dissemination program</td>
<td></td>
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</tbody>
</table>
### Appendix 1

#### 5. Recommendations to design sound incentive structures, as part of the report to the State Council

<table>
<thead>
<tr>
<th>Timeframe</th>
<th>Activities</th>
<th>Outputs</th>
<th>Recommendations</th>
</tr>
</thead>
<tbody>
<tr>
<td>months of the TA inception</td>
<td>First round of EPES outcomes supported by TA published in news media</td>
<td>Completed report to the State Council</td>
<td>Market participants (for monitoring listed SOEs)</td>
</tr>
</tbody>
</table>

#### Activities

- All items identified in the Methodology and Key Activities Section of the TA paper
- Preparation of a comprehensive report to the State Council, based on analysis, interviews, consultations with SOEs, and evaluation of the current practices
- Consultation and dissemination workshops
- External training program for selected officials, aimed at increasing awareness of internationally accepted sound practices for evaluating financial and corporate governance performance in large enterprises and conglomerates

#### Outputs

- Sound progress demonstrated by timely submission of interim assessments
- Report finalized
- Workshop materials and outcomes
- Final training report from those participating in the external training activities
- Consultants’ and the government’s reports
- Monthly consultation meetings, and interim and final workshops
- Final review meeting
- Availability of counterpart support, and full cooperation between all the relevant government agencies

#### Inputs

- 26 person-months of consulting services, comprising 9 person-months of international consulting inputs of an enterprise evaluation expert and an SOE governance expert; and 17 person-months of domestic consulting inputs in enterprise evaluation, SOE governance, and statistics and system design areas
- Periodic reports
- Delivery of quality advisory services
### COST ESTIMATES AND FINANCING PLAN
($'000)

<table>
<thead>
<tr>
<th>Item</th>
<th>Foreign Exchange</th>
<th>Local Currency</th>
<th>Total Cost</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>A. Asian Development Bank Financing</strong>&lt;sup&gt;1&lt;/sup&gt;</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. International Consultants</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>a. Remuneration (9 person-months)</td>
<td>231,000</td>
<td>0</td>
<td>231,000</td>
</tr>
<tr>
<td>&amp; per diem</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>b. International Travel</td>
<td>15,000</td>
<td>0</td>
<td>15,000</td>
</tr>
<tr>
<td>2. Domestic Consultants - Remuneration (17 person-months)</td>
<td>0</td>
<td>68,000</td>
<td>68,000</td>
</tr>
<tr>
<td>3. Domestic Travel and Inspection Visits to SOEs</td>
<td>0</td>
<td>15,000</td>
<td>15,000</td>
</tr>
<tr>
<td>4. Equipment and Software Design</td>
<td>10,000</td>
<td>20,000</td>
<td>30,000</td>
</tr>
<tr>
<td>5. External Training</td>
<td>55,000</td>
<td>0</td>
<td>55,000</td>
</tr>
<tr>
<td>6. Translation and Communication</td>
<td>0</td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td>7. Interim and Final Workshops</td>
<td>0</td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td>8. Contract Negotiations</td>
<td>5,000</td>
<td>0</td>
<td>5,000</td>
</tr>
<tr>
<td>9. Contingencies</td>
<td>56,000</td>
<td>5,000</td>
<td>61,000</td>
</tr>
<tr>
<td><strong>Subtotal (A)</strong></td>
<td>372,000</td>
<td>128,000</td>
<td>500,000</td>
</tr>
<tr>
<td><strong>B. Government Financing</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Office/Logistical Support</td>
<td>0</td>
<td>40,000</td>
<td>40,000</td>
</tr>
<tr>
<td>2. Support from the Pilot Group of SOEs</td>
<td>0</td>
<td>30,000</td>
<td>30,000</td>
</tr>
<tr>
<td>3. Compilation of Data</td>
<td>0</td>
<td>40,000</td>
<td>40,000</td>
</tr>
<tr>
<td>4. Workshops</td>
<td>0</td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td>5. Domestic Transportation</td>
<td>0</td>
<td>10,000</td>
<td>10,000</td>
</tr>
<tr>
<td><strong>Subtotal (B)</strong></td>
<td>0</td>
<td>130,000</td>
<td>130,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>372,000</td>
<td>258,000</td>
<td>630,000</td>
</tr>
</tbody>
</table>

<sup>1</sup> Financed from ADB’s TA Special Fund
SOE=state-owned Enterprises
Source: Asian Development Bank estimates.
OUTLINE TERMS OF REFERENCE FOR CONSULTANTS

1. The TA will provide for the advisory services of 9 person-months of international and 17 person-months of domestic consultants. The terms of reference are provided to outline indicative tasks, and the consultants will be required to undertake any other related tasks in order to fulfill the objectives of the technical assistance (TA).

A. International Consultants

1. Enterprise Evaluation Specialist, Team Leader—5 person-months

2. The enterprise evaluation specialist will have high-level academic qualifications, preferably in financial analysis, and in evaluating the overall operational, economic, and financial performance of enterprises with different ownership structures. Prior experience in the state-owned enterprises (SOE) sector in the People's Republic of China (PRC) is preferable. The specialist will

   (i) advise the Ministry of Finance (MOF) on internationally accepted practices for evaluating financial and operational performance in large enterprises and conglomerates and refine the current standard enterprise performance evaluation system (EPES) and its subindexes by incorporating elements of corporate and financial governance ratings of SOEs;

   (ii) review the Rules on Evaluation of State Capital Fund Efficiency and the Detailed Rules for the Implementation of Methods for Evaluation of State Capital Fund Efficiency, and provide recommendations, as appropriate, to improve the methodology of evaluation;

   (iii) review the report, “Performance Evaluation Method and Standard for State-owned Enterprises,” and critically evaluate and revise the theoretical basis and operational elements of scheme;

   (iv) review the EPES index and its reliability and benefits, and recommend how to improve it;

   (v) review the performance of the 24 pilot SOE groups to refine, test and implement the EPES at the central level in the PRC—this will be preceded by a field-visit to test the accuracy and reliability of data and information, and to explore implementation of an enhanced EPES at the headquarters level of 6 SOE groups; and the rest will be based on published outputs available from the SOE groups;

   (vi) offer recommendations on effectively using the findings of EPES to streamline the state share management and internal corporate management within the SOEs;

   (vii) advise the government on the application of EPES by examining how its outcomes could be linked with decisions on assignment of managers, their incentive structures and policy and regulatory incentives;

   (viii) develop EPES to serve as a tool for early warnings, integrating overall economic and financial sector concerns, and establish a technical interface between EPES outcomes, People's Bank of China, and China Securities Regulatory Commission regulatory practices to effectively use the results in enforcing existing legislation;

   (ix) integrate “upstream” link into the EPES, i.e., between enterprise level performance and decisions on revenue distribution to State Asset Operating Corporations (SAOCs) and State Holding Companies (SHCs); examine also the means for linking EPES outcomes with the role played by SAOCs/SHCs through
incentives or constraints, and decisions on appointment or removal of SAOC/SHC level officials;

(x) in coordination with the SOE governance expert, integrate effectively the financial and other indicators used in the current EPES system with the corporate governance rating system developed under the TA;

(xi) based on all of the above, support MOF in (a) improving the EPES (including evaluation standards and methods and the index system) for all SOEs, enterprises listed on the stock exchanges, and state-owned financial institutions, and (b) effectively coordinating with the State Economic and Trade Commission, Ministry of Labor and Social Security, and other key agencies in getting their concurrence for the EPES designs;

(xii) provide advisory support to staff of MOF and other agencies (as required) working on EPES; design an appropriate training program and conduct capacity building workshops focusing on (a) sound practices in enterprise performance evaluation adopted in other countries; (b) basic evaluation methodologies; and (c) effectively using EPES outcomes to design proper schemes to strengthen enterprise performance;

(xiii) provide advisory support to the domestic statisticians and software/system designers, to ensure coherence between the improved conceptual basis for the EPES, and data and system design;

(xiv) based on the work undertaken, prepare a guide on the EPES, as a reference manual for MOF and other staff;

(xv) advise MOF in designing a public information dissemination system to make the EPES results publicly available on a continuous basis;

(xvi) provide advice, contacts, and coordination support for the international training component, and coordinating support as needed, as outlined in Appendix 4;

(xvii) oversee the inputs of all the domestic consultants and coordinate with the SOE corporate governance expert in all aspects of the TA; and

(xviii) prepare a detailed report for the State Council (as outlined in the scope of the TA) summarizing all the technical findings and recommendations stemming from the above tasks, with the corporate governance inputs integrated, and based on inputs provided by the SOE governance expert and the domestic experts for their tasks.

2. State-owned Enterprise Governance Expert—4 person-months

3. The SOE governance expert will have high-level academic qualifications in an appropriate discipline, and significant experience in evaluating the internal and oversight structures in place to ensure good corporate and financial governance in SOEs. Preferably the expert will have had prior experience in similar projects in the PRC. With focus on entities owned by the central Government, the expert will

(i) support the enterprise evaluation specialist (team leader) in all aspects of improving the EPES;

(ii) assess the current EPES, particularly its qualitative and governance-related features; evaluate if the EPES is adaptable, in its current form, for integration of subindexes that capture the corporate governance performance of SAOCs, SHCs, and the SOEs; if the EPES is not readily adaptable, provide initial recommendations on reorienting it to achieve that goal;

(iii) based on inputs from the domestic consultants, oversee the preparation of a full mapping of the SAOCs, SHCs, and SOEs under the SAOC-SHC groups, for at
least the 20 largest SAOCs that have significant central Government share ownership; and compile data on shareholdings by categories at the level of the individual SOEs in the selected SAOCs;

(iv) oversee the work of domestic consultants to compile data and analyze the trends, over the last 5 years, in budgetary transfers, loans, innovation grants, subsidies for capital expenditures, and all other types of transfers to the SOEs through the SAOCs/SHCs, in line with paragraph 2(v), and field-test the accuracy and reliability of data from at least 6 SOE groups;

(v) assess the corporate governance structures in place at the SAOCs, SHCs, and SOEs against the legal and regulatory requirements established by the Government; in particular, examine the board structures (subject to the entities being corporatized), appointment practices to the boards of directors and management, managerial autonomy, conduct of shareholders meetings including annual general and other extraordinary meetings (if appropriate, as many groups may not have any private shareholdings), incentive systems, internal controls and audit functions, risk management (if appropriate), and financial disclosure practices, among others;

(vi) examine the oversight structure, particularly the extent of separation between the government (central or provincial level) and SAOCs, SHCs, and SOEs, in terms of managerial functions; assess whether sufficient safeguards are in place to protect the interests of minority and outside investors;

(vii) evaluate the legal requirements on corporate governance, including provisions in laws, codes, or guidelines, and assess whether the enforcement framework is sound; then, given the widespread concerns that the governance practices in general are not sound in SHCs or SOEs, assess if legal or regulatory requirements are stringent enough;

(viii) assess the degree of adherence of central-level SHCs and SOEs with the recently adopted Code of Corporate Governance Conduct for SOEs;

(ix) based on the above, formulate a corporate and financial governance rating system, which captures quantitatively and qualitatively the state of corporate governance in the central government–owned entities; and translate this into an effective system for monitoring and evaluating performance and outcomes in all of the above areas that are not covered at present in EPES, and embed such a system in the EPES, based on the recommendations provided as outlined in paragraph 3(i);

(x) initiate a separate pilot program for selected SOEs listed on the stock exchanges to introduce the enhanced EPES, for benchmarking and comparing corporate governance and financial performance in listed SOEs that are monitored by the market with that of unlisted SHCs and SOEs that are supervised by the SAOCs;

(xi) support the Government in implementing the enhanced performance evaluation system in the pilot group of SAOCs that are being monitored by MOF, and classify SAOCs and SHCs into different grades based on outcomes, to facilitate formulation of effective remedial measures to address any weaknesses and constraints;

(xii) provide advice and contacts on the training component (Appendix 4) to the team leader, and coordinating support as needed;

(xiii) provide inputs in designing a public information dissemination system to make the corporate governance ratings and the EPES outcomes available to the public on a continuous basis; and

(xiv) based on the above, prepare a report on SOE governance and linkage between good governance structures and improvements in overall economic efficiency
and economic performance, incentive structures etc., for integration into the Report to the State Council.

B. Domestic Consultants

4. Three domestic consultants will be recruited to support the work of the international consultants. An enterprise evaluation expert will be recruited for 7 person-months, a systems designer and statistician for 6 person-months, and an SOE governance expert for 4 person-months. All domestic consultants will be able to speak, read, and write fluently in English. The outline terms of reference for the evaluation and governance experts will mirror those of the international experts in these areas.

1. Enterprise Evaluation Expert

5. The expert’s terms of reference will include but not be limited to

(i) undertaking overall responsibility for compiling all relevant data and materials on the selected 24 pilot SOE groups—initially, field testing will be done in 6 selected pilot SOE groups to verify the accuracy and reliability of the data provided by the SOE groups; data for the other SOE groups will be collected through questionnaires or regulatory reporting to the Government;

(ii) participating in all reviews and assessments conducted by the international experts, and coordinating all activities with the 24 selected SOE groups; in particular, the domestic expert will focus on conducting a preliminary assessment of the Rules on Evaluation of State Capital Fund Efficiency and the Detailed Rules for the Implementation of Methods for Evaluation of State Capital Fund Efficiency, and the research report on Performance Evaluation Methods and Standards for State-Owned Enterprises;

(iii) undertaking partially (coordinating with the international and domestic experts) the responsibility for mapping the organizational and functional structures of SAOCs, SHCs, and SOEs; and

(iv) supporting all aspects of strengthening the EPES methodology, and contributing to the analysis and preparation of all interim and final reports in English—in particular, the expert will submit at least an interim report (within 2 months of the TA inception) and a final report (within the time-frame to be decided by the team leader) on enterprise performance evaluation, with a section on the data compilation initiatives, for integration in the team leader’s reports.

2. SOE Governance Expert

6. The expert’s duties will include the following:

(i) providing overall support to the team and the international SOE governance expert in all governance-related dimensions of the TA;

(ii) undertaking the exercise to compile and prepare the organizational and functional structures of the SAOCs, SHCs, and SOEs, with close coordination and supervision of the international expert;

(iii) compiling data and analyzing the trends over the last 5 years in budgetary transfers, loans, innovation grants, subsidies for capital expenditures, and all other types of transfers to the SOEs through the SAOCs and SHCs;
(iv) reviewing the legal framework governing the corporate governance, internal control, and external oversight structures for SAOCs, SHCs and SOEs; and
(v) supporting all aspects of corporate governance assessment and rating exercises for the SOEs, and contributing to the overall analysis and preparation of all interim and final reports in English—in particular, the expert will submit at least an interim report (within 2 months of the TA inception) and a final report (within the time-frame to be decided by the team leader) on SOE governance assessment, for integration in the governance expert’s and team leader’s reports.

3. Systems Designer and Statistician

7. The consultant will have advanced qualifications in designing data analysis tools for large data systems, and preferably in areas closely related to enterprise performance evaluation. Among other tasks to be identified during the implementation of the TA, the consultant will

(i) support the team leader’s tasks by providing adequate interface in systems capacity assessment (including hardware and software) and data quality and reliability;
(ii) assess the current data analysis system and design modules for integrating the corporate governance rating system into the EPES;
(iii) support the team in compiling adequate data and improving the data quality;
(iv) test the enhanced EPES to ensure consistency and reliability for full implementation; and
(v) prepare and submit at least an interim report (within 2 months of the TA inception) and a final report (within the time-frame to be decided by the team leader) on system design and statistics, for integration in the governance expert’s and team leader’s reports.

C. Reporting Arrangements

8. The team leader will be responsible for preparing (i) brief monthly progress reports, providing updates on implementation until the project is completed; (ii) an interim report, to be submitted 2 months after the initiation of the TA (which could be combined in an enhanced monthly report); and (iii) a draft final report, 2 weeks prior to the completion of the tasks under the TA. The draft final report will be revised and resubmitted, upon receiving comments from the Government and ADB. The SOE governance expert (international) will be responsible for submitting reports on all governance related matters to the team leader as often as needed, and will oversee the work of the domestic expert in this area.
1. The enterprise performance evaluation system has three major shortcomings: (i) its financial indexes do not capture all the details that are necessary to assess enterprise performance; (ii) it does not include any assessment of financial or corporate governance structures in place in the state-owned enterprises, despite the significant problems in this area; and (iii) its outcomes are not linked to the design of incentives (or disincentives). As a result, the enterprise performance evaluation system has become a static tool.

2. While there are no countries with which to compare the People’s Republic of China’s state-owned enterprises evaluation practices, many large enterprises and financial and corporate conglomerates conduct periodic performance assessments. Major institutional investors (the California Public Employees’ Retirement Fund–CALPERS, for example) have pioneered enterprise assessment methodologies to evaluate the stability and profitability of investment options. Such assessments have also focused on corporate governance structures in corporations or holding groups.

3. The purpose of the proposed training component is to integrate international practices adopted in advanced economies to assess financial and corporate performance. The training will comprise overseas visits to one or two selected countries, and up to three officials will be included in the training activities. Given the focus of the training, the officials will have a background and prior training in economics and finance; they will also be conversant in the English language. The selection of the participating officials, as well as the countries, conglomerates and other organizations to be visited, will be carried jointly by the Government and the ADB, with inputs and coordination support provided by the team of consultants. The training will consist of the following:

   (i) **Advanced Courses in Corporate Financial Analysis**: a 2–3 week training course on advanced methods in corporate financial and operational performance analysis will be identified;

   (ii) **Consultation Visit to 2–3 Large Conglomerates**: discuss and learn international practices for enterprise performance evaluation and design of incentive structures;

   (iii) **Consultation Visit to Institutional Investors/Credit Rating Institutions**: to understand recent measures to assess corporate and financial governance outcomes in corporations in the United States/Europe and elsewhere; and

   (iv) **Consultations with Securities Market Regulator(s)**: to understand how securities regulatory bodies assess compliance with corporate governance norms, and if any early warning systems are available.

4. All the participating officials will submit a comprehensive report in English to ADB, outlining clearly (i) the goal that they had set; (ii) the purpose of participating in the training; (iii) the activities undertaken during the training; (iv) the accomplishments; and (v) how the training findings will be integrated in their day-to-day work in the Government.