

---

## **CORPORATE GOVERNANCE OF THE BKV – WHO IS RESPONSIBLE FOR THE SCANDALS?**

**Gabriella Keczer**

Institution of Rural Development and Economics  
University of Szeged, Faculty of Engineering  
Szeged, Mars tér 7.  
keczergabriella@gmail.com

### **ABSTRACT**

Corporate governance is an internal system encompassing policies, processes and people, which serves the needs of shareholders and other stakeholders, by directing and controlling management activities with good business savvy, objectivity, accountability and integrity. In the case of government-owned companies orderly operation and management is crucial, since they are spending the property of the tax-payers. In the greatest corporate scandal in Hungary, that of the BKV millions of Euros were wasted on fictitious services. The case has several considerations on corporate governance regulation and practice in Hungary. In my paper, as a case study, I present the corporate governance system of the BKV and analyze the responsibilities concerning the BKV scandals from an organizational point of view.

### **1. INTRODUCTION: BKV AND THE BKV SCANDAL**

BKV is a closed company limited by shares, with the Metropolitan Government as its founder and owner (shareholder). It is in charge of public transport of the capital and its surroundings, operating five large sections of public transport (bus, tram, subway, suburban railway line, trolleybus) in an integrated system. The fleet of BKV vehicles accomplish nearly 1.4 billion passenger rides annually. The capital of BKV amounts to HUF 127 billion, registered in shares. The company faces financial difficulties, its revenues do not provide sufficient coverage for its expenditures. In 2008, the balance sheet loss of BKV amounted to HUF 5.7 billion, its operation could only be maintained through taking up a credit (HUF 4.5 billion in total) and utilizing considerable state subsidy (HUF 70.5 billion). In December 2008, the company received a single-sum reimbursement from the state, which amounted to HUF 10 billion. The price supplement granted was over HUF 17 billion (source: BKV Annual Report for 2008). At present, BKV has a total external debt of 90 billion forints, with the company's estimated internal debt amounting to HUF 350–700 billion (source: Report of the Commission of Inquiry of the Metropolitan General Assembly).

Starting from 2007, a number of scandals related to BKV have occurred. They may be assigned to two groups: those concerning the salaries and severance pay of top employees, and those associated with consultation and other contracts. Several people are now under arrest charged with embezzlement because they had concluded contractors' and service agreements on behalf of BKV, despite its loss-making operation, for the provision of unjustified and unnecessary services, or endorsed performance thereof, thereby causing the transport company damage to property amounting to more than HUF 100 million. Also several people have been arrested because of the salaries and severance payments. Extra payments were made on 48 occasions and the company suffered a damage amounting to around half a billion HUF.

## 2. CASE STUDY

### 2.1. Corporate governance of BKV

#### *The owner*

In accordance with Act no. IV of 2006 on Business Associations, the supreme body of a company limited by shares is the general meeting. However, no general meeting functions in the event of a single-member company limited by shares, and the sole member is entitled to decide, through written resolutions, on all issues falling within the competence specified in the deed of foundation of the company (source: Act on Business Associations). In case of BKV, the body exercising the founding members' rights of a single-member closed company limited by shares is the general assembly of the capital city (the "city assembly"), or a committee thereof. The related details of operation of the founding member are determined in the rules of organization and operation of the Metropolitan Government (the "Metropolitan Government Rules").

Since the change of the political regime in 1990, a liberal-social majority has operated the Metropolitan Government, with Gábor Demszky being the mayor (Free Liberal Party). The recent 66-member board of representatives which was formed after the local government elections in 2006, consists of 24 Socialist, 26 Young Democrat, 4 Christian Democrat, 9 Free Liberal, and 3 Hungarian Democratic Forum members (Source: the Metropolitan Government).

The city assembly as the body exercising the rights and fulfilling the obligations of the single-member BKV closed company has transferred the above owner's competence of the Metropolitan Government to the Economic Committee of the city assembly in the Rules (source: the Metropolitan Government Rules).

In pursuance of the Act on Business Associations, several rights, among them certain rights relevant for the present research, fall within the exclusive competence of the supreme body of the company:

- establishment and modification of the statutes;
- election, withdrawal, and specification of remuneration of the members of the board of directors, the chief executive officer, the members of the supervisory board, and the auditors;
- adoption of the annual report;
- decision on all issues that fall within the exclusive competence of the general meeting in pursuance of the statutes or the law.

(Source: Act on Business Associations)

Compared to that set forth in legal regulations, the Deed of Foundation of BKV extends the scope of issues falling within the exclusive competence of the founder with the following founder's rights that are relevant for the present research:

- approval of the annual business plans of the company,
- approval of the rules of operation of the board of directors and the rules of functioning of the supervisory board ("SB").
- elaboration of the rules regulating the system of remuneration of senior officers and top managers of the company (wages, severance pay, other personal payments).

The founder reviews and evaluates the following documents and/or activities pertaining to the present research, and makes the relevant decisions:

- report of the board of directors on the management of the company during the previous year, its assets and business policy,
- report of the SB on the review of the annual report and the proposal regarding the utilization of profits,

- auditor's report,
- remuneration of the board of directors, the SB, the auditor, and the chief executive officer.

(Source: Deed of Foundation of BKV in the version valid as of April 11, 2010)

#### ***Professional monitoring***

From December 21, 2006, the supervision of public utility companies, business associations performing public utility activities, and also trust administrator companies owned by the capital city, including BKV, were the task of one person, the vice-mayor in charge of city operation and trust administration, Mr. Miklós Hagyó (socialist). Starting from March 06, 2007, these tasks were carried out in conjunction with Mr. Imre Ikvai-Szabó (free liberal), vice-mayor in charge of city development, management, and social policy, in such a way that the activities of the above companies solely related to economic management were relegated to Mr. Imre Ikvai-Szabó.

On September 03, 2009, Mr. Miklós Hagyó left his office as the officer in charge of supervision of BKV., and the related roles went over to Mr. Csaba Horváth (socialist), vice-mayor in charge of Culture and Education. As the socialist-free liberal coalition broke up on December 22, 2009, Mr. Imre Ikvai-Szabó remained the only functioning vice-mayor, so he took over Csaba Horváth's tasks connected to BKV (see Note 1) (source: Report of the city assembly Commission of Inquiry)

#### ***Internal management***

BKV has a two-tier internal management system, that is, the company operates a board of directors (executive board) and a supervisory board.

#### ***The board of directors***

The management of a closed company limited by shares may be carried out either by a single person, that is, the chief executive officer, or the board of directors as a body. The law also provides an opportunity for senior officers to grant the right of representation in various matters to certain groups of employees. Pursuant to the Act on Business Associations, the executive officer of the company exercises the employer's rights vis-à-vis the employees of the company. The law also allows exercising the employer's rights to be delegated to some employee at a lower level of the working organization.

As the law provides, the executive officer is required to conduct the management of the business association with the increased care generally expected from persons occupying such positions, give priority to the interests of the business association, and report to the shareholders in the course of fulfilling his duties. The board of directors is required to prepare a report on the management, the financial situation and the business policy of the company at the regular intervals set forth in the deed of foundation (statutes), but at least once every year for the general meeting, and at least once every three months for the supervisory board.

According to the ruling of the Act on Business Associations, the board of directors shall consist of at least three and at most eleven members. Act no. CXXII of 2009 on the More Economical Operation of Publicly Owned Business Associations specifies the number of members of the board of directors of closed companies limited by shares as an exception to the ruling contained in the Act on Business Associations. It defines the number of members of the board of directors to be minimum three and maximum five. If the business association concerned qualifies as a company of special importance for the national economy, the maximum number of the members of the board of directors is limited to seven. The particular number of members of the board of directors is fixed, within the confines

permitted by law, in the Deed of Foundation of the given company (source: Act on Business Associations and Act no. CXXII of 2009).

The Deed of Foundation of BKV Zrt. regulates the operation of the board of directors as follows:

The board of directors is the management body of the company which acts as an independent body exercising its scope of rights in the course of meetings of the board of directors. The board of directors consists of 5 to 7 members appointed by the founder. The board of directors performs the following duties relevant for the present research:

- establishment of the business organization of the company
- passing decisions related to the financial management of the company
- preparation of business plans and annual reports for the founder
- preparation of written reports for the founder on the management and operation of the company on a semi-annual basis
- preparation of quarterly reports for the SB on the management and operation of the company
- establishment of the Rules of the company
- exercising the rights associated with the legal relationship of the chief executive officer (except those granted to the founder)
- taking necessary measures that may be required pursuant to assumptions formulated by bodies involved in the external or internal control of the company.

As the task at hand is a public duty and the founder is responsible for the public services, and because the owner's participation is vested exclusively in the local government of the capital city, the executive officer is obliged to proceed in accordance with the instructions of the person acting on behalf of the founder. The founder is entitled to withdraw or limit the executive officer's competence (source: Deed of Foundation of BKV in the version valid as of April 11, 2010).

#### *The Supervisory Board*

The basic duty of the SB is to monitor the management of the company in the founders' interests, and is liable for its activity towards the shareholders. In accordance with the provisions of the Act on Business Associations regarding the number of the members of the supervisory board, the supervisory board may consist of at least three and at most fifteen members. Act no. CXXII of 2009 on the More Economical Operation of Publicly Owned Business Associations has reduced the number of members of the supervisory board of publicly owned companies as well: in case the registered capital of the company exceeds two hundred million HUF, that number may vary between three and six members. The order of operation of the supervisory board is approved by the supreme body of the company.

The Act on Business Associations regulates the operation of supervisory boards as follows. The board of directors is required to inform the supervisory board on the management and the financial situation of the company at least once every three months. The supervisory board may directly inform the owners, by way of a meeting of the supreme body of the company, about irregularities and deficiencies established from the reports or revealed in the course of supervision. While performing his supervisory function, a member of the supervisory board is entitled to request information from the executive officers or the managerial employees of the company. Members of the supervisory board may inspect the books and documents of the company, review and investigate them. As a most important security and a major regulation for the protection of public interest, the supreme body of the company may pass a resolution regarding the adoption of the annual report prepared

by the board of directors in compliance with the provisions of the act on accounting only in possession of the written report of the supervisory board. If, in the judgment of the supervisory board, the activity of the executive officers is contrary to the law, the deed of foundation or the resolutions of the general meeting, or otherwise infringes on the interests of the company or its members, the supervisory board has the right to call an extraordinary meeting of the supreme body (general meeting) and simultaneously propose its agenda (source: Act on Business Associations).

As regards BKV, there are several legal provisions which make the establishment of the SB mandatory. The SB consists of 3 to 6 members. Two-thirds of the members are appointed by the founder, and one-third is elected by the plant council from among the employees.

The Deed of Foundation of BKV regulates the operation of the SB in the areas relevant for the present research in the following way. The SB is required to supervise the management of the company and its business policy decisions for the founder on a regular basis. The founder may pass a valid resolution on the annual report and the appropriation of after-tax profits only in possession of the findings of the supervision of the SB. The auditor is obligated to inform the founder and the SB if he learns about a fact that appears to confirm the responsibility of the executive officer or the members of the SB. The supervisory board is entitled to request a report or information from the executive officers or the managerial employees of the company. The requested report or information shall be provided to the SB within a period of fifteen days. The SB has the right to inspect the books, documents, and petty cash of the company at any time, if necessary, through the inclusion of experts. Members of the SB are obliged to perform their duties with the care generally expected from persons occupying such positions. They are liable to the company in accordance with the rules of civil law for damages caused to such by violation of their duties (source: Deed of Foundation of BKV in the version valid as of April 11, 2010).

#### *The management*

The management of BKV is in charge of the daily operation of the company. In accordance with the rules of organization and operation, the management is comprised of the following offices:

- the chief executive officer,
- the deputy chief executive officers.

(Source: Report of the city assembly Commission of Inquiry)

The chief executive officer is a member of the board of directors. As the manager in charge of the business organization, he exercises the employer's rights, which he may transfer to other managers of the business organization (source: Deed of Foundation of BKV in the version valid as of April 11, 2010).

The chief executive officer of the company — both as a member of the board of directors and as the person entitled to use the chief executive officer's title — is appointed and commissioned exclusively by the founder, who is also exclusively entitled to decide on his withdrawal and the establishment of his remuneration. All other rights in respect of the legal relationship of the chief executive officer are exercised by the board of directors as an independent body.

The scope of competence of the chief executive officer as a senior officer is specified in the Rules. In accordance with the relevant provisions, the chief executive officer is empowered to establish the detailed rules of organization and operation of the business organization within the confines of the Rules. The Rules sets out the major authorizations of the chief executive officer, viz., the right to make decisions and measures individually in

any matters not falling within the exclusive competence of the owner or the executive body of the company, and also to assign any decisions and measures in the business organization to his own sphere of competence (source: Report of the city assembly Commission of Inquiry).

The following persons were chief executive officers of BKV in the period of this research:

Botond Aba, from July 01, 1993 to December 31, 2006; Attila Antal, from January 01, 2007 to April 15, 2008; Zsolt Balogh (appointed chief executive officer), from February 19, 2008 to December 31, 2008; Dr. István Kocsis, from September 01, 2008 on (source: Deed of Foundation of BKV in the version valid as of April 11, 2010).

The tasks and competence of the deputy chief executive officers are regulated in the Rules. In the period under review, the following positions of deputy chief executive officer existed at BKV (which changed frequently, on a total of 4 occasions during the three-year period): deputy chief executive officer in charge of transport, deputy chief executive officer in charge of financial management, deputy chief executive officer in charge of investment and public procurement, deputy chief executive officer in charge of DBR Subway, deputy chief executive officer in charge of technical issues, deputy chief executive officer in charge of sales and communication, general and technical deputy chief executive officer (source: Report of the city assembly Commission of Inquiry)

#### *The auditor*

The auditor is appointed by the founder for a period of 4 years. The board of directors proposes the person to be appointed as the auditor, upon the approval of the supervisory board. The auditor reviews all annual reports and any other reports submitted to the founder, for their compliance with reality and legality. The auditor may inquire about the management of the company. The auditor is obliged to inform both the founder and the SB if he learns about a fact that appears to confirm the responsibility of an executive officer or the members of the SB regarding an issue. In the period under review, the auditor of BKV was the Deloitte Ltd. (source: Deed of Foundation of BKV in the version valid as of April 11, 2010).

## **2.2. Authorities and responsibilities in the BKV scandals**

Corporate governance is an internal system encompassing policies, processes and people, which serve the needs of shareholders and other stakeholders, by directing and controlling management activities with good business savvy, objectivity, accountability and integrity. Sound corporate governance is reliant on external marketplace commitment and legislation, plus a healthy board culture which safeguards policies and processes. (O'Donovan, 2003) Corporate governance ensures that boards are able to exercise appropriate scrutiny over management and that shareholders, as owners of the company, are able to hold boards accountable. (Angyal 2001) As such, a high level of corporate governance contributes significantly to investors' confidence and market stability, thus fostering business efficiency. (Frydman-Rapaczynski 1994)

Appropriate financial management is of special importance in case of companies financed by public money, since such firms spend Hungarian taxpayers' money. Accordingly, it is crucial for such companies that the activity of their management is appropriately controlled both internally and externally, in the direct interest of the owner municipality and also the taxpayers financing them indirectly.

In theory, the Act on Business Associations provides for the control over the operation of the companies by clearly identifying the responsibilities and scopes of action of the management, the supervisory board, and the owner. The system, however, failed to function appropriately in practice in the case of BKV. On the one hand, the bodies that are in charge of controlling the management of the company failed to detect and/or prevent wasting taxpayers' moneys both inside and outside the company. On the other hand, one cannot exclude the possibility that the owner's representative abused of the owner's rights and interfered with the company's internal operation with the purpose to acquire moneys for himself, rather than safeguard public moneys.

The SB claims they had no information about the agreements that were disadvantageous for BKV, and the law does not provide the supervisory board with sufficient room for manoeuvring. In line with the ruling of the Act on Business Associations, the board of directors is required to prepare a report on the management, the financial situation and the business policy of the company for the supervisory board at least once every three months. Each member of the supervisory board is entitled to request information from the executive officers or the managerial employees of the company. Members of the supervisory board may inspect the books and documents of the company, review and investigate them. If the supervisory board finds that some activity is contrary to the law or there is some deficiency in the operation of the company, it may notify the owners accordingly. All these opportunities granted in the Act on Business Associations would have enabled the SB to supervise the operation of the company more strictly, detect the abuse, and notify the owner. The case at hand does not represent an anomaly of the relevant regulations, rather, it is a case where the SB failed to use the authorization granted to it and did not meet its obligation set forth in the Deed of Foundation of BKV: „to supervise, on a regular basis, the management of the company and its business policy decisions”, and „members of the SB shall conduct their duties with the care generally expected from persons occupying such positions.”

The owner also referred to its lack of awareness of the things going on at BKV. According to the ruling of the Act on Business Associations, specification of remuneration of the members of the board of directors and the chief executive officer fall within the exclusive competence of the supreme body of the company, thus it is difficult to see why city assembly did not know about the severance paid to the chief executive officers. Pursuant to the Deed of Foundation of BKV, approval of the annual business plan of the company, review and adoption or rejection of the report of the board of directors on management and business policy, as well as adoption of the report of the supervisory board and the auditors also fall within the exclusive competence of the supreme body of the company. In addition, decisions regarding issues which the statutes refer to the exclusive competence of the general assembly also fall within the exclusive competence of the supreme body of the company. Consequently, the city assembly may have reserved the right of decision in any of the issues raised. That would have enabled the owner to impose more stringent control over the operation of the company and, thus, identify cases of abuse and put an end to them. In other words, here, too, the case has nothing to do with any anomaly of the relevant regulations, rather, it is a case where the owner failed to use the authorization granted to it.

As far as the other aspect of the issue at hand, that is, the owner's interference with the operation of BKV for its own purposes is concerned, the underlying regulation appears to raise problems. As the Deed of Foundation of BKV rules, the owner is responsible for the provision of public services, and, since only the local government has an owner's participation, the executive officer is obligated to proceed in accordance with the instructions of the person representing the founder. This ruling formulated in a general manner in practice allows the owner to manually control the day-to-day operation and administration of the company, thereby releasing the company management all of its responsibility.

### 3. CONCLUSIONS AND PROPOSALS

It follows from the above considerations that the inappropriate functioning of the SB is related to the poor performance of its members, rather than to a deficiency in legal regulations. Consequently, the present practice of delegating party representatives as members to the supervisory boards of publicly owned companies deserves reconsideration. As a more appropriate solution, members in such bodies should be dedicated and qualified experts who are, at least formally, independent of the parties, and capable of, and dedicated to, exercising the necessary control over the management of the companies.

It also follows from the above that it was due to distorted application of the law, rather than to some deficiency in legal regulations, that the owner's control turned into representation of self-interest instead of protection of the public interest. It appears that the practice whereby supervision of companies owned by local governments is performed by a person – the vice-mayor – whose education and professional experience surely do not qualify him for this position. Furthermore, as such positions are occupied by party representatives, they may very likely represent the interests of politics or the party concerned, instead of those of the public.

Another source of problem may be associated with the fact that the composition of the general assembly and the related power relations, including the mayor's and his deputies' person, would change every four years in line with local government elections or, in case of coalition rearrangement, even more frequently. This may give rise to instability of the operation of the companies they supervise. Much like in the case of state-owned companies where maintenance of their operation is not the duty of the Parliament and its officers and committees, but rather the task of the ministries, maintenance of operation of the companies owned by local governments could be relegated to the competent departments of the mayor's office. Expansion of the authorization of the National Audit Office to include companies owned by local governments may also be an idea worth considering. It would appear appropriate to keep the parties and the politics as far away from the companies as possible.

The deed of foundation of BKV and similar regulations should be modified in such a way that executive officers would be required to proceed in accordance with the instructions representing the owner exclusively *in matters within the owner's competence*. This way, the owner would be prevented from interfering with the operative functioning of the company, in addition, scopes of responsibilities and competence would be identified more clearly.

It should not be left to a specific local government or some company regulation (rules of organization and operation, coalition agreements, deeds of foundation) to determine who and under what kind of authorization should provide for the control of companies of a local government on behalf of the owner. This should be regulated uniformly, through the law, in a manner that best protects the public interest.

The method of appointing executive officers for publicly owned companies should also be specified in the law (e.g., mandatory international tender), and they should be required to meet stringent performance criteria which the SB and the owner should call to account. Loop-holes in the public procurement procedures should be eliminated.

## REFERENCES

1. Angyal (2001): *Vállalati kormányzás (Corporate Governance)*. Aula, Budapest.
2. Frydman, R. and Rapaczynski, A. (1994): *Privatization in Eastern Europe: is the state withering away?* Central European University Press, Budapest.
3. O' Donovan, Gabrielle (2003): *Corporate Governance International Journal*, "A Board Culture of Corporate Governance", Vol 6 Issue 3.
4. Act no. IV of 2006 on Business Associations
5. Act no. CXXII of 2009
6. Deed of Foundation of BKV
7. Report of the city assembly Commission of Inquiry
8. Central Statistics Agency
9. Metropolitan Government Rules
10. World Economics Weekly archive