

László Domokos – Viktor Várpalotai – Katalin Jakovác –
Erzsébet Németh – Mária Makkai – Margit Horváth

Renewal of Public Management

Contributions of State Audit Office of Hungary to enhance corporate governance of state-owned enterprises

SUMMARY: One of the key areas of public management is the corporate management of state- and local government-owned enterprises, in brief state-owned enterprises. By reviewing the relevant international literature we identified the key factors of well-managed state-owned enterprises. A legal analysis of effective Hungarian laws concerning the corporate governance of state-owned enterprises showed that the legislations provide management frameworks that are in line with international recommendations. However, a comparative analysis describing the audit experiences of 113 audit reports of state- and local government-owned enterprises released by the State Audit Office of Hungary in the period 2011–2015 revealed fundamental and recurring management problems, such as lack or deficiency of performance requirements, planning, prime cost calculation and proprietary control that have lead to serious consequences in the management of public funds. To remedy the systemic problems we proposed detailed recommendations for those exercising the proprietary rights, the supervisory boards and the managements of state-owned enterprises.¹

KEYWORDS: public management, state-owned enterprises, local government-owned enterprises, corporate management, portfolio management

JEL CODES: G34, G38, H11, H30, M10

INTRODUCTION

Only well-managed, effectively and efficiently governed state-/local government-owned enterprises serve the interest of the public. The assets managed by these companies are public assets, on the one hand their activities and the quality, effectiveness and efficiency of their financial management contribute to the responsible management of public funds, and on the other hand the goods and services produced

by them affect the quality of life, security, health and welfare of the population. To what extent does today's Hungarian practice ensure the achievability of these goals? Do we have to worry about the management of state-/local government-owned enterprises? Are there general corporate governance problems that may prevent these companies from pursuing effective and efficient management? What are those key management areas where progress can or should be made? Our study intends to examine the above questions.

The auditing of state-/local government-

E-mail address: varpalotaiv@gmail.com

owned enterprises has become a relatively new, but increasingly important area of audits of State Audit Office of Hungary (SAO). Although Act XXXVIII of 1989 on the State Audit Office already provided for the auditability of state-owned enterprises, the auditability of local government-owned enterprises was only made possible by a legislative amendment effective as of 1th January 2011. The SAO audits of state-/local government-owned enterprises revealed serious, corporate governance related problems. For example:

- the improper management of certain larger companies that may place considerable burden on the budget or may bring the affected local government city to the edge of insolvency;
- reductions in assets hidden as disguised debt;
- high bonuses paid to the management of a company generating losses of tens of billions;
- accounting deficiencies rendering sound management impossible;
- contracts failed to be updated referring still to legal regulations that were effective 19 years ago;
- unrealistically low asset management fees, etc.

The State Audit Office of Hungary made recommendations on the renewal of corporate governance in public sector based on the audit experiences of state- and local government-owned enterprises. As a result, the government declared in a decision² its commitment to establishing transparent, effective and economically viable operating conditions for state-owned enterprises, and to the continuous performance assessment of the managers of state-owned enterprises from the aspects of regularity, effectiveness and economy; and furthermore, to the fact that the managers of state-owned enterprises are required to abide by stringent ethical and integrity principles (SAO, 2015).

The objective of this study is to support the intention set out in the government decision by identifying the system-level corporate governance problems of state-/local government-owned enterprises and by giving detailed recommendations after having considered the effective legal environment and the recommendations for good practices outlined in the literature.³ Furthermore, our aim is to incentivise the professionals to discuss our recommendations given for the renewal of corporate governance in the public sector and to encourage them to contribute with their knowledge and experiences to the development of good public management.

In the first chapter of the study we wish to place the issue and key actors of the corporate governance of state-/local government-owned enterprises. In the second chapter, we intend to analyse the recommendations given in relation to the corporate governance of state-/local government-owned enterprises by reviewing the related literature. In the third chapter, by a legal analysis of the effective Hungarian legislations applicable to the corporate governance of state-/local government-owned enterprises we intend to support our hypothesis that the effective corporate governance model established by the laws is in line with the recommendations of the literature, however, the model is more like a framework, and the substantive content is expected to be added by those managing the systems. In the fourth chapter, we present our arguments for the necessity of the renewal of corporate governance in public sector by making references to the societal and economic importance of state-/local government-owned enterprises and to the system-level problems uncovered by the comparative analysis of SAO audits. In the fifth chapter, we present our recommendations given for the enhancing of corporate governance in public sector categorised by the main actors: ownership entity, supervisory board

and management. We close our study by emphasising the importance of the role played by audits in the renewal of public management.

METHOD OF ANALYSIS

In our study we assess the recommendations given for the corporate governance of state- and local government-owned enterprises by relying on the international literature, with particular regard to papers published by international organisations and consulting companies. We carry out a legal analysis for reviewing the effective Hungarian regulations on the corporate governance of state- and local government-owned enterprises, which are compared to the recommendations found in international literature. We present the practice of corporate governance of the state- and local government-owned enterprises by carrying out descriptive statistical analysis of the experiences published in the 113 audit reports prepared by the State Audit Office of Hungary (SAO), and by identifying areas of concern. We will put forward our recommendations on the renewal of the corporate governance of state- and local government-owned enterprises based on the comparison of the recommendations found in international literature and problems associated with the corporate governance of state- and local government-owned enterprises outlined in the analysis of SAO reports.

THE CONCEPT OF PUBLIC MANAGEMENT

One of the key measures of good governance is the method, by which the state develops and operates its institutional system for fulfilling its societal role and its service provider functions. The ultimate goal of this set-up is the effective, efficient and accountable perfor-

mance of public functions by the cost-efficient use of available resources. The concept of public management includes all those planning, organising, management and monitoring activities that are necessary for the development and operation of an institutional system ensuring the fulfilment of state functions.

Our study is focused on a sub-field of public management. Its aim is to analyse what the best method is to ensure that those involved in the governance of state- and local government-owned enterprises perform effective and efficient management in the manner best serving the public good with respect to community assets entrusted to them for the purposes of public service, and which are ultimately owned by the citizens of a country. For the purpose of our analysis, the concept of the corporate governance of state-/local government-owned enterprises includes the exercise of rights and fulfilment of obligations performed on the one hand by the ownership entity or by the bodies assigned by them (typically supervisory board), and performed on the other hand by the managing directors or supreme bodies (board of directors) responsible for the operation of state-owned companies, hereinafter referred to as management (*see Figure 1*).

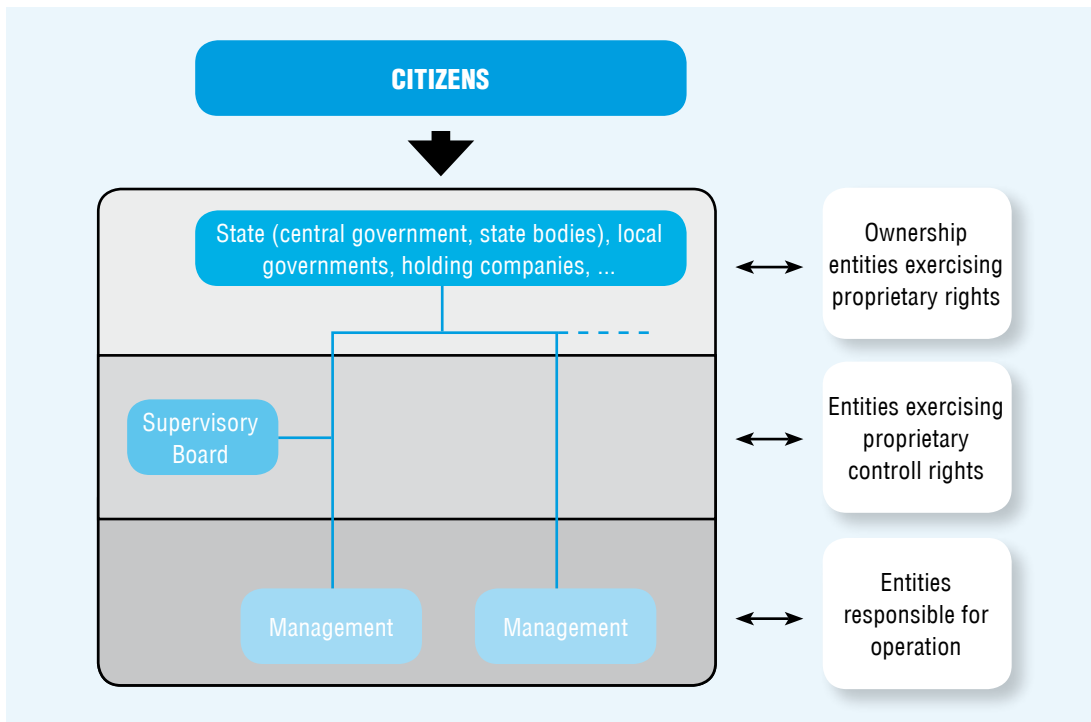
GOOD PUBLIC MANAGEMENT: AN OVERVIEW

Theories, analyses, foreign good practices and international recommendations may help find the answers to challenges encountered in relation to the corporate governance of state-/local government-owned enterprises.

The specialists of economics and management studies have long been interested in the question in what way the highest level of economic prosperity, effectiveness and profitability can be achieved at national economy's

Figure 1

KEY ACTORS OF THE CORPORATE GOVERNANCE OF STATE-/LOCAL GOVERNMENT-OWNED ENTERPRISES



Source: author's own editing

level or at individual companies' level. It has long been known that the institutional environment, i.e. the legislative, organisational and cultural conditions and the resulting circumstances are of key relevance for economic performance both at the level of the national economy and of corporations (Coase, 1937; North, 1961). In addition to those listed above, the prosperity of a company is determined by the performance of its managers. When looking at the elements of this performance, management studies usually identify four management-related functions (see for example Bartol and Martin, 1991).

❶ Planning: goal setting, determining the frameworks and direction of an activity and allocating the assets to the targets.

❷ Organisation: assignment of tasks, physi-

cal and human assets to one another with a view to making the related tasks achievable and effectively completed.

❸ Management: incentivising, supporting, enforcing and influencing people, so that they can accomplish the goals set and can achieve the desired performance.

❹ Monitoring: continuous measurement of the goals against the results achieved, taking the necessary actions in case of deviations to ensure completion or for readapting the related goals.

Although management studies do not have a single, universally applicable formula guaranteeing the best solutions, nevertheless, it is essentially important that all managers should be aware of the above mentioned four functions.

The effective performance of the above mentioned four functions is indispensable in public management. Each of the recommendations found in the literature on public management to be reviewed hereunder may be linked to one of these four functions.

However, before we would proceed to presenting these recommendations, we find it important to emphasise that a consistent approach may be the best method to effectuate the effective and efficient management of state- and local government-owned enterprises. As a matter of fact, their duties, management-related challenges and operating environment are basically the same: all these companies are expected to serve the public, they are to face the same type of conflicts of interest and challenges arising from the roles of the ownership entity, the supervisory board and the management, and all these companies operate in the same societal and economic environment.^{4,5} The joint discussion of the issues related to the corporate governance of state- and local government-owned enterprises is a general practice in the related documents of the international organisations. The OECD analyses and recommendations also commonly treat all those companies as SOEs, which are recognised by the laws of the given country as enterprises, and in which the state exercises proprietary rights by effectively supervising the operation of these companies by holding the majority or a predominant minority of the voting rights. In their case, the term “state” may refer to any entity holding public authority (for example, the central government, local and county governments, public administration bodies), as well as companies entitled by those above to exercise the owner’s rights (for example holding companies, asset managers) (OECD, 2015a). A similar approach is applied by Commission Directive 80/723/EEC on the transparency of financial relations between Member States and public

undertakings, which applies the term public undertaking to all undertakings, “over which the state and the regional (or local) public authorities may exercise directly or indirectly a dominant influence by virtue of their ownership of it, their financial participation therein, or the rules which govern them”. The strategic document focusing on the corporate governance of state-owned enterprises published by PwC’s Public Sector Research Centre does not distinguish between state- and local government-owned enterprises as far as public management is concerned (PwC, 2015).⁶

The OECD analysis (OECD, 2015a), by utilising the experiences gained from the consultations carried out with the member states, has put forward detailed recommendations for the corporate governance of SOEs – we emphasize again that the OECD analysis does not distinguish between state- and local government-owned entities – with a view to making their operation more effective, efficient, transparent and accountable. The recommendations provide guidance primarily for governments and for ownership entities, so that these bodies can avoid the problems arising from passive ownership or excessive state intervention while exercising their ownership rights. The corporate governance of state- and privately owned enterprises raise similar challenges to some extent, therefore, according to the OECD, the recommendations given for private companies may also prevail when applied to the renewal of the corporate governance of SOEs.⁷

The OECD organises its recommendations around seven topics:

- ① Recommendations underlining the ownership function of the state.
- ② Recommendations addressing the ownership function of the state.
- ③ Recommendations related to the market behaviour of SOEs.
- ④ Recommendations related to the equal treatment of private co-owners and investors.

5 Recommendations addressing the relationships with stakeholders and to responsible business.

6 Recommendations related to disclosure and transparency.

7 Recommendations related to the responsibilities of the board of directors and supervisory boards of SOEs.

The OECD gives highly detailed recommendations in relation to certain issues. For reasons of limited space, we will only discuss a few of these hereunder. According to the OECD's recommendation, the state must use its ownership role for serving the public good. For this purpose, state must clarify, or must review at regular intervals why she finds reasonable to maintain state ownership in a given case, and what public policy goal she aims to achieve by state ownership. In addition, she must define its owner's policy, in which she declares her role played in governance, as well as the rules and responsibilities of those involved in the executive tasks.

The corporate governance of state-owned enterprises should be active, professional and effective, similarly to that of privately owned peers. The state should give full operation autonomy to the managements of her companies for the achievements of the goals set, and should refrain from interfering in the management activities. The ownership entity must have appropriate capacity and competence for performing its duties effectively. In addition to establishing an adequate incentive scheme, the state must define the goals to be achieved by the company, including the financial and asset-related goals and a tolerable risk level, and the achievement of these must be monitored.

The legal and regulatory environment must ensure equal conditions for the state- and privately owned companies by guaranteeing fair competition. To ensure this, the proprietary and regulatory responsibilities of the state must be separated. If a state-owned company has

private owners as well, it must be ensured that they are given equal treatment and have access to company data. In addition, if a state-owned company enters into a private-public partnership, the contracting party must ensure that the rights conferred by the contract are maintained. The state, the ownership entities and the SOEs must respect the rights of the stakeholders as specified by law or the agreement.

SOEs and their governance must be transparent and must meet the accounting, disclosure, compliance and audit standards of private companies. The reports prepared by SOEs must include the following, amongst others for the purpose of their regular monitoring, measuring the performance of those involved in their governance and of informing the wider public:

- material financial and other data relevant for their activities, such as their goals and the achievement thereof,
- financial and operating incomes, including the costs and coverage of public sector duties fulfilled,
- the remuneration of the company's managers, the qualification of the senior officers and their selection procedure,
- foreseeable risks and the actions taken for their management,
- financial assistance and guarantees received from the state.

Reports comparable across companies and time must be disclosed and must be subjected to independent, external audits.

In addition to putting forward recommendations, the OECD prepared an overview (OECD, 2011) on the trends observed in the corporate governance of SOEs operating in the member states. Increase in transparency and disclosure (Switzerland, Turkey, Germany, Sweden and New Zealand) and the specification of selection and employment principles with respect to managers (Czech Republic, Finland, Norway and Sweden) were seen as

general trends in the past years. According to the OECD study, the centralisation of ownership roles and the enhancement of transparency and accountability were clearly observable in the years following the global economic crisis. A special focus area was the revision of the rules and procedures pertinent to the appointment, functioning and remuneration of senior officers and bodies effectuated with a view to limiting the political influence on the operation of the companies and ensuring high professional performance in the management of the companies.

Strong overlap is indicated between the recommendations given by the World Bank in relation to the corporate governance of SOEs (World Bank, 2014) and the recommendations put forward by the OECD (OECD, 2015a). The World Bank document is enriched by practical examples gathered from many parts of the world.

PwC, an advisory company, organised its recommendations around four key words in its study analysing the management of state-owned companies (PwC, 2015).⁸ (1) The goal to be achieved by the state-owned company must be clarified, as well as the method, by which the company can reach it. (2) Adequate resources and time must be committed for achieving proper governance. (3) Managers must have adequate capabilities and experiences for the governance of state-owned companies. (4) Managers committed to integrity are needed, who are able to serve citizens in a manner creating public added value.

REGULATION OF THE GOVERNANCE OF STATE- AND LOCAL GOVERNMENT-OWNED ENTERPRISES IN HUNGARY

There is a high number of legislations affecting the corporate governance of state-owned enterprises in Hungary. At a general level, the

responsibilities and powers associated with the roles of key importance from the aspect of governing enterprises, such as the owners of enterprises (members), senior officers and the supervisory board, are regulated by the Civil Code⁹ without making any distinction between private and public ownership. However, the Civil Code, in harmony with its focus on private life, only regulates the main frameworks related to the management of companies, and leaves the details to be specified primarily by the owners of enterprises (members, shareholders).

In terms of state-owned enterprises, Act CXCVI of 2011 on National Assets provides for the criteria of responsible financial management, for the transparent, effective and cost-efficient operation of assets and for maintaining or enhancing the value of the same. Act CXXII of 2009 providing for the mandatory establishment of supervisory boards, for the minimum and maximum number of the members in a board of directors and in a supervisory board, for the maximum level of their remuneration and for the mandatory disclosure of the related information, is also related to the corporate governance of state-owned enterprises. Another related legal regulation is the government decision on the renewal of the remuneration system of the senior officers of business association in majority state ownership incentivising profitable financial management by prohibiting the payment of manager bonuses in case of loss-making financial management.

The transparent operation of publicly owned companies is further enhanced by Act C of 2000 on Accounting, which finds it indispensable that objective information must be made available on the asset, financial, profit situation, and the trends thereof, of business entities. In addition, it also specifies accounting rules, on the basis of which true and fair account and information can be provided on

the revenue generating capacity, assets, development of assets, financial situation and future plans of those falling under the scope of this legislation. A provision of Act CXII of 2011 on the Right of Informational Self-determination and on Freedom of Information providing for the disclosure of data on state- and local government-owned assets for public interest is also aimed at focusing on the transparent management of state- and local government-owned enterprises. The scope of public data is further extended by Act CVI of 2007 on State Property.

Government Decree 370/2011 (XII. 31.) on the Internal Control System and on the Internal Audit of Central Budgetary Institutions providing for the establishment, operation and development of an adequate control environment, risk management system, control activities, as well as communication and monitoring systems, thus promoting regular, effective and efficient management, is also related to the governance of state-owned enterprises linked to the government sector.¹⁰

As for the exercise of proprietary rights, the Act on State Property provides for the obligation to maintain records on and to properly utilise state property. In addition to the legal provisions, MNV Zrt.¹¹, as the entity authorised to exercise the owner's rights of a number of state-owned enterprises, has put forward highly detailed corporate governance recommendations and suggestions incorporating the relevant OECD recommendations and enterprise and stock market practices.¹² For the purpose of promoting the integrity of companies falling within the portfolio managed by MNV Zrt., the state entity recommends the application of its own Code of Ethics (MNV, 2013).

As for the strategic governance of local government-owned enterprises, another important legislation is Act CLXXXIX of 2011 on Local Governments in Hungary, which provides that the long-term development concepts of

the representative councils of the local governments are required to be outlined in economic programmes or development plans. The development concepts for ensuring certain public services and for improving the standards of the same must be included in these economic programmes or development plans.

In addition to general regulations, the effective sectoral legislations (for example Act XVIII of 2005 on District Heating Services, Act CCIX of 2011 on Water Public Utility Services and Act CLXXXV of 2012 on Waste) put it forward as a general principle that enterprises providing public services are expected to perform sustainable and cost-effective management.

When comparing the recommendations with the effective regulations on the management and operation of state-owned companies, it can be stated that the frameworks laid down in the effective Hungarian regulations, and the guidance put forward by the entity exercising proprietary rights show similarities and in many cases are in harmony with the international recommendations. However, as we explain in the next sections, according to the SAO audit experiences the governance practices of state- and local government-owned enterprises in several cases fail to comply with the legal provisions, or fail to fill in the legal frameworks with substantive contents incentivising for effective, efficient and transparent management.

WHAT MAKES THE RENEWAL OF PUBLIC MANAGEMENT NECESSARY?

State-owned enterprises play an important role in the national economy. Their societal role is also indispensable, as almost all citizens encounter their (public) services on a daily basis, for which citizens pay considerable amounts directly or indirectly. The effective and effi-

cient governance of, and the protection and enhancement of the assets of state-owned enterprises are on the one hand considered as basic public interest, and on the other hand represent large responsibility and challenge. The necessity for renewing public management, as we will see hereunder, arises from the joint effects of two factors, namely, the societal and economic importance of state-owned enterprises and their many problems and shortcomings detected by the SAO audits.

Increasing importance, increasing challenges

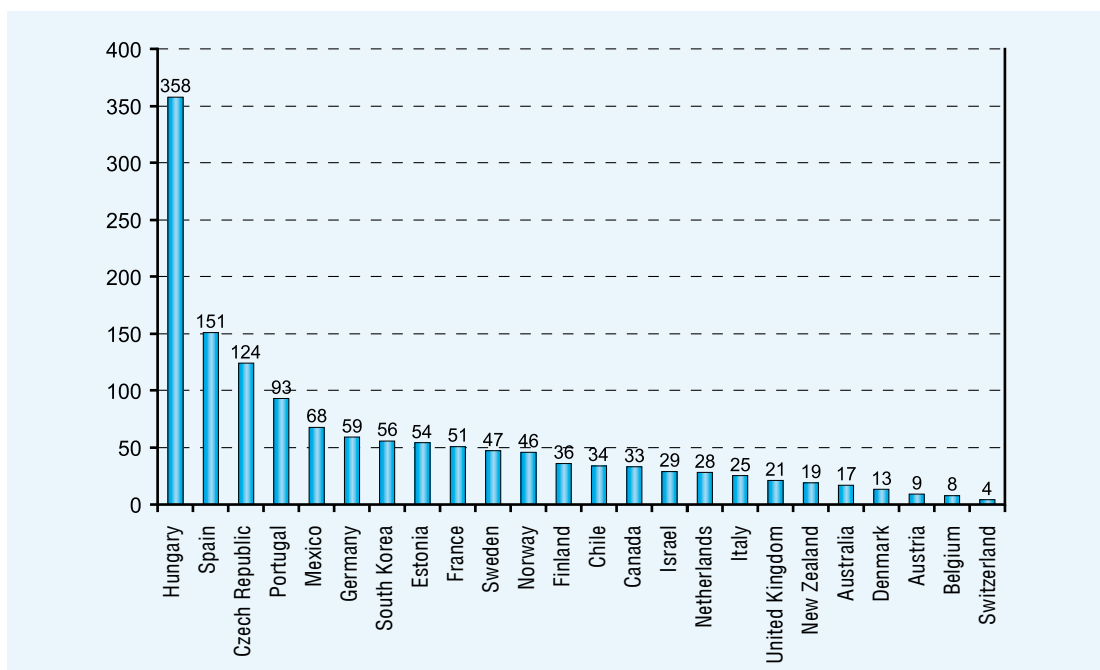
The economic importance of SOEs is considerable both in the developed and in the developing countries. According to *Christiansen* (2011) in the OECD member countries the

majority of central governments owned dozens of enterprises (*see Figure 2*). In this respect, Hungary is at the top of the list, while Spain ranking as second owning less than half of the number of SOEs when compared to the Hungarian figures.¹³

In terms of the proportion of those employed in enterprises owned by the central government in the OECD countries, Hungary ranked as third, behind Norway and Estonia, in 2009 (*see Figure 3*). In the case of Hungary, it meant that the enterprises owned by the central government alone had more than 150,000 employees in 2009, in other words, in the Hungarian labour market every 25th employee was employed by a state-owned enterprises. By comparing the number of the enterprises and the employment weights it can be also established that the size of the enterprises owned by the Hungarian cen-

Figure 2

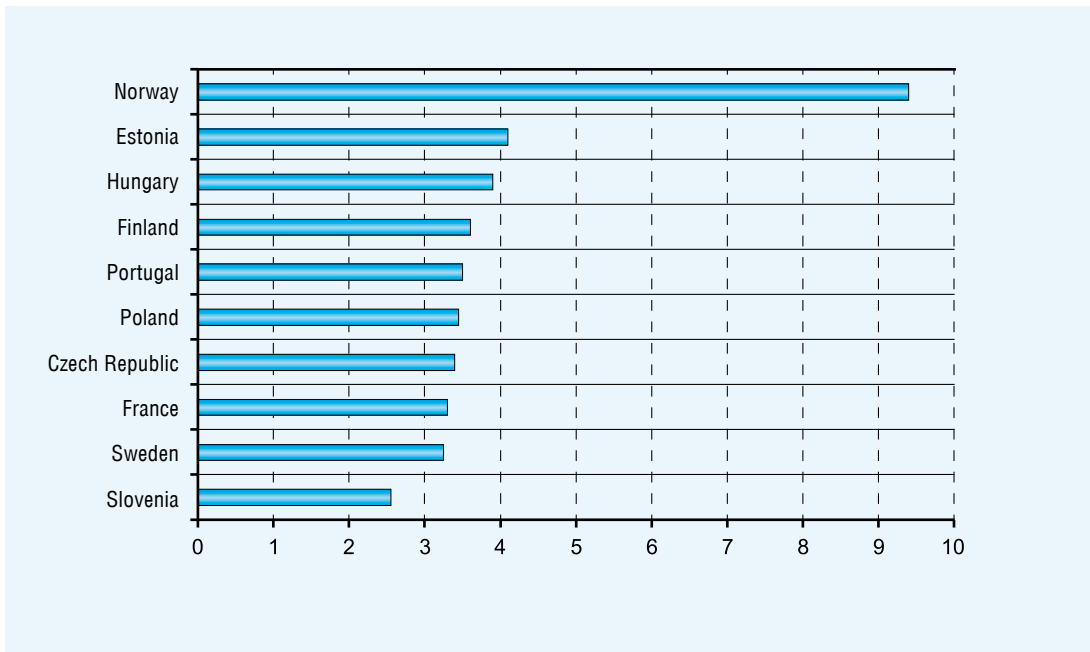
NUMBER OF ENTERPRISES IN THE MAJORITY OWNERSHIP OF THE CENTRAL GOVERNMENT IN 2009 (PCS)



Source: Christiansen (2011)

Figure 3

**NUMBER OF EMPLOYEES EMPLOYED BY CENTRAL GOVERNMENT-OWNED ENTERPRISES
(% OF TOTAL EMPLOYMENT IN 2009)**



Source: Christiansen (2011)

tral government is relatively small than their counterparts operating in other OECD member states. On the one hand it is explained by the fact that in most EU member states SOEs have been organised in holding companies, therefore, there are less enterprises which have a higher number of employees on average. On the other hand, in these countries the majority of companies are owned by the local governments or the provinces, which were not included in these data.

Compared to the situation in 2009, both the number of state-owned and the number of local government-owned companies have increased in Hungary. As part of the change in economic policy introduced in 2010, today natural monopolies (such as gas, electricity, water supply, waste management) are ultimately owned by either the central or local. The (increased) volume of public assets

serving economic purposes sets a number of challenges both from the aspect of ownership and governance requiring actions from public management setup.

FINANCIAL CHALLENGE is set by the need to provide the funds required to acquire property, which affects the central or local budget. In addition, the funding of the investments of state-owned enterprises, and potentially the required owner's guarantee, is provided from the central budget, with particular regard to those cases, where market funding or EU funding is not available due to the scale of the projects or the nature of the investment (see for example Paks nuclear plant project). Not least, the potentially required capital replacement of state-owned enterprises may present funding needs.

PROFESSIONAL CHALLENGE is raised by the fact that the high standards of the goods and ser-

vices provided by the state-owned enterprises and the fulfilment of expanding management and proprietary roles require adequate competences that are to be acquired by the public sector by competing with private companies in the labour market.

ETHICAL CHALLENGE is set by the expanding interface where private and public sectors meet resulting in increased corruption risks, provided that all other factors remain unchanged.¹⁴

Audit Experiences of the State Audit Office of Hungary in relation to state-owned enterprises

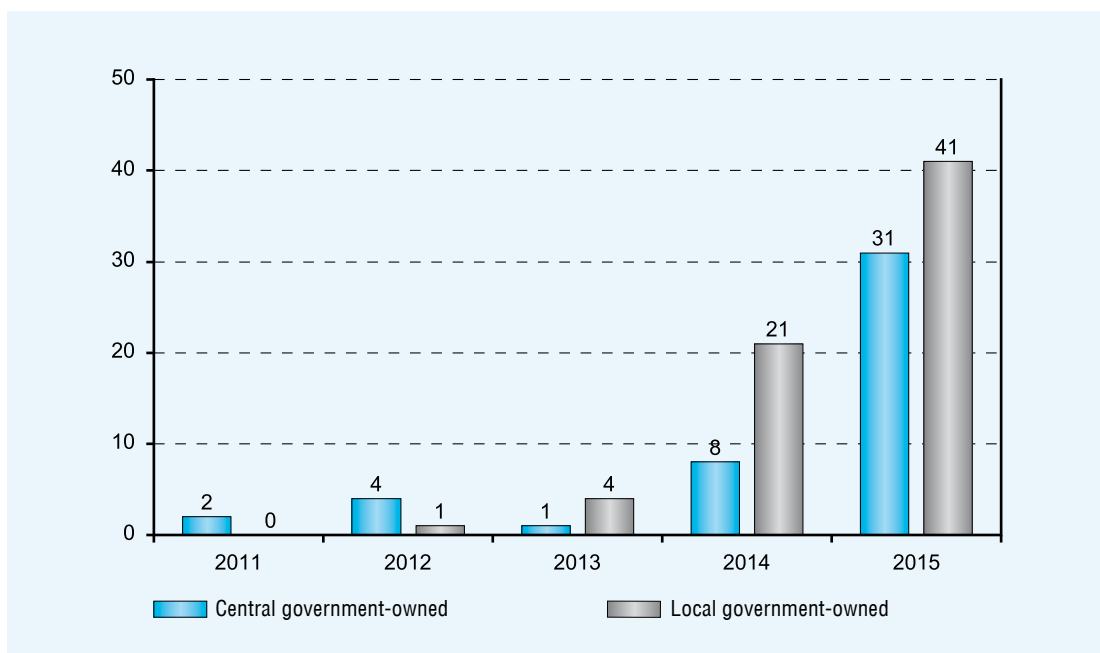
In the period 2011–2015, the number of SAO audits investigating state-/local government-owned enterprises kept increasing year by year

(see Figure 4). Although the audits primarily focused on the financial situation, asset management, structure of the internal control system of the companies, as well as the regularity of the inherent fields of the above, we can put forward system-level findings in relation to the corporate governance of SOEs by comparative analysis of the related audit reports.

In the period under review, 113 SAO audit reports were prepared in relation to the audits of state-/local government-owned enterprises operating in different sectors. The following entities were amongst the audited enterprises: 35 district heating companies, 17 theatres, 22 forestries, 9 waste management companies, 6 transport companies, 5 waterworks, and 19 other enterprises operating in the financial, infrastructural, other service sectors and ownership entities authorised to exercise proprietary rights (see Figure 5).

Figure 4

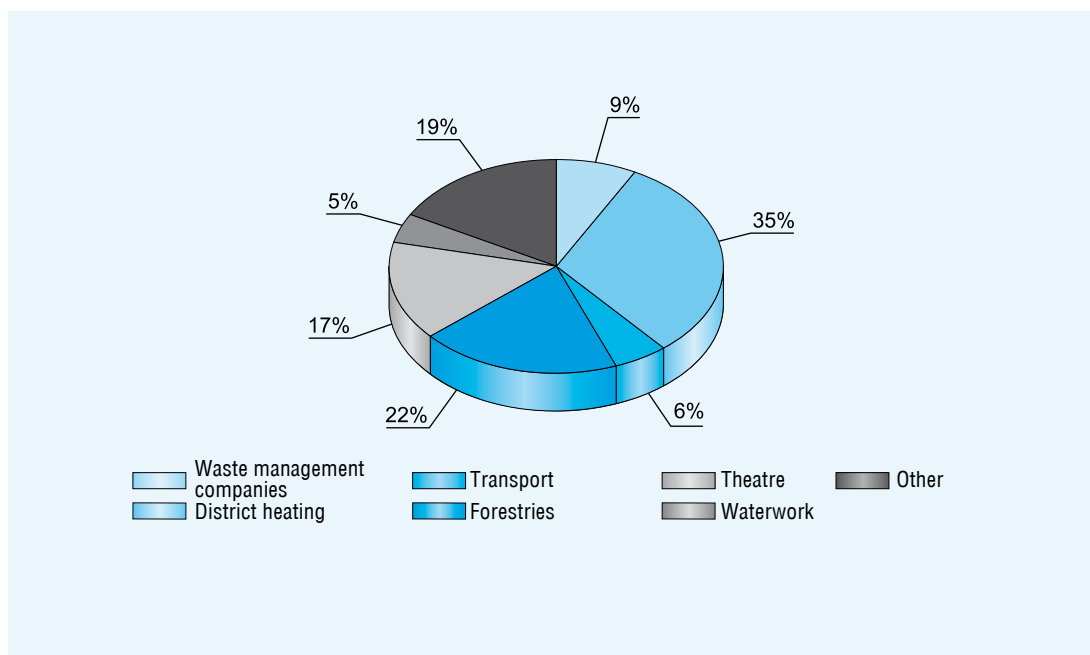
NUMBER OF AUDITS CONDUCTED BY THE STATE AUDIT OFFICE OF HUNGARY INVESTIGATING STATE-/LOCAL GOVERNMENT-OWNED ENTERPRISES



Source: authors' calculation based on SAO audit reports

Figure 5

DISTRIBUTION OF THE AUDITS CONDUCTED BY THE STATE AUDIT OFFICE OF HUNGARY INVESTIGATING STATE-/LOCAL GOVERNMENT-OWNED ENTERPRISES (2011–2015)



Sources: authors' calculation based on SAO audit reports

The increasing number of the recommendations given in the SAO reports and the addressees therein from year to year (see Figure 6) indicates that there are still lots to improve in the management of public assets. There are lots of things to be improved in the case of state-owned enterprises, too. For example, in relation to the auditing of state-owned enterprises, the SAO put forward the following number of recommendations requiring mandatory actions: in the case of the 36 district heating and waste management companies 186 recommendations, in the case of the theatres 94 recommendations, 87 recommendations for the forestries and 42 recommendations for public water supply companies. The recommendations requiring mandatory measures are primarily intended to ensure the regular operation of state- and local government-owned enterprises by orientating the affected entities

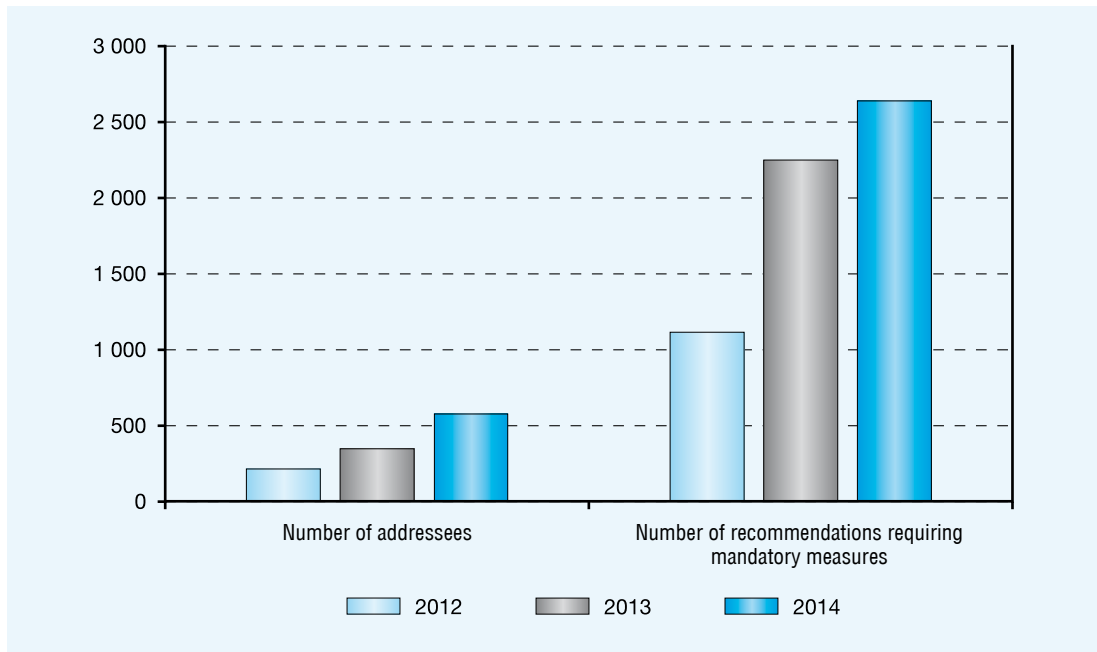
to integrate the recommendations in the working practices of state- and local government-owned enterprises by eliminating irregularities, shortcomings and inadequate practices detected in the corporate governance of the audited enterprises.

We identified the following issues as recurring problems in the corporate governance of state-owned enterprises based on the findings and recommendations set out in the 113 SAO audit reports, and based on the studies of Horváth and Szilas (2015) and of Németh, Jakovác and Várpalotai (2015).

LACK OF ESTABLISHED PERFORMANCE REQUIREMENTS. In the case of the three quarters of the 36 local government-owned waste management and district heating companies the business plan did not include any set of criteria or indicators suitable for measuring the economy and effectiveness of their professional perfor-

Figure 6

NUMBER OF RECOMMENDATIONS REQUIRING MANDATORY MEASURES AND THEIR ADDRESSEES (2012–2014)



Source: authors' calculation based on annual SAO reports

mance. This is a problem, because without performance requirements, the goal aimed to be achieved and the effect to be exerted become unclear, effectiveness and efficiency will be unmeasurable and accountability will be rendered impossible.

LACK OF BUSINESS PLANS AND SHORTCOMINGS IN THE CONTENTS THEREOF. Business plans are important documents for companies that are intended to set out the goals expected to be achieved by the companies through their activities and management, and at the same time represent reference points for the related assessments. Although the audited 36 waste management and district heating companies prepared their respective business plans for the year 2012, with the exception of five undertakings, however, considerable differences were found with respect to the contents and the level of detail of such business plans. Only one local govern-

ment, acting as owner, specified expectations in relation to the business plan. The comparability of the revenue and expenditure data included in the business plans and reports was limited by the fact that the audited companies failed to adequately separate their activities, and as far as the budgeting of was concerned, certain companies budgeted the subsidy, while others indicated the necessary amount of subsidy in their budgeted deficit amounts. Only ten companies gave accounts on the implementation of the business plans and on variances from the revenue and expenditure expectations. And only five companies out of the ten included performance indicators in their business plans. While 23 companies did not have a set of criteria suitable for measuring performance or any relevant requirements.

NON-COMPLIANT COST CALCULATION AND UNJUSTIFIED PRICING. The auditing of the FKF

Zrt.¹⁵, the transport companies, district heating companies, waste management companies and theatres detected irregularities and shortcomings related to prime cost calculation. Without appropriate cost calculation, neither full compliance with the regulations defined by the Act on Accounting, nor the complete fulfilment of management and supervisory functions (such as planning, pricing, cost analysis, efficiency measurement and monitoring) can be expected. The detected shortcomings in cost calculation rendered it impossible to judge whether the prices and fees paid for public services are or were in harmony with the expenditures of the companies related to the provision of public services, and whether the households were burdened to the smallest possible extent, but suitable for preserving public assets and for improving the standards of the services. The unfoundedness of the pricing of public services is further confirmed by the fact that in the less capital intensive waste shipment sector, in the case of the audited 9 service providers the highest service fee was 2.5 times higher than the lowest service fee in 2012.

■ **SHORTCOMINGS IN THE PROTECTION AND ENHANCEMENT OF PUBLIC ASSETS.** The audits of the State Audit Office revealed that in case of certain local government-owned enterprises the replacement of assets exceeding the level of amortisation failed to be effectuated, which led to hidden indebtedness. On the other hand, in many cases business plans did not include calculations underlining the capital expenditures. Whereas, in the absence of these, sound decisions cannot be made with respect to the replacement or enhancement of the assets. Moreover, the audits also detected shortcomings in the accounting records of assets and their justification by inventories. The audits of water public utilities and forestries also revealed shortcomings in the updating of asset management contracts, as a consequence

of which, for example forestries paid unrealistically low charges to MNV Zrt. for the areas they used.

■ **SHORTCOMINGS IN PROPRIETARY CONTROL AND IN THE EXERCISE OF SUPERVISORY RIGHTS.** One of the guarantees for accountability, responsible public spending and asset management is the appropriate exercise of ownership rights and tight ownership control. At the same time, the audits of water public utility companies revealed that the entity exercising the ownership rights did not require calculations underlining capital expenditures, and failed to control the preservation and enhancement of assets. The situation was similar in the case of companies in majority local government ownership, where the internal controls of the local governments typically did not contribute to regular fulfilment and to the preservation of assets.

■ **LACK OF ACTIVE GOVERNANCE BEYOND THE LEVEL OF STATUTORY OBLIGATIONS.** Under the rule of law it is a basic requirement for those involved in the corporate governance of state-/local government-owned enterprises to comply with the statutory obligations. This is a necessary, but in itself insufficient condition for serving the public good. As we explained it earlier, legislations typically provide a framework for the governance of companies, which must be filled up with substantive contents by those involved in management tasks to enable the company to serve the interest of the community as effectively and efficiently as possible and to achieve the strategic goals set. The audits of the State Audit Office of Hungary revealed that it is typical of the corporate governance of state-owned enterprises that the ownership entity, the supervisory board and the management primarily strives to meet the mandatory legal requirements and they are less interested in adding to their activities any additional active management instruments supplementing the statutory requirements of the applicable laws.

RECOMMENDATIONS FOR THE RENEWAL OF PUBLIC MANAGEMENT

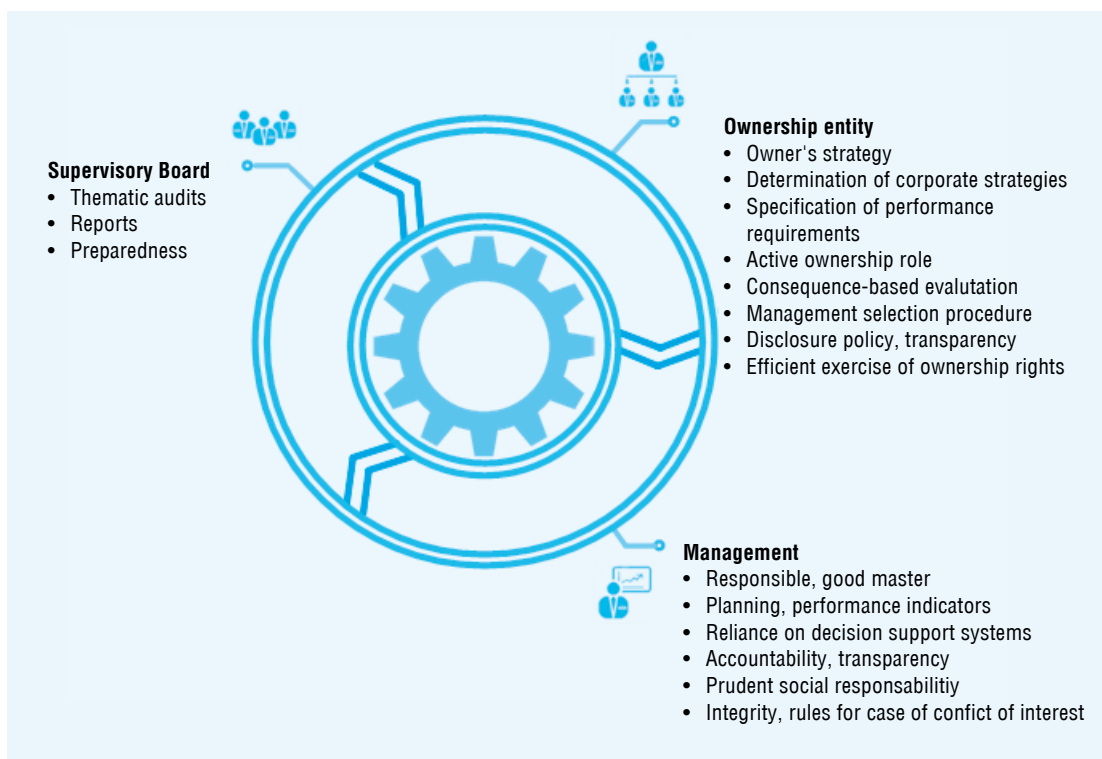
The societal and economic importance of state-owned enterprises, as well as the management-related problems and shortcomings detected based on the summary of the SAO audits necessitate the renewal of public management. To make their operation more effective and efficient, and ultimately to be recognised by the public as providing higher standard services, the concerted renewal of the proprietary, proprietary representative and management roles responsible for their governance is required. It is achievable by way of a coordinated renewal process that the individual management responsibilities form an

incentive system ensuring the preservation and enhancement of public assets and the production of affordable and high standard (public) services and products in a sustainable manner to the satisfaction of the public, in addition to the responsible and cost-effective use of public funds. (See Figure 7)

In the forthcoming sections, we wish to give an overview of our recommendations affecting proprietary, proprietary representative and management roles.¹⁶ By presenting the recommendations we wish to provide the possibility for the experts and workshops to discuss those. We believe that the implementation of our audit-based recommendations would result in considerable progress in many currently poorly functioning areas and would

Figure 7

ASPECTS TO BE CONSIDERED FOR THE RENEWAL OF THE CORPORATE GOVERNANCE OF STATE-OWNED ENTERPRISES



Source: author's own editing

support the establishment of an effectively, efficiently and expediently functioning public management. In addition, we hope that the experts and workshops will also make their contributions to the achievement of good governance by proposing further aspects and recommendations.

Recommendations related to ownership roles

① The ownership entity should regularly review and disclose those public policy targets that justify the state ownership of the affected companies.

② The ownership entity should set strategic goals for each individual company and should define their mission.

③ The ownership entity must specify clear performance requirements for the management operating the company and for the supervisory board.

④ The entity exercising the ownership rights must act as a well-informed and actively involved proprietor. The performance of the management and of the supervisory board must be evaluated regularly. This evaluation must have an effect on the operation of the management and the supervisory board, and on the remuneration and on the mandates of those involved in the above tasks.

⑤ The ownership entity should select the members of the management and the supervisory board based on their previous professional performance, capabilities and their commitment to public service.

⑥ For the attraction and retention of qualified managers capable of achieving challenging performance targets and of operating enterprises in an effective and efficient manner, management remunerations should be aligned to the level prevalent in the market. The fulfilment of the required performance and quality

criteria is an essential requirement and is not subject to bonus payment.

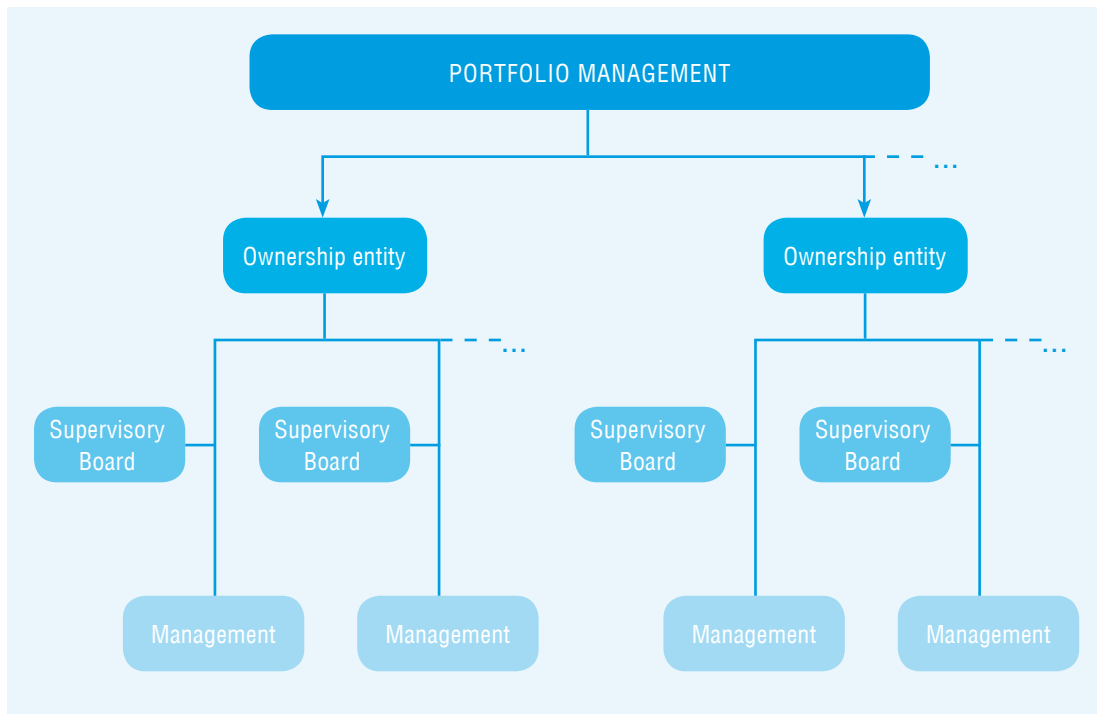
⑦ The ownership entity should perform its activities in a transparent manner, accessible by the greater public. It should define transparency rules related to its own operation, and to the operation of the management and the supervisory board and the scope of publicly available data.

⑧ The state and the local governments should develop an effective method for their exercising the proprietary rights.

State-owned enterprises can fulfil their societal and economic roles effectively, only if their owners clarify to the general public the public policy goals set for and strategy to be followed by such companies, and if clear performance requirements, understood by the management, are determined. The entities exercising the ownership rights may facilitate the achievement of the requirements by employing highly qualified managers, by continuously monitoring and assessing the results, and by ensuring transparency, i.e. the power of the public eye.

For the improvement of public management, the method of performing ownership tasks should also be reconsidered. Due to the high number of the companies (see Figure 2), it is a real challenge for the state and any local government having a large company portfolio to ensure proper awareness and active cooperation, since these require the availability of appropriate level and standard of competence. Accordingly, it is reasonable to consider the establishment of a new public management structure, concentrating management knowledge and being in harmony with the international experiences, which would be responsible for preparing strategic directions and decisions, for the evaluation of the implementation thereof according to consistent principles and for the development of an assessment methodology (see Figure 8).

PORTFOLIO MANAGEMENT SYSTEM



Source: author's own editing

Recommendations related to the supervisory board

1 In order to promote the interests of the owners, the members of the supervisory board must regularly verify that the company working under their supervision and its management operate regularly, and that the company's reports include credible and reliable information. Within this framework, they must carry out thematic audits, in particular for the purpose of utilising the indications given by the internal control, and with respect to the performance requirements defined by the owner and regarding compliance with the disclosure policy.

2 The supervisory board must regularly report to the owner on the results of their audits and inspections by assuming full responsibility for their contents.

3 The members of the supervisory board must have such competence and experience that guarantees the monitoring of the implementation of the owner's interests, the ability to understand the operation of the companies entrusted to their supervision and to recognise any possible irregularities.

The supervisory board is basically an organisation established for enforcing the owner's interests, which performs its duties effectively, if it actively monitors the operation of the management and the company, and makes sure that credible information are included in the company's reports, monitors the implementation of the disclosure policy, and informs the owner about its experiences. However, its performance can only be comprehensive, if it does not only have a complex image of the company's performance, but it is aware of all those processes,

events, risks emerged that may affect the company's operation in compliance with external and internal rules, as well as its profitability and assets. It can only meet its diverse tasks by possessing the appropriate competencies.

Recommendations related to the management

- ① The managers of SOEs must work as good masters being committed to public service, abiding by the rules and budget frameworks, enforcing the payment of claims and fulfilling the obligations in a timely manner.
- ② The management must develop detailed business plans, and specify performance criteria and indicators.
- ③ The managers of SOEs must establish management information systems supporting decision-making processes. The managers of state-owned companies must establish internal control systems, and must take into account their indications when making decisions and managing processes.
- ④ The managers of SOEs must ensure transparent operation both to the owners and to the public, in addition to fulfilling their reporting obligations.
- ⑤ The managers of SOEs should only be allowed to develop their social responsibility programmes subject to the owner's approval, and should only be allowed to pursue any other, non-core activities under the same conditions.
- ⑥ The managers of SOEs should abide by the ethical and integrity principles of public service.

Under the rule of law, the method for performing public service is determined by legal regulations, therefore, public sector managers are primarily expected to comply with these rules. In addition, a manager must be able to adapt to the fast and challenging changes of the environment, therefore, public sector

managers are increasingly expected to have innovation skills and an ability to promote risk management and organisational learning.

Good managers have up-to-date information on the operation of the company, on the special features and quality of its activities and processes, furthermore, they perform responsible management, behave ethically, abides by and causes others to abide by the rules, and ensures that the organisation entrusted to him operates effectively in the implementation of the required performance (streets should be clean, trains should arrive on time, drinking water should be healthy, etc.).

The management's high level of integrity is indispensable, which might be supported by the recognition of the indications given by the internal control department, by transparent operation, by minimising the interfaces affected by corruption risks and by respecting the ethical principles. Of the players authorised to conduct auditing, the department for internal control has the possibility to monitor the regularity of the company's operation most directly owing to its continuous presence within the organisation.

SUMMARY AND CONCLUSIONS

In our study we compared the recommendations on the corporate governance of state-owned enterprises available in the international literature with the effective national regulations and the actual practice depicted by the audits conducted by the State Audit Office of Hungary. We concluded that national regulations provide a corporate governance framework for state-owned enterprises that is in line with the international recommendations. However, the findings detected by the SAO audits revealed that the management practices of state- and local government-owned enterprises in several cases fail to comply with the

legal provisions, or those involved in their governance fail to fill in the legal frameworks with substantive contents incentivising for effective, efficient and transparent management. We established that the societal and economic importance of state-owned enterprises, as well as the management-related problems and shortcomings revealed by the SAO audits necessitate the renewal of public management. In our study we have put forward suggestions, being in harmony with the recommendations of the international literature, by the implementation of which considerable improvement could be achieved in several, currently poorly functioning management areas that would further contribute to the establishment of an effectively, efficiently and expediently functioning public management.

The experiences gained from SAO audits have revealed that full compliance with the rules on the governance and operation of state-owned enterprises alone could induce considerable improvement in the management of public funds and public assets. The proposed renewal of the regulations related to the governance of SOEs would only result in tangible improvement as far as effectiveness and efficiency are concerned, if the rules were fully observed by those affected.

It is general experience that orderliness is only achieved by those entities, where compliance is regularly inspected. The renewal of the regulations on the corporate governance of SOEs, and the increasing financial resources and possibilities provided by the expanding economic environment shall be to no avail, if the governance and operation of state-owned enterprises would not be audited regularly and the findings of such audits are not subjected to any consequences.

As the construction of the defence lines makes a fortress resistant, so will multilevel audits promote law-abiding behaviour. Accordingly, it is important in terms of the management of SOEs that as many control mechanisms should be integrated as possible, and that the internal control, the management audits, the supervisory board, the auditor, the ownership entity, the Government Audit Office and the State Audit Office of Hungary, as supreme guardian of public funds, should all apply and enforce their audit-related authorities.

The renewal of the corporate governance of SOEs, accompanied by its consistent enforcement and control may contribute to the establishment of a well-functioning public management serving and enhancing the public good.

NOTES

¹ Unless otherwise indicated, figures included in this paper were created by the authors.

² Government Decision No. 1660/2015. (IX. 15.) on the Renewal of the Remuneration System of the Senior Officers of Business Association in Majority State Ownership.

³ This study is not intended to analyse what economic functions the state or the local governments should be entrusted with.

⁴ The similarities are also emphasised by *Domokos* (2015), who suggests that the criteria set out in the government decision on the appointment of the managers of state-owned companies could also be reasonably applied to local government-owned companies.

⁵ Hereunder, unless there is a need to distinguish between companies in state and local government ownership, the terms state-owned enterprises (SOE) will be used as synonyms for state-/local government-owned enterprises.

- ⁶ The World Bank puts forward its recommendations for narrowly-defined state-owned enterprises. However, it notes that the recommendations set out in its document may also have positive influence on the performance of other publicly owned enterprises, such as local government-owned enterprises (World Bank, 2014, page 28)
- ⁷ The recommendations applicable to privately owned enterprises can be found in the OECD (2015b).
- ⁸ 4Cs: Clarity, Capacity, Capability and Commitment.
- ⁹ Act V of 2013 on the Civil Code of Hungary
- ¹⁰ The Ministry for National Economy of Hungary prepared guidelines for the establishment of an internal control system. See: <http://ngmszakmaiteruletek.kormany.hu/belso-kontrollrendszer>
- ¹¹ Hungarian National Asset Management Inc.
- ¹² The recommendation issued for state-owned enterprises also acknowledges that the effective and transparent corporate governance of companies falling under the scope of state-owned, or more generally publicly owned companies, has been an increasing societal expectation in Hungary (MNV, 2014).
- ¹³ The fact that the referred study only published partial data for Poland somewhat might modify our evaluation. According to data data approximately 600 companies owned by Polish government operated in Poland at the time of the research. We note that the numbers of companies might be fairly volatile in time, as for example in the case of organisational changes, such as mergers or demergers, the number of state-owned enterprises operating in a country may be reduced to a fraction or may be multiplied in a relatively short time.
- ¹⁴ An example for the expansion of interface between the private and public sectors is the case of experts involved in EU tenders by public institutions. The involved experts were not expected to meet the same ethical criteria that had been set for public servants according to the integrity survey conducted by the SAO (Pulay, 2015).
- ¹⁵ Metropolitan Public Domain Maintenance Company.
- ¹⁶ In relation to our recommendations further considerations can be found in *Domokos et al.* (2016).

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