

University of West Hungary
„Széchenyi István” PhD-School in Management and
Organizational Science

The Contents of the Notes to the Financial
Statements and Their Role in Providing a
„True and Fair View” Based on Accounting
Information

Summary of the PhD thesis

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Sopron

2010

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1. Objectives and Hypotheses

For a market economy to function properly it is indispensable that economic agents, in making their decisions, be provided with accurate and unbiased information on the financial position and performance of enterprises, non-profit organizations and other entities at any given time.¹

Accounting information is a special kind of information serving a double purpose. On the one hand it shows the consequences of measures and actions taken during the financial year by recording and processing transactions in a self-contained system. On the other hand – and this shall be the main focus of this dissertation – it is necessary in order to present the company to stakeholders, primarily by disclosing reporting and prior (base) period data and explanations further elucidating such data and matters.

While this dichotomy may lead to differing motivations among those preparing the financial statements, such accounts must be a reliable source of information and present a "true and fair view" of the company to stakeholders.

The most important objective of accounting regulations is to introduce standards ensuring that financial statements are unambiguous and comparable.

The notes to the financial statements, in addition to providing explanations regarding accounting worksheets such as the balance sheet, the income statement and the cash-flow statement and being a vehicle to disclose and expound on details from the ledger and sub-ledgers, are a public document of companies consolidating facts and data from various sources thus adding an extra dimension of information.

Efforts to gradually extend the range of information to be disclosed and measures to reduce administrative burdens are being undertaken simultaneously. The final step towards the latter objective was the introduction of the so-called simplified financial statements in Hungary, doing away with the notes to the accounts. A significant part of companies and partnerships are eligible to use this kind of financial statements

¹ Preamble of the Accounting Act

Subject to mandatory disclosure part of the accounting information of any given company has already been publicly available. Accessing such information, however, was time-consuming and incurred a small fee. Currently this is a rather hot topic as a new set of rules has been introduced providing for the web-based availability of financial statements thus alleviating the difficulties associated with the scarce availability of business information. As of April 30, 2009 publication requirements in Hungary stipulate that such information be published electronically. Electronic publication creates the opportunity for economic agents to obtain the financial statements of their business partners quickly and free of charge. This development is expected to gradually spark some interest for financial statements among economic agents who up until now have failed to show any.

As a consequence the quantity and quality of data and information contained in the financial statements are growing in importance, just like the responsibility of the disclosing entity/individuals with regard to the information disclosed, and information not disclosed in spite of mandatory requirements to the contrary.

In times of economic and financial hardship and against the backdrop of the growing number of liquidations and bankruptcies there is an increased demand for precise risk assessment and reliable conclusions derived from business information.

A growing number of critics claim that financial statements fail to provide a true and fair view of the assets, the financial position and the net income of enterprises. There is thus an urgent demand for financial statements to reflect the real and actual situation of enterprises meaning that the principle of truthfulness be fully brought to bear. The information provided in the notes to the accounts serves as a tool to achieve this objective.

Many domestic investors founded companies in neighbouring countries, sparking interest in and generating demand for unambiguous, straightforward, comparable and reliable accounting information.

The objective of the research underlying the dissertation was to analyse and assess notes to the accounts from various perspectives, being a constituent part of the financial statements according to both domestic and international regulations.

The primary objective of the analysis was to establish to what extent the notes to the accounts contribute their share to making the information obtained from the financial statements reliable and truthful. Do notes to the accounts enable one to derive a reliable and truthful view of the financial position and performance of the entity under scrutiny, by providing extra information (by way of disclosure, presentation, explanation, analysis and assessment) in excess of and in addition to the figures in the balance sheet, income statement and cash-flow statement?

Another objective of the research conducted was to trace the evolution of financial statements in an international setting over the past two decades and to establish the level of conformity between Hungarian and international standards and regulations, as well as to follow up the process of introducing international regulations and their amendments in Hungary. By gaining a better understanding of the idiosyncrasies and the evolution of the respective national regulations of some neighbouring countries (the economic agents of which often act as participants in FDI transactions in Hungary) and highlighting the similarities and differences one is better positioned to assess the domestic system.

From the historical perspective the objective of the research is to highlight the influencing factors, to identify the junctions where major changes occurred and to give an account of the current situation.

It is worthwhile comparing how the requirements set out in the regulations on notes to the accounts relate to the notes to the non-consolidated financial statements prepared by enterprises included in the research and to establish to what extent the amount, contents and quality of information complies with such requirements. Another interesting point is to ascertain whether notes, in addition to formal compliance, do actually contribute to the presentation of a true and reliable overall view.

In designing the questionnaires, interpreting the findings of the primary research, generalizing the criteria for categorizing small and medium enterprises and making sound and reasonable recommendations the author could draw upon 25 years of experience in auditing, tax, financial and business consulting

Amendments in regulations encompass the alignment of reporting and disclosure requirements with certain company characteristics. As far as the structure of their economies is concerned Hungary and other countries the private sectors of which are mainly made up of small (or even micro-) enterprises differ markedly from their economically more powerful counterparts with more sophisticated capital markets. As the size and relative importance of groups of companies categorized according to the same set of criteria may differ significantly depending on whether they are based in one of the EU's economic powerhouses or in Hungary the author performed calculations on how changes in various threshold values applying to reporting and disclosure requirements may influence the categorization of companies. Categories based on characteristics (such as the number of employees, net sales, total assets) used in assigning companies to certain groups (types of SME's, type of the financial statements to be prepared, whether or not the financial statements must be audited, whether or not a chartered accountant must be hired) are affected by changes in threshold values, thus affecting, in turn, the amount and quality of information provided in the notes to the accounts.

In performing this kind of analysis the dissertation aims to demonstrate, based on the current structure of the Hungarian economy, the share of domestic companies that would be exempt from reporting and disclosure requirements and elude control by accounting professionals were the EU and international threshold values used..

Given the problem on hand research focused on the notes to the accounts:

Research objectives:

- to explore and define the role and the position of the notes to the accounts in the financial statements?
- to identify the requirements applying to the contents of the financial statements and analyse the changes to and the compliance with such requirements and to perform a survey in that respect.
- to establish the characteristics of notes complying with mandatory and professional requirements;

- to establish links between the factors and metrics used in describing the position of companies and the amount and quality of information provided in the notes to the accounts (and prior to that defining and establishing the qualitative characteristics best describing the notes);
- to explore, by conducting interviews, the opinions of those who prepare and those who use the notes to the accounts with regard to the circumstances surrounding their preparation and to their practical uses, respectively, and to establish the characteristics that may be generalized.

Based on the practical insights gained from the research the author shall make recommendations aimed at improving the professional aspects of notes to the accounts, as well as at the simplification of their preparation and clarification their uses. In such recommendation the author shall set out practical building blocks aimed at improving the provision of a “true and fair view” as well as on stressing the importance of a standardized approach geared towards small and micro enterprises in particular.

Some important areas with regard to notes to the accounts were not covered by this research. Nevertheless the author hopes to come back to issues such as consolidated financial statements and the public benefit reports of special purpose organisations, non-profit organisations and public interest entities when resuming and continuing her research in this area.

Hypotheses:

H1: Hungarian accounting regulations are gradually approaching ever changing international regulations, EU-directives, the International Accounting Standards/International Financial Reporting Standards (IAS/IFRS) and recommendations. This may be true for notes to the financial statements as well but significant differences and features idiosyncratic to Hungarian regulations can nevertheless be observed on account of differences in international approaches to certain issues and the effects of protracted legislative harmonization of Hungarian accounting regulations.

In default of full conformity and in case of partial harmonization differences between international and Hungarian regulations and practices will be more marked in some areas and less so in others. The differences, however, must not be such that they affect essential basic features.

H2: The Accounting Act (Act No. XVIII of 1991) is considered to be one of the fundamental laws laying the groundwork for socio-economic transition, preceding in time the regulation of many other areas generally deemed to be more important. Amendments to the Accounting Act in the intervening period gradually accommodated changes both in the social and economic context as was deemed necessary from time to time and according to domestic and international demands. In 2000 legislators decided to propose an altogether new Accounting Act instead of further amending the existing one. Some areas were left unchanged, while others saw new and significantly different provisions added to them. The process of amendment has been ongoing ever since: at the beginning on account of the harmonisation of domestic legislation with EU and international standards and later in order to accommodate changes in such foreign regulations and domestic clarifications and reconsiderations.

Regulations on notes to the accounts were subject to multiple amendments as well. Due to permanent changes such amendments were hard to implement and encountered some difficulty prior to gaining traction in practice.

H3: Notes to the accounts, if prepared in compliance with mandatory requirements, contribute much in the way of presenting a true and fair view of the financial position and performance of enterprises. There are four different basic types of financial statements applying to enterprises, each with a different set of rules governing the preparation of the notes. There is no room for further concessions in the presentation of a true and fair view without compromising the purpose of the regulations.

While individual small and medium enterprises (SME's) may not appear to be significant for the economy, they do constitute a considerable force in the Hungarian private sector once viewed collectively. Changing threshold values applying the categorization of companies according to various size-related criteria would result in major shifts among such categories and thus in less information of inferior quality and consequently in a lack of information.

H4: Objective metrics describing the quality of notes to the accounts can be obtained by conducting and subsequently analysing surveys.

The quality of notes to the accounts can be established and measured, allowing for differences in such notes and in the quality of their individual constituent parts to be identified.

H5: The quality of notes to the accounts can be linked to some well-defined characteristics of enterprises. These links can be identified.

The quality of notes to the accounts of enterprises categorized according to well-defined sets of criteria is markedly different.

H6: Based on the opinions of those preparing and using the financial statements one can get a realistic insight into the circumstances under which notes to the accounts are prepared and used.

H7: Significant relationships can be ascertained allowing for recommendations to be made with regard to improving the quality and to the modernisation of the notes to the accounts.

2. The Focus, Method and Rationale of the Research

In preparing the dissertation the author resorted to both secondary and primary research.

Secondary research was based on materials such as domestic and international accounting regulation, laws and directives as well as established research literature.

In reviewing the relevant domestic and foreign directives, laws and standards the dissertation focused on rules and regulations regarding notes to the accounts, a constituent part of financial statements, and, if necessary, on two other main components of such statements: the balance sheet and the income statement. The relevant EU rules and directives and the degree of conformity between EU and domestic regulations were reviewed as well. In addition to domestic rules the relevant regulations of some neighbouring countries with strong economic ties to Hungary were analysed.

Since conducting a large-scale survey with questionnaires would require substantial funds the research method used consisted of a mix of qualitative and quantitative methods (hybrid research method).

In order to review compliance with regulations the author used quantitative methods in establishing the usefulness of the notes with regard to completeness, reliability and quality.

The notes to the financial statements of 150 enterprises were reviewed in the primary research. Various industries, legal structures and company sizes were included in the sample.

In addition to 14 out of the 100 largest medium-sized enterprises in Hungary almost all (20 out of 22) forestry companies operated as public limited companies were included, the latter being state-owned and organised and run under rules specific to their industry. Additionally, these two groups were subject to separate review. In case of forestry companies, in addition to general analysis, it was expressly scrutinized whether data and information on industry-specific non-financial items and on the conservation and protection of the environment were included.

Upon reviewing the notes to the accounts some important items of and changes to both balance sheets and income statements had to be taken into consideration as well. In order to establish whether such notes comply with mandatory requirements the author performed an analysis of the information to be

provided based on the exhaustive enumeration rule, as well as of the optional information derived from the balance sheet and the income statement.

In connection with the review and with the help of questionnaires the author conducted a survey among individuals in charge of preparing the financial statements, such individuals including chief accounting officers employed by the companies in the sample and employees of external contractors charged with accounting and the preparation of the financial statements. Users and readers of the financial statements such as financial institutions and managing directors were interviewed as well.

The questionnaire devised for evaluating the contents and the quality of the notes to the financial statements was comprised of 135 questions on quality-related aspects and of 38 questions on informative features. The design of the questionnaire allowed for primary information and qualitative data to be obtained. Based on the answers to the questions different types of variables were used:

- interval scale (ranging from 1 to 5) indicating the degree of compliance with the relevant statutory provisions or the attitudes towards the question
- discrete random variables (e.g. sales revenues, number of employees, etc.)
- binary variables (yes - no)

The author added to the sample companies that were put into liquidation shortly after publishing their financial statements (until August 2009). In case of such companies the author was looking for information in the 2008 financial statements indicating impending hardship.

In the course of processing the information thus obtained the answers given to the structured questions were identified as independent and dependent variables and fed into Excel spreadsheets, whereupon the author proceeded by using statistical methods admissible for the variables in question to perform quantitative analysis.

3. The Findings of the Research – New Scientific Results

T1. Based on international and EU accounting regulations and the accounting rules of neighbouring countries the author established that

- there is no standard model to be used in the design of the notes to the accounts with requirements regarding similar topics and issues being set out in completely different sections of such regulations;
- similar policy objectives are achieved without the need to resort to particular formal requirements;
- a general trend towards simplification can be observed.

T2. Based on domestic amendments to regulations and the current situation the author established that

- permanent changes to both international and domestic regulations are not conducive to the quality of the notes to the accounts and to the attitudes of individuals preparing and using the them;
- any additional simplification of notes to the accounts and relaxation of regulations on the mandatory disclosure of material and significant items will result in the further impairment of the true and fair view, with restricted audits further deteriorating the quality;
- observing inadequate quality should not act as a catalyst for abolishing or weakening existing regulation but as a force driving measures aimed at disclosing audited information.

In connection with the rules applying to the preparation of the financial statements it was established that

- broadening exemptions from reporting and disclosure requirements (that is adopting EU thresholds in the domestic economy having an altogether different structure) would increase risks in terms of performance, employment and complexity
- the availability for analysis of several thousand medium and large Hungarian enterprises cannot be taken as representing the wealth of information on the scale of the economy as a whole;

- the data and information provided by large corporations were not significantly better or useful – such corporations availing themselves of other means to present their position (stock exchange, risk analyses, etc.)
- enterprises are mainly interested in the financial and overall position and performance of their close business partners in order to forestall, manage and alleviate problems.

T3. Based on the questionnaire developed in order to survey the compliance with mandatory requirements characteristics and metrics suited for describing notes to the accounts were established.

Data obtained from the survey and its subsequent analysis:

- are suited to be used in comparing notes to the accounts;
- adequately describe individual companies and groups of companies.

At the same time it was established that general compliance with the rules applying to notes to the accounts and with the “extensions” necessary for the provision of a “true and fair view of the financial position and performance” cannot be controlled with total accuracy.

T4. The author established that as far as requirements are concerned companies should, instead of being automatically categorised according to performance indicators, be obliged to give priority to the “true and fair view” presentation because including significant and material items improves the usefulness.

There is no direct way of assessing whether the going-concern principle, one of the most important accounting principles, is applied and no significant conclusions to that effect can be inferred from indirect items either.

T5. The author established that the quality of notes to the accounts is decidedly good in case of certain groups of companies, containing information in excess of mandatory requirements.

Pursuant to the survey it was established that the financial statements and in particular the notes to the accounts of certain groups of companies were

prepared using a strongly “accounting-oriented” approach failing to disclose information of significance to users and readers in adequate detail on

- industry-specific aspects of their operations
- and on various physical and operational characteristics.

It was further established that the quality of notes to the accounts of larger enterprises is hardly superior to the average, having trouble in certain areas to even comply with mandatory requirements.

It was established that the notes prepared by companies with **other general characteristics** included in the sample were also only partially up to the task of satisfying the requirements prescribed by law.

It was established that the **notes to simplified financial statements** were in only partial compliance with the respective requirements, in spite of such requirements being less stringent on account of the simplification rules applying.

- T6. The author established that, based on the data obtained from the financial statements and the additional pieces of information from the notes to the accounts, **impending liquidation** cannot be forecasted with a sufficient degree of certainty.

The main reasons for this failure are the following:

- the review of so-called subsequent events is one of the weakest links in notes to the accounts; the companies surveyed failed to address this issue and thus did not disclose looming problems and significant information;
- the financial and economic crisis that started in late 2008 did not yet affect the data contained in financial statements for 2008 in any significant way;
- based on year 2008 and 2007 data provided in the financial statements of such companies it became obvious upon calculating the changes occurring in the main items that the intensity of change was subject to

significant standard deviation; thus analysing this feature alone was not suited to identify with a sufficient degree of certainty companies that were to be liquidated at a later point in time.

The most important indications of imminent failure are diminishing funds, decreasing equity and increasing liabilities.

T7. The analysis of the opinions of individuals preparing and others using the notes to the accounts resulted in conclusions that may be generalized.

The set of features describing the problems associated with notes to the financial statements was identified from the **users' perspective**.

- up until recently published financial statements were difficult to obtain for potential users;
- potential users failed to show interest in such notes;
- there was hardly any information in the notes that was relevant to users (timeliness, accounting lingo, only formal compliance, etc.).
- the group of individuals and bodies looking into the notes to the accounts was largely confined to auditors, members of the executive and supervisory boards, financial institutions and employees of other organizations issuing calls for tenders.

The set of features describing the problems associated with notes to the financial statements was identified from the **perspective of individuals charged with their preparation**:

- as is obvious from the above enumeration individuals in charge of preparing the notes were up until recently not confronted with complaints and demands on professional grounds from the users;
- with heavy focus on other constituent parts of the financial statements (most notably on schedules such as the balance sheet, the income statement and the cash-flow statement) notes were, though recognized as a necessary element, treated as something of a “nuisance” prepared
 - under time pressure;

- and mainly by merely reediting prior period notes;
- The attitudes of those preparing such notes are characterised by caution manifesting itself in the withholding of information constituting trade secrets or information that may become detrimental to the company if disclosed, as well as the in the aim to reduce the informative function to a minimum.

The author established that the sum of the above factors resulted in notes to the account complying with only formal requirements.

T8. The author proved that it is necessary to improve the quality of notes to the accounts.

It was established that the amendment in May 2009 of the rules relating to the publication of the financial statements providing for quick, easy and free-of-charge access could be a starting point for improving the quality of the notes to the financial statements.

The attitudes of the individuals in charge of preparing the notes to the accounts will be influenced in the long run by the more widespread use of notes, as well as by more and increasingly significant and relevant remarks and feedback from the users, while in the short run easy availability will make for improved compliance in terms of formal requirements.

In order for such improvement to be lasting, however, impediments will have to be done away with and incentives will have to be introduced:

- improving the timeliness of the information provided (e. g. by reshuffling year-end procedures allowing filing and publication to be moved closer to balance-sheet date)
- reversing the current trend towards simplification and narrowing down the scope of information to be audited, allowing for boarder and deeper audits of the information disclosed as well as of the procedure of preparing the financial statements.

4. Conclusions and Recommendations

In the dissertation the author makes recommendations aimed at modernising notes to the accounts in the hope of furthering the following positive developments:

- reducing the use of general elements pasted into the document (re-editing prior period accounting policies, failure to mention scarce recognition and measurement options, doing away with the use of indicators and metrics of little significance);
- enhancing the relevance of the notes to the accounts in the presentation of a true and fair view of the company:
 - stricter rules applying to the presentation of the going concern judgement;
 - the pursuit to highlight important and material items and amounts;
 - defining the set of items to be reported even if the corresponding value is nil or non-existent (in conjunction with the importance and materiality criteria above);
- defining a set of clear rules or even standards regarding notes to the financial statements;
- making available auxiliary software and templates.

Even upon the implementation of such measures and corrections the notes to the financial statements will remain a predominantly accounting-oriented document, thus the importance of other information regarding the operations and management of companies will not be compromised.

5. List of the Author's Publications in the Area Covered by the Dissertation

- 1. Tóthné Szabó E. (2009): The Role of Accounting Information in the Crisis. National Science Day Event, University of West Hungary Sopron (November 3, 2009) Published by: University of West Hungary, Faculty of Economics, ISBN 978-963-9871-30-4 (18 pages)*
- 2. Tóthné Szabó E. (2009): Some Alternatives of Reducing Corporate Income Tax. Agricultural Subsidies and Tenders. Loose leaf handbook. RAABE Kiadó Budapest. ISBN 963 9600 01 6 (13 pages)*
- 3. Tóthné Szabó E. (2009): Accounting Treatment of Special Funding Arrangements and their Effect on Net Income. Agricultural Subsidies and Tenders. Loose-leaf handbook. RAABE Kiadó Budapest. ISBN 963 9600 01 6 (p12)*
- 4. Tóthné Szabó E. (2007): Accounting Regulations. Conference on "Competitiveness – Development – Reform", University of West Hungary Sopron (November 7 and 8, 2007) Published by: Soproni Felsőoktatásért Alapítvány, ISBN 978-963-06-6387-8 (11 pages)*
- 5. Hungarian National Auditing Standards 2005. (2006) – (Ed.: Fekete Imréné) (Loose-leaf handbook) Hungarian Adaptation of the International Standards on Auditing issued by the IFAC (joint effort by the Expert Committee of the Hungarian Chamber of Certified Public Accountants) Published by: Magyar Könyvvizsgálói Kamara Oktatási Központ Kft. ISBN 963 86989 0 X (989 pages)*
- 6. Tóthné Szabó E. – Varga J. – Dr. Vágyi F. (2005): Accounting 2005. ISBN 963 00 6209 7, Nebuló 2001 Kiadó Budapest (184 pages)*
- 7. Tóthné – Királyné – Lehotainé – Dr. Vágyi: (2004) Accounting Exercises – Ed.: Tóthné Szabó E. (Published by: „Soproni Pénzügyszakos Hallgatók” Alapítvány) (155 pages)*
- 8. Tóthné – Királyné – Lehotainé – Juhászné: (2003) Accounting Exercises – Ed.: Tóthné Szabó E. (Published by: „Soproni Pénzügyszakos Hallgatók” Alapítvány) Expert reviewer: Dr. Lett Béla, (174 pages)*
- 9. Tóthné Szabó E. (2002): International Accounting Regulations. National Science Day Event, University of West Hungary Sopron (November 15, 2002)*

- 10 *Tóthné Szabó E. (2001): The Tax-Related Aspects of Leases in "Pénzügyi szilánkok" 2001. (Published by: „Soproni Pénzügyszakos Hallgatók” Alapítvány) ISBN 963 00 7520 2 (pp. 475-482)*
11. *Hungarian National Auditing Standards 2001. (2001) – (Ed.: Somogyiné Dr. Kovács Erzsébet) Hungarian Adaptation of the International Standards on Auditing issued by the IFAC (joint effort by the Expert Committee of the Hungarian Chamber of Certified Public Accountants) Published by: Magyar Könyvvizsgálói Kamara Oktatási Központ Kft. ISBN 963 00 1608 X (613 pages).*
12. *Tóthné Szabó E. (2000): The Role of Methodological Guides in Auditing. Conference organised in 2000 by the Hungarian Chamber of Certified Public Accountants (September 6 and 7, 2000)*
13. *Tóthné Szabó E.(1998): Audit Tasks Related to the Year 2000 – Számvitel Adó Könyvvizsgálat ma (SZAK-MA) (40) 9. (p: 376)*

Publications in Foreign Languages:

1. *Kovács R. - Tóthné Szabó E.- Vajna I-né Dr. Tangl A. (2009) A Survey of the Reliability of Accounting and Financial Information with Special Consideration of the Financial and Economic Crisis – “Bulletin of Szent István University 2009” Published by: Szent István Egyetem Gödöllő – (Publication pending) (15 pages)*
2. *Tóthné Szabó E. (2004): A Survey of the Impact of Globalization on Accounting and Auditing Regulation. - Sesiune de Comuniári Sthntifice Cu Participare Internationala Lumea Financiara – Present Si Perspective. Universitatea „Babes-Bolyi” Cluj-Napoca (12-13 Noiembrie 2004.) (pp. 465-470) Ed.: Babes Bolyai Universiti Cluj-Napoca Published by: Sincron Cluj-Napoca (Romania, Kolozsvár)*