

REPORT ON THE OBSERVANCE OF STANDARDS AND CODES (ROSC) Hungary

ACCOUNTING AND AUDITING

June 20, 2004

Contents

Executive Summary

- I. Introduction
- II. Institutional Framework
- III. Accounting Standards as Designed and as Practiced
- IV. Auditing Standards as Designed and as Practiced
- V. Perception on the Quality of Financial Reporting
- VI. Policy Recommendations

Executive Summary

This report provides an assessment of accounting, financial reporting, and auditing requirements and practices within the enterprise and financial sectors in Hungary using International Financial Reporting Standards (IFRS), International Standards on Auditing (ISA), and the relevant portions of European Union (EU) law (also known as the *acquis communautaire*) as benchmarks. It also draws on international experience and good practices in the field of accounting and audit regulation.

In the area of accounting, financial reporting, and auditing law, Hungary implemented the Fourth, Seventh, and Eighth EU Company Law Directives, and ISA. All companies, including banks and insurance entities, are required to present financial statements and, insofar as they are parent companies, consolidated financial statements prepared in conformity with the accounting regulations in Act C on Accounting of 2000. The Budapest Stock Exchange requires its Category A companies to publish IFRS consolidated financial statements and, beginning January 1, 2005, all stock exchange listed companies will be required to publish IFRS consolidated financial statements by virtue of EU Regulation 1606 on the use of IFRS. However, Hungary will not extend this requirement to all *public interest entities* (e.g., approximately 10 listed companies that do not have subsidiaries, non-listed banks and insurance companies). While Hungarian accounting regulations are based on the Fourth and Seventh EU Company Law directives, they may not always be adequate to meet the expectations and needs of users—especially foreign users—of financial statements prepared by those *public interest entities*. While the newly established Hungarian Accounting Standards Board is expected to seek full convergence of Hungarian Accounting Standards with IFRS within the next six to eight years, this report recommends adopting IFRS for *public interest entities* to enhance the transparency of their financial reporting.

The Hungarian Financial Supervisory Authority (HFSA) reviews the financial statements of listed companies, banks and insurance entities and other financial and investment institutions, but its procedures fall short of the requirements of Standard No. 1 of the Committee of European Securities Regulators (CESR). The ROSC assessment identified some compliance issues in IFRS financial statements and the related audit reports of listed companies. Urgent action is required to implement national procedures that comply with CESR Standard No. 1 on Financial Information, Enforcement of Standards on Financial Information in Europe.

In the area of auditing requirements, Hungary now complies with the Eighth EU Company Law Directive and with ISA. The Chamber of Auditors has full and sole responsibility for the development and issuance of national auditing standards, the audit profession's code of ethics, and quality control. This report draws upon recent international experience in other countries, as well as expected amendments to EU Directives, and recommends that the current self-regulation of the audit profession should be reviewed and an adequate oversight mechanism be established. This issue should be addressed as a matter of urgency.

This report was prepared by a team from the World Bank on the basis of the findings from a diagnostic review carried out in Hungary in June 2004. The staff team comprised Frédéric Gielen (ECSPS). The review was conducted through a participatory process involving various stakeholders and led by the country authorities.

I. INTRODUCTION

1. This assessment of accounting and auditing practices in Hungary is part of a joint initiative of the World Bank and the International Monetary Fund (IMF) to prepare Reports on the Observance of Standards and Codes (ROSCs). The assessment focused on the strengths and weaknesses of the accounting and auditing environment that influence the quality of corporate financial reporting. International Financial Reporting Standards (IFRS)¹ and International Standards on Auditing (ISA) have served as benchmarks for the assessment, which involved a review of both mandatory and actual practice.

2. Hungary has a population of 10.2 million and Gross National Income (GNI, *Atlas Method*) per capita of US\$ 5,280² as of end-2002. The country has successfully attracted substantial inflows of foreign direct investment, built up a robust private export sector, and achieved solid economic growth with low unemployment. In its drive to join the EU, it has concentrated on completing the transformation agenda while establishing a sustainable, prudently-managed macroeconomic environment.

3. There are 53 companies listed on the Budapest Stock Exchange—24 on the A list and 28 on the B list—with a market capitalization of approximately US\$16.7 billion as of the end of 2003, which represents approximately 19.5 percent of 2003 GDP.³ Most listed companies have a strategic investor or other large shareholder, with the result that the free float and stock exchange trading of most companies are small in comparison to major markets. As of the end of 2003, there were 31 banks operating in the Hungarian banking system, with banking assets totaling HUF11.7 trillion (equivalent to approximately US\$56.2 billion). There were 66 insurance companies, which wrote around HUF467 billion (equivalent to approximately US\$2.2 billion) in premiums in 2003.

4. Hungary became a member of the European Union (EU) on May 1, 2004. Its accession to the EU has been the driving force behind the adoption of updated accounting and auditing laws and related reforms. In joining the EU, the Government and market institutions have had to introduce and implement the *acquis communautaire* for corporate financial reporting within their respective regulatory domains. Necessary though headline regulations may be, a clear lesson from recent corporate scandals is that they need to be effectively enforced and supplemented by the use of incentives and information to maximize the number of well-informed, well-motivated stakeholders. Toward that end, this report recommends that Hungary continue to strengthen the enforcement of accounting and auditing standards.

II. INSTITUTIONAL FRAMEWORK

A. Statutory Framework

5. **Hungary's accounting and auditing laws comply with the relevant EU Directives and allow for the implementation of the EU Regulation on the use of IFRS in the consolidated financial statements of stock exchange listed companies from 2005.** Act C of

¹ Within this report, IFRS refer to both International Financial Reporting Standards (IFRS) issued by the International Accounting Standards Board and the Standards issued by the Board of the International Accounting Standards Committee, and each applicable Interpretation of the International Financial Reporting Interpretations Committee.

² Value based on the rate applicable on December 31, 2003 (HUF208=US\$1).

³ Budapest Stock Exchange, Annual Statistics 2003.

2000 on Accounting, which has been effective since January 1, 2001, complies with the Fourth and Seventh EU Company Law Directives and subsequent amendments to those Directives. The Government decrees on reporting by banks and insurance companies comply with the EU Bank and Insurance Accounts Directives. The Act on the Chamber of Auditors and Auditing Activities complies fully with the Eighth EU Company Law Directive.⁴

6. **Currently, all economic entities, including banks and insurance entities, are required to present legal entity financial statements and, insofar as they are parent companies, consolidated financial statements prepared in conformity with the accounting regulations in Act C on Accounting of 2000 (the Act on Accounting).** The Act on Accounting requires that all companies prepare their financial statements in accordance with Hungarian Accounting Standards (HAS).⁵ These Standards are detailed and reflect the requirements of the EU Directives and IFRS. Companies are allowed to prepare consolidated financial statements in accordance with IFRS or other internationally recognized accounting standards, provided that these financial statements are reconciled to the amounts required by Hungarian Accounting Standards. Legal entities are not allowed, and will not be allowed, to publish IFRS financial statements instead of HAS financial statements until any possible tax implications of the adoption of IFRS have been resolved.

7. **The financial statements of banks must comply with Government Decree 250/2000 on Special Provisions Regarding the Annual Reporting and Bookkeeping Obligations of Credit Institutions and Financial Enterprises, in addition to the requirements of the Act on Accounting.** The Decree complies with the EU Bank Accounts Directive. The Decree is supplemented by Decree 14/2001 on loan loss provisioning, the application of which is compulsory and may possibly conflict with the equivalent requirement in IAS 39, *Financial Instruments: Recognition and Measurement*. Neither the National Bank nor the Hungarian Financial Supervisory Authority (HFSA) has issued any requirements on the content of bank financial statements.

8. **The financial statements of insurance entities must comply with Government Decree 192/2000 on Reporting and Bookkeeping Requirements of Insurers, in addition to the requirements of Act on Accounting.** The Decree complies with the EU Insurance Accounts Directive.

9. **The Regulations for Listing, Continued Trading and Disclosure of the Budapest Stock Exchange require that all Category A companies publish financial statements in accordance with IFRS or accounting principles generally accepted in the United States (US GAAP). The regulations also require that all Category B companies publish financial**

⁴ Hungary has implemented the provisions of the Eighth EU Company Law Directive (1984), which contains some requirements on registration and professional integrity. This Directive does not include requirements on how a statutory audit should be conducted and the degree of public oversight or external quality assurance, which is needed to ensure a high-quality audit. The lack of a harmonized approach to statutory auditing in the EU was the main reason behind the Commission's proposal for a new Eighth EU Company Law Directive (March 2004), which maintains the basic conditions on education and training from the existing Eighth Directive but broadens the scope of application of EU legislation by introducing new requirements concerning the manner in which an audit should be carried out and the structures needed to ensure audit quality as well as ensure trust in the audit function. As discussed more thoroughly in paragraph 39, the provisions of the proposed new Eighth EU Company Law Directive have not yet been adopted in Hungarian legislation.

⁵ Within this report and for convenience purposes, Hungarian Accounting Standards refers to accounting requirements set out in Hungarian legislation, in particular Act C of 2000 on Accounting.

statements in accordance with either Hungarian Accounting Standards, IFRS or US GAAP. Category A companies must have a minimum market capitalization of HUF2.5 billion (equivalent to approximately US\$12 million), at least 100 shareholders and at least three completed and audited years. Category B companies are other listed companies. Those companies that publish IFRS or US GAAP financial statements must publish a reconciliation from IFRS/US GAAP to Hungarian Accounting Standards. Beginning January 1, 2005, by virtue of EU Regulation 1606/2002 on the use of IFRS,⁶ both Category A and Category B companies will be required to publish IFRS consolidated financial statements. However, since the EU does not require all public interest entities to comply with IFRS, Hungary will not extend this requirement to all *public interest entities* (e.g., approximately 10 listed companies that do not have subsidiaries, non-listed banks and insurance companies). As discussed more thoroughly in paragraph 30 below, the ROSC team believes that Hungarian Accounting Standards may not always be adequate to meet the expectations and needs of users—especially foreign users—of financial statements prepared by those *public interest entities*.

10. **The Act on Accounting requires the audit of the legal entity and any consolidated financial statements of all companies whose annual net sales exceed HUF50 million (equivalent to approximately US\$240,000).** The size limit is substantially below the equivalent limit in the Fourth EU Company Law Directive (Euro 7.3 million, or approximately US\$8.7 million), which means that the financial statements of many small- and medium-sized companies in Hungary are subject to annual audit, whereas the financial statements of equivalent companies in other EU Member States are generally not. If Hungary increased the size limit to the maximum allowed by the Fourth EU Company Law Directive, it is understood that less than 100 Hungarian companies (other than banks, insurance companies and other financial institutions) would require an audit.

11. **Shareholders appoint the statutory auditor for a renewable period of up to five years, but unlike in certain EU Member States, there are no termination mechanisms that could provide additional safeguards to ensure auditor independence.** Hence, a statutory auditor may resign or be dismissed to avoid an audit opinion qualification. Either an individual auditor (i.e. natural person that is a member of the Chamber of Auditors) or an audit firm may be appointed as the registered auditor of a company; however, in the latter case, the appointment document must also designate the individual auditor who will act on behalf of the audit firm and be responsible for the annual audit. Currently, the dismissal of auditors is not regulated by the EU; however a new directive is being drafted to deal with this issue, which should come into force in 2005 or 2006. Hence, discussions are in progress with regard to the elaboration of a Hungarian legal regulation aligned with the upcoming EU auditing directive.

12. **All companies must file their financial statements and auditor’s report with the Court of Registration and with the Company Information Office of the Ministry of Justice. Financial statements are readily available and can be downloaded from the website**

⁶ Regulation (EC) No. 1606/2002 of the European Parliament and of the Council of July 19, 2002 *on the application of international accounting standards*. Regulation 1606/2002 requires that listed companies prepare their consolidated financial statements in accordance with endorsed IFRS (i.e., IFRS adopted by the European Commission). Accordingly, if a standard is not endorsed, it is not required or—in certain instances—not permitted to be applied by a company. Refer to Comments of the European Commission dated November 2003 concerning certain Articles of Regulation No. 1606/2002 and the Fourth and Seventh EU Directives. The Comments set out that “to the extent that a rejected standard conflicts with a standard which has been endorsed – for example where an endorsed standard is amended – the rejected standard may not be applied. The company must continue to apply fully the standard endorsed by the EU.”

operated by the Office. Legal entity financial statements must be filed within 150 days of the balance sheet date, and consolidated financial statements within 180 days of the balance sheet date. These financial statements are available for public inspection. Companies will be able to file electronically from 2005, and electronic access to filings will be available from 2007. If a company does not file its financial statements with the Court of Registration, it will not be permitted to carry on trading. In order to evaluate the actual availability of financial statements, the ROSC team selected a sample of companies and obtained the audited financial statements for such companies from the Office website.

13. **Stock Exchange listed companies, banks, insurance companies and other financial entities must file their financial statements with the Hungarian Financial Supervisory Authority within four months of the balance sheet date.** Act CXX of 2001 on the Capital Market and the Regulations for Listing, Continued Trading and Disclosure of the Budapest Stock Exchange require listed companies to also file their financial statements with the Budapest Stock Exchange within four months of the balance sheet date.

B. The Profession

14. **The Hungarian Chamber of Auditors was established by Act LV of 1997 on the Chamber of Hungarian Auditors and Auditing Activities as a self-regulatory body.** When passing the Act, Parliament acknowledged the right of auditors to self-regulation albeit within the framework established by law. The Act gives the Hungarian Chamber of Auditors the responsibilities and rights with respect to:

- the development and issuance of auditing standards;
- the development and issuance of ethical regulations relating to auditors;
- the quality control of audit work;
- the determination of requirements for pre-qualification education, professional experience and examinations of prospective auditors;
- the maintenance of a register of auditors and audit companies; and
- the discipline of auditors.

15. **The Hungarian Chamber of Auditors has 5,780 individual members, of which 3,695 are actively engaged in audit work either as practitioners or as employees in an audit firm.** Only members of the Hungarian Chamber of Auditors may carry out statutory audits. The membership includes a significant number of auditors who qualified prior to the Act on the Chamber of Auditors and the establishment of the Chamber. Members of the Chamber who do not perform auditing activities are treated as suspended members (2,085 as of December 31, 2003). There are approximately 1,800 audit firms registered with the Chamber. These include local member firms of international audit firm networks, as well as many strictly local firms. There is a perception that the number of auditors is high for the population of the country.

16. **Professional ethics requirements are developed and issued by the Hungarian Chamber of Auditors and are based on the IFAC Code of Ethics (1996 version).** The ethics requirements were developed by the Chamber of Auditors' ethics committee and approved by the Chamber's assembly. The principles in the IFAC Code of Ethics have been modified to a more rules-based approach in order to reflect the Hungarian legal environment. The Code is supplemented by the requirements of the Act on the Chamber of Auditors and Auditing

Activities, which forbid an individual auditor or an audit firm from providing non-audit services to audit clients, although some audit firms provide advisory services through separate companies. The combined requirements of the Chamber of Auditors' Code of Ethics and the Act on Accounting generally comply with the European Commission's 2002 recommendations on the independence of statutory auditors.⁷

17. **While auditors have unlimited liability under the civil law, there have been no significant legal actions against auditors or audit firms.** Under the general rules of the Hungarian Civil Code (Articles 318, *liability for breach of contracts*, and 339, *tortious liability*, of Act IV of 1959), a company—based on Article 318⁸—and any shareholder, any creditor, or any other damaged party—based on Article 339—of a company can sue the statutory auditor if any of them suffers damages in (causal) connection with the auditor's culpable breach of duties (whether negligent or intentional). Active members of the Chamber of Auditors or their audit firms are required to hold professional indemnity insurance with a minimum cover of HUF5 million (equivalent to approximately US\$24,000). Failure to obtain such insurance leads to exclusion from membership. As a general rule, the board of directors and the auditors of a company are not jointly and severally liable for each other's breach of duty.⁹ Creditors and equity holders tend not to pursue claims against auditors, in part due to a perception that such claims are too time-consuming and costly.

18. **Auditors may also be reported to the Chamber of Auditors' ethics committee for violations of their obligations as auditors, breaches of ethical regulations, negligence, and professional deficiencies.** The committee considers about 70 to 80 cases a year but few result in any disciplinary action against the auditors. The Committee has the authority to impose disciplinary sanctions on an auditor or audit firm ranging from a reprimand, a pecuniary penalty of up to five times the member's annual dues to the Chamber, or permanent suspension. The auditor may appeal any disciplinary sanction of the Committee before the president of the Chamber within 30 days. If the appeal is not successful, the auditor may challenge the Chamber president's ruling before ordinary courts within 60 days.

19. **Auditors are not subject to criminal liability.** A breach of duty by the auditor is not penalized by the Hungarian Criminal Code (Act IV of 1978), as such a breach of duty is not considered a *sui generis* criminal offense. However, an auditor may, of course, commit various criminal offenses by abusing his or her position (e.g., if he or she deliberately contributes to the fraudulent actions of a director; deliberately and illegally discloses or sells clients' business secrets; assists the directors in tampering with the accounts, etc.). In such cases, he or she would, indeed, be subjected to criminal liability according to the general rules of the Criminal Code.

20. **Any person responsible for preparing financial statements within a company or providing accounting services to a company must hold a "certified accountant" license issued by the Ministry of Finance.** Government Decree 93 dated May 5, 2002 on accounting services (as amended in May 2004) requires that any person responsible for preparing financial statements within a company or providing accounting services to a company must hold a

⁷ European Commission Recommendation of May 16, 2002, *Statutory Auditors' Independence in the EU: A Set of Fundamental Principles*.

⁸ The ROSC team noted that some audit firms add a liability cap in the agreement they enter into with the audited company. However, Hungarian lawyers contend that this cap is not enforceable based on Article 314 of the Civil Code.

⁹ However, if damages were caused jointly by the directors and the auditor (e.g., a fraud where the auditor and the directors were also involved) they would be jointly and severally liable to any damaged party pursuant to Article 344 of the Civil Code.

“certified accountant” license issued by the Ministry of Finance. The ROSC team recognizes that the asymmetry of knowledge between professionals and users of services may require adequate rules on education in the public interest. The debate as to whether the legislature should create a monopoly for the provision of accounting services is less clear. Some EU Member States still have such monopolies, in part due to historical reasons. However, there is a clear trend away from such monopolistic rules, as evidenced by the recent debate on the *acquis communautaire* (Chapter VI – Competition Policy).¹⁰

C. Professional Education and Training

21. **Applicants for the membership of the Chamber of Auditors must have acquired appropriate higher education, obtained initial practical experience (three years), passed the Chamber examinations (three years part-time study) and obtained further professional experience (three years) as an audit assistant under the supervision of an active member of the Chamber.** The nine-year program exceeds the current requirements of the Eighth EU Company Law Directive although it is similar to existing national requirements in some other EU Member States. The Chamber defines the requirements and provides the textbooks and tuition for its examinations. It has also established a training company to provide the education. The Chamber evaluates the professional experience obtained by applicants after passing the examinations. Some auditors and others are studying for the qualification of the Chartered Association of Certified Accountants (ACCA).

22. **The Act on the Chamber of Auditors and Auditing Activities and the Chamber require that auditors obtain continuing professional education (CPE).** The Chamber of Auditors requires its members to obtain 24 hours a year of CPE, all of which must currently be provided by the Chamber. The Chamber intends to allow external training providers to provide CPE after approving the providers of CPE programs in line with IFAC guidance. The objective of the Chamber’s CPE programs is to develop, standardize and update members’ knowledge. In recent years, there has been a substantial focus on education related to the implementation of national auditing standards. CPE programs offered by organizations other than the Chamber, including in-company programs provided by audit firms, are currently not recognized by the Chamber for CPE purposes.

D. Setting Accounting and Auditing Standards

23. **Hungarian Accounting Standards are currently set by the Ministry of Finance and are incorporated in the Act on Accounting.** The Act on Accounting includes very detailed accounting requirements based on the Fourth and Seventh EU Company Law Directives and IFRS. Beginning January 1 2005, these Standards will apply only to the legal entity financial statements of companies and to the consolidated financial statements of non-stock exchange listed companies that do not opt to present financial statements prepared in accordance with IFRS.

24. **The Hungarian Accounting Standards Board has recently been established to take over the responsibility for setting Hungarian Accounting Standards from the Ministry of Finance.** The Board was established by Government Decree 202 of 2003 under the authority of the Accounting Act. Its establishment reflects the desire of the Ministry of Finance for accounting

¹⁰ The overall context is that in 2000, in Lisbon, the European Council set the ambitious goal for the EU of becoming the most competitive and dynamic knowledge-based economy in the world by 2010, as set out in “Competition in Professional Services: New Light and New Challenges,” by Mr. Mario Monti, Commissioner for Competition, European Commission, March 21, 2003.

standards to be developed by the accounting and auditing professions rather than by government. The Ministry of Finance envisages that the Board will work to ensure full convergence of Hungarian Accounting Standards with IFRS within six to eight years. The Board consists of 32 members from a variety of backgrounds but the standards will be developed by a sub-committee consisting solely of members of the accounting and auditing professions. The full Board is required to approve the standards but it is not yet clear how much of a role Board members will play in reviewing the work of the standards sub-committee. Once approved, the standards will be issued by the Ministry of Finance.

25. **The Hungarian translation of IFRS for 2003 is readily available.** The translation of IFRS was carried out in cooperation with the European Commission and the International Accounting Standards Committee Foundation (IASCF) and is now complete. However, there are criticisms of the IASCF's support for the translation process and of delays in the IASCF's own processes.

26. **Hungarian Standards on Auditing are set by the Chamber of Auditors and are based on International Standards of Auditing.** The Act on the Chamber of Auditors and Auditing Activities requires auditors to carry out their audits in accordance with Hungarian Standards on Auditing drawn up by the Chamber. The Chamber is required by the Act to continuously update, amend and publish Hungarian Standards on Auditing and take measures for the harmonization of those Standards with ISA. The Chamber has adopted virtually all ISA as national standards and has plans to adopt the remaining, more recently published, ISA. The Chamber has added to the Standards explanatory material dealing with the Hungarian environment. The Chamber has also developed guidance on the application of the Standards to micro and small entities. Auditors reporting on IFRS consolidated financial statements generally strive to conduct their audits in accordance with ISA, which ensures compliance with Hungarian Standards on Auditing.

E. Enforcing Accounting and Auditing Standards

27. **Like other EU Member States, Hungary has to address significant issues in the design and strengthening of suitable institutions to implement and enforce the requirements set out in the *acquis communautaire*.** As discussed in Section II.A above, the existence of a well-developed *acquis* in the area of accounting and auditing regulation facilitated the choice of appropriate models to follow. In addition, policymakers have to keep abreast with ongoing changes to the *acquis*, which are part of the international response to recent corporate accounting scandals.

28. **The Hungarian Financial Supervisory Authority (HFSA) reviews the financial statements of listed companies, banks and insurance entities and other financial and investment institutions but its procedures fall short of the requirements of Standard 1 of the Committee of European Securities Regulators (CESR).**¹¹ The HFSA checks to see that required company financial information has been published but does not carry out any checks on whether the financial statements comply, as appropriate, with Hungarian Accounting Standards, IFRS or US GAAP. The HFSA assumes that audited financial statements comply with the appropriate accounting standards. CESR Standard 1, which was developed to support the implementation of EU Regulation 1606/2002 on the use of IFRS, requires national regulators to, among other things, review a sample of financial statements of listed companies for compliance

¹¹ Committee of European Securities Regulators, Standard No. 1 on Financial Information, *Enforcement of Standards on Financial Information in Europe*, March 2003 (hereinafter, "CESR Standard 1").

with IFRS and require the restatements of errors in those financial statements. The HFSA represents Hungary in meetings of CESR and has recommended to the Ministry of Finance that the necessary legal changes should be made so as to implement CESR Standard 1. The Budapest Stock Exchange receives, but does not review, the financial statements of listed entities.

29. **The Act on the Chamber of Auditors and Auditing Activities requires that the Chamber organize and oversee the quality control regime of the work of auditors, including the evaluation of the quality control systems employed by audit firms.** In May 2002, the members of the Chamber of Auditors approved the necessary quality control regulation under which the Chamber will conduct inspections of its members to assess the degree of compliance with professional standards. The Chamber plans to inspect about 700 auditors annually so that all of its members will be inspected within five years. The inspections will be conducted not less than once every three years for auditors with public interest clients and every four years for auditors who employ five or more auditors. The inspections are to be carried out by selected members of the Chamber who have:

- at least six years membership of Chamber;
- carried out at least 30 audits;
- been inspected and found to be satisfactory; and
- completed a special Chamber training program.

The first inspections began in September 2003 and focused on the application of national auditing standards. It is contemplated that later inspections will be more extensive. The Chamber will issue a report of the overall findings but not on individual inspections. The quality control program is intended to comply in principle with the European Commission's 2000 recommendations on minimum quality assurance standards for audits, except for the lack of public oversight and the lack of involvement of non-auditors.¹²

III. ACCOUNTING STANDARDS AS DESIGNED AND AS PRACTICED

30. **There has been a substantial effort in Hungary to reduce the differences between Hungarian Accounting Standards and IFRS but some significant differences remain.** While some stakeholders claim that Hungarian Accounting Standards (HAS) are based on the same logic, philosophy and concepts as IFRS and are, therefore, very similar to IFRS, others argue that the application of Hungarian Accounting Standards is heavily influenced by tax considerations when tax rules conflict with IFRS. This argument appears to be supported by the Ministry of Finance's view that IFRS should not be used in legal entity financial statements because of the possible tax consequences. Specific differences between Hungarian Accounting Standards and IFRS include:

- ***Capitalization of foreign exchange losses.*** HAS require that foreign exchange differences arising in reporting an enterprise's long-term liabilities at rates different from those at which they were initially recorded during the period, or reported in previous financial statements, should be recognized as an asset (rather than as an expense) when the debt is associated with the acquisition of fixed assets. Such capitalization could result in overstated fixed assets, and the deferral of foreign

¹² European Commission Recommendation of November 15, 2000, *Quality Assurance for the Statutory Audit in the European Union: Minimum Requirements*.

exchange losses (or gains) may not comply with IAS 21, *The Effects of Changes in Foreign Exchange Rates*.

- **Capitalization of intangible assets or the deferral of similar costs.** HAS permit/require that intangible assets and start-up costs should be capitalized (rather than expensed) in circumstances that may not be permitted by IAS 38, *Intangible Assets*.
- **Recognition of provisions for contingent liabilities, future liabilities and possible losses.** HAS require provisions to be recorded based on criteria that may not comply with IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, and IAS 39. Generally, because of the influence of taxation on HAS (see paragraph 31 below), provisions are likely to be understated as compared to IFRS.
- **Recognition of special provisions or allowances by banks, insurance companies and other financial institutions.** These provisions (e.g., the general risk reserve of up to 1.25 percent of the adjusted balance sheet in banks) may not comply with IAS 30, *Disclosures in the Financial Statements of Banks and Similar Financial Institutions*, IAS 37 and IAS 39.
- **Non-recognition of deferred taxes with respect to taxable and deductible temporary differences.** HAS do not mention deferred tax accounting; whereas IAS 12, *Income Taxes*, requires that an enterprise recognize the amount of current and future tax related to events that have been recognized in financial accounting income. Consequently, deferred tax liabilities derived from situations where future taxable income will be greater than future financial accounting income due to temporary differences (e.g., due to differences between tax depreciation and book depreciation) are not reported under HAS. Conversely, deferred tax assets are not recorded either.
- **HAS do not require that information be reported for business segments and geographical segments.** The lack of segment information hinders analysis of a company's financial performance, and its absence is severely criticized by investors and bankers. Many enterprises provide groups of products and services or operate in geographical areas that are subject to differing rates of profitability, opportunities for growth, future prospects, and risks. Information about an enterprise's different types of products and services and its operations in different geographical areas (i.e., segment information) is relevant to assessing the risks and returns of a diversified or multinational enterprise but may not be determinable from the aggregated data. Therefore, segment information is widely regarded as necessary to meeting the needs of users of financial statements.
- **Treasury stock is recorded as an investment.** HAS require that an enterprise should record the cost it incurs to re-acquire its own equity instruments as a financial asset. This does not conform to SIC 16, *Share Capital - Reacquired Own Equity Instruments (Treasury Shares)*, which require that the cost of acquiring treasury stock should be deducted from equity. Presenting treasury shares as an asset may mislead users of financial statements when assessing capital adequacy.
- **Recognition of revenue and costs on service and construction contracts based on invoiced amounts rather than the stage of completion.** IAS 11, *Construction Contracts*, and IAS 18, *Revenue*, require that revenue and costs on service and construction contracts should be recorded based on the stage or percentage of completion. Under this stage of completion method, contract revenue is matched with the contract costs incurred in reaching the stage of completion, resulting in the

reporting of revenue, expenses and profit, which can be attributed to the proportion or percentage of work completed. The IFRS method provides useful information on the extent of contract activity and performance during a period, which is not available in HAS financial statements.

- **Broader definition of extraordinary items.** The definition of extraordinary items under HAS 17 is somewhat broader than under IFRS. HAS specifically require the classification of specific gains and losses as extraordinary items; whereas IAS 8, *Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies*, requires those items to be classified as ordinary items.
- **Limited related-party disclosures.** HAS require disclosures of the name of subsidiaries, associates, jointly-managed companies, other enterprises with a share ownership relationship, and loans and advances to directors, management and the supervisory board. However, the definition of related parties under HAS does not appear to include (a) individuals owning an interest in the voting power of the reporting enterprise that gives them significant influence over the enterprise, and (b) enterprises in which a substantial interest in the voting power is owned, directly or indirectly, by any person described in (a) or over which such a person is able to exercise significant influence. The ROSC team noted examples of a Category B listed company, which while complying with HAS did not disclose significant related party transactions with a privately-held enterprise owned by a significant shareholder of the Category B listed company. In order for a reader of the financial statements to form a view about the effects of related party relationships, IAS 24, *Related Party Disclosures*, requires disclosure of such related-party transactions.

31. **Corporate taxation is closely related to the recording of financial transactions in conformity with detailed accounting rules set out in the Act on Accounting.** To satisfy requirements of taxation authorities with regard to recognition of revenues and expenses, preparers of general-purpose financial statements tend to follow tax rules rather than the accounting treatment required by HAS in various areas (e.g., depreciation, accruals, revenue recognition, provisions). Transparency and accountability suffer from this emphasis on tax.

32. **The ROSC team made assessments of the compliance gap with IFRS and the HAS.** For the review, the ROSC team selected IFRS financial statements prepared by nine companies listed on the Budapest Stock Exchange, including one bank. The team also reviewed the HAS-based financial statements prepared by six companies, including two Category B listed companies, two non-listed medium-sized companies subject to statutory audit requirements, and two non-listed small companies. The two small companies were not subject to a statutory audit. The results of the ROSC team review are set forth in the following paragraphs 33 to 36 below.

33. **In the IFRS financial statements of one listed company, the ROSC team identified a material departure from IFRS, which resulted in the financial statements presenting a misleading view of the company's performance.¹³ The audit opinion on these financial statements was not qualified.** The company measured inventory in accordance with IAS 2 for

¹³ Note to paragraphs 33 to 36: the ROSC team used stratified random sampling to select the companies that were analyzed in this report. However, due to the sample's small size, it cannot be considered to be representative of all listed companies. Hence, the findings, although useful for illustrating potential problems in financial reporting, pertain to shortcomings found in the financial statements of specific companies. The findings are not meant to reflect systemic problems that would apply to listed companies in general.

the first time in 2003. In prior periods, the measurement of inventory excluded some or all production overheads, a practice that does not comply with IAS 2. The successive changes in measurement practice were dealt with by valuing the closing inventory, but not the opening inventory, in accordance with the new method—a practice that does not comply with IAS 8. A change in measurement practice is a change in accounting policy. However, the financial statements did not include restated comparative information or restated pro forma comparative information, information that is required by IAS 8 unless it is impracticable to provide it. The effect of including all production overheads in the measurement of closing inventory but only some overheads in opening inventory had a very material effect on reported performance in 2003 (for example, it doubled the increase in operating profit and accounted for the whole of the increase in profit before tax). In the view of the ROSC team, the effect of the change in the inventory measurement practice on the 2003 financial statements was so material as to make those financial statements misleading. The company did draw attention to the effects of the change in the inventory valuation method in its financial review and its quarterly announcements. However, the audit opinion in 2003 was not qualified. Furthermore, the audit opinions in 2000, 2001 and 2002 were not qualified for non-compliance with IAS 2. The statutory auditor is a local member firm of an international audit firm network (see paragraph 38).

34. The IFRS consolidated financial statements prepared by the other listed companies (other than the bank) generally complied with IFRS. The ROSC team identified a small number of possible conflicts with IFRS; however, none of the possible conflicts were deemed to be material. The related audit reports were not qualified, which suggests that the auditors also felt that the issues were not material. These include the following:

- one company used US\$ as the measurement currency of a subsidiary in a country with very high inflation, a practice that may not comply with IAS 21 and SIC 19, *Reporting Currency – Measurement and Presentation of Financial Statements under IAS 21 and IAS 29*. Such IAS would require the use of local currency and, if appropriate, the use of IAS 29, *Financial Reporting in Hyperinflationary Economies*, to deal with the effects of very high inflation in this country.
- one company included gains and losses on treasury shares in profit or loss instead of equity as required by SIC 16.
- one company recognized revenue for fees for connection services, in accordance with legal requirements, rather than the substance of the arrangement. Pre-1997 fees were deferred and amortized over the life of the related assets. Post-1997 fees were recognized on activation of the service. Neither of these policies may comply with IAS 18.

35. The IFRS-based consolidated financial statements prepared by the listed bank generally complied with IFRS but some loss provisions may exceed those required by IFRS. Provisions for losses on loans, off-balance sheet commitments and contingent liabilities are maintained at a level adequate to absorb probable future losses, which may exceed incurred losses as required by IAS 39. In essence, the additional reserves may represent a “cushion” to enable the bank to manage or smooth its earnings, which may not be in accordance with IAS 39. The bank also does not publish segment information for its other activities, which are a reportable segment under IAS 14, *Segment Reporting*. Some, but not all, of the missing information about the insurance segment is provided in the income statement, balance sheet and notes.

36. **The financial statements prepared under HAS generally complied with HAS.** The ROSC team identified a small number of possible conflicts with the Standards. These included the following:

- ***One of the Category B listed companies presented financial statements, including note disclosures, which were of such poor quality as to preclude investors and other users from judging whether the company's securities were a sound investment; nor could the financial statements be relied on for other decision-making purposes.*** The notes to the financial statements relating to accounting policies were incomplete, not understandable or of limited use. For example, the notes indicated that “an allowance for bad debt is recorded where the credit rating of the customer makes it necessary” or “liabilities are stated in the balance sheet at their carrying amount.” In addition, there appeared to be a significant amount of related party transactions but the details of these transactions were not disclosed in the notes. While these issues are not, strictly speaking, a breach of HAS, these significant issues raise questions about the relevance of the related unqualified audit opinion. The other Category B listed company generally complied with HAS.
- ***Similarly, the notes to the audited financial statements of the two non-listed companies also provided little information on accounting policies. The ROSC team also noted accuracy problems, since the amounts reported on the face of the balance sheet did not tie in with the amounts disclosed in the notes.*** The related audit reports were unqualified.

IV. AUDITING STANDARDS AS DESIGNED AND AS PRACTICED

37. **There are no significant differences between Hungarian Auditing Standards and ISA.** Areas of difference relate only to the more recent standards, which the Chamber of Auditors plans to adopt in the near future. Auditors reporting on IFRS consolidated financial statements generally conduct their audits in accordance with ISA, which ensures compliance with Hungarian Standards on Auditing.

38. **In its assessment of the compliance gap with IFRS and the HAS in the consolidated financial statements of listed companies, the ROSC team identified possible conflicts with ISA or best practices.** These include the following:

- The auditors of the company that measured inventory in accordance with IAS 2 for the first time only in 2003 (refer to paragraph 33 above) issued an unqualified IFRS opinion on the 2000, 2001, 2002 and 2003 IFRS financial statements notwithstanding material non-compliance with IAS 2 and IAS 8. As a result, in the opinion of the ROSC team, the audit report does not comply with ISA 700 *The Auditor's Report on Financial Statements*. The auditors justified their opinion to the ROSC team on the basis that the changes in measurement practice were changes in accounting estimates, and not a change in accounting policies. They stated that it was impracticable to quantify the effects of the changes because the necessary information was not available to the company and that, in any event, all the different measurement practices were allowed by the flexible approach in IAS 2 on the inclusion of overheads in the measurement of inventories.
- The auditor of another company relied entirely on the audit report of other auditors for the audit opinion with respect to a subsidiary that represented 23 percent of total assets and 22 percent of total sales, and an associate that represented 5 percent of total assets. The sole reliance on the audit report is permitted but not recommended

by ISA 600, *Using the Work of Another Auditor*, which recommends that the principal auditor obtain sufficient appropriate audit evidence that the work of the other auditor is adequate for the principal auditor's purposes. The ROSC team recommends that statutory auditors, especially local member firms of international audit firm networks, discontinue this practice in line with the proposal for a new Eighth EU Company Law Directive.

39. **There is no public involvement in the oversight of the audit profession.** The Chamber of Auditors has been established as a self-regulatory organization, which reflects the policy of the Ministry of Finance. There are no non-members involved in any of the work or committees of the Chamber, in particular in the approval of auditing standards and the ethical code, operation of the quality control system, and disciplinary procedures. The European Commission recommends that quality assurance systems should have adequate public oversight with a majority of nonpractitioners on the overview board of the quality assurance system. This public oversight requirement is meant to ensure that the quality assurance is, in fact and appearance, an exercise with sufficient public integrity. The Chamber, Ministry of Finance and HFSA have the matter under consideration.

V. PERCEPTIONS ON THE QUALITY OF FINANCIAL REPORTING

40. **There are divergent views about the quality of financial statements prepared in accordance with HAS.** Many participants in the ROSC process argued that there are few differences between HAS and IFRS and suggested that the transition to IFRS would be relatively easy. Others pointed to the influence of taxation on the application of HAS and the limited disciplines enforced by regulators and capital markets.

VI. POLICY RECOMMENDATIONS

41. **The recommendations of this ROSC for Hungary are mutually supportive in some obvious ways.** For example, superb accounting standards are jeopardized at the beginning if people do not understand how to translate the standards into a journal entry. Without attempting to provide a detailed tactical design for reform, and without pretending to do justice to the true specificity of the country's conditions, this assessment of accounting and auditing practices outlines certain policy recommendations to enhance the quality of corporate financial reporting. The implementation of these recommendations will contribute to promoting private sector growth and reducing volatility, through:

- strengthening the country's financial architecture and reducing the risk of financial market crises, and their associated negative economic impacts;
- contributing to foreign direct investment and helping to mobilize domestic savings;
- facilitating the access of smaller-scale corporate borrowers to credit from the formal financial sector by lowering the barrier of high information and borrowing costs; and
- allowing investors to evaluate corporate prospects and make informed investment and voting decisions, which will result in a lower cost of capital and a better allocation of resources.

Financial reporting is also a building block of a market-based monitoring of companies, which allows shareholders and the public at large to assess management performance, thus influencing its behavior.

42. **Although not currently required by the EU, Hungary should extend mandatory application of IFRS to all public interest entities.** Listed companies will be required by EU Regulation 1606/2002 on the use of IFRS to comply with IFRS in their consolidated financial statements from 2005. A similar national requirement should be applied to banks, insurance companies, other financial institutions and other *public interest entities*. In addition, listed companies that do not have subsidiaries should be required to present stand-alone IFRS financial statements. This recommendation goes beyond the current *acquis communautaire*.

43. **Financial reporting by small- and medium-sized companies and micro-enterprises.** The level of detail in current HAS may be excessive for the needs of users of the financial statements of small- and medium-sized companies and micro-enterprises. This problem is likely to increase as the new Hungarian Accounting Standards Board seeks convergence between HAS and IFRS. Therefore, the Hungarian Accounting Standards Board and other stakeholders should consider how HAS should be modified to meet the needs of users of the financial statements of small- and medium-sized companies. They should monitor the work of the International Accounting Standards Board (IASB) on the application of IFRS to small- and medium-sized entities and consider the adoption of any resulting IASB pronouncements. Consideration should also be given to raising the audit threshold to a level that is closer to that allowed by the Fourth EU Company Law Directive and is applied in other EU Member States.

44. **Ensure that the Hungarian Accounting Standards Board adequately oversees the development of accounting standards.** As discussed in paragraph 24 above, the legislature has recently established the Board to take over the responsibility for setting HAS from the Ministry of Finance. While the Board consists of 32 members from a variety of backgrounds, the Standards themselves will be developed by a sub-committee, which consists solely of members of the accounting and auditing professions. The ROSC team is concerned by the lack of involvement of other stakeholders in the development of the Standards. While the full Board is required to approve the Standards, the ROSC team is not sure how much of a role Board members will play in reviewing the work of the Standards sub-committee. The ROSC team recommends that policy makers take all appropriate measures to ensure that the public interest remains the overriding principle in the development of HAS.

45. **The legislature should not restrict management's right to appoint as head of accounting a person that it deems appropriate.** Hungary should remove the requirement that that the person responsible for preparing financial statements hold a "certified accountant" license issued by the Ministry of Finance (refer to paragraph 20 above). This requirement appears to be somewhat arcane in the context of modern corporate governance practices. The High Level Group of Company Law Experts, which was set up by the European Commission in September 2001 to make recommendations on a modern regulatory framework in the EU for company law, recommended that the board should be collectively responsible for the probity of financial statements of the company. In a one-tier structure, this is a collective responsibility of both executive and non-executive directors, and in a two-tier structure, this is the collective responsibility of both the managing directors and the supervisory directors. The head of the accounting function should work under the responsibility of management and the directors, who should be held accountable to select and hire an officer they deem capable.

46. **Enhance audit regulation to strengthen audit quality.** The legislature should incorporate the provisions within the proposal for a new Eighth EU Company Law Directive, including the following:

- Ensure that the legal provisions regarding dismissal and resignation of statutory auditors provide adequate safeguards for his or her independence. In line with the forthcoming *acquis communautaire*, the law could introduce the principle that the statutory auditor or audit firm can only be dismissed if there is a significant reason why the statutory auditor cannot finalize the audit.
- Undertake a detailed assessment of the professional liability of auditors under Hungarian Law. The assessment should be conducted by a panel of experts independent from the audit profession and make recommendations to enhance the rules on liability of auditors.
- As a condition of using an international network name, require the local member firms of international audit firm networks to disclose sufficient information about the structure and operation of their respective networks and about their individual relationships with them. This disclosure would enable an audit report user to assess the extent of reliance that can be placed on the implicit quality assertion that underlies the use of a common international network brand name. Such disclosures should describe the quality standards applied by the networks, the quality assurance for enforcement of standards, and details of how frequently the local firm is subject to network review. This would force the networks to exercise a much higher standard of care with respect to the quality of their member firms—since their procedures would be publicly transparent—and would ensure that quality weaknesses are addressed rapidly.
- Require that fees for statutory audit and other services be disclosed. This would allow users to assess whether the fees for statutory audits are reasonable to allow proper audit quality, and are not influenced or determined by the provision of additional services to the audited entity.

47. **Increase public oversight of the audit profession.** While the ROSC review has found only a limited compliance gap relating to accounting and auditing standards (see paragraphs 34, 36, and 38 above), deficiencies of self-regulatory arrangements on the international scene call for a review of the current audit profession’s self-regulatory arrangements. These should be balanced with an adequate oversight system, which is currently lacking. The authorities should make sure that the public oversight system is in line with the proposal for a new Eighth EU Company Law Directive, when adopted by the Council and Parliament. The objective of public oversight of the audit profession is to improve public confidence and the credibility of high quality financial reporting. The public oversight mechanisms should evaluate whether (1) the framework for setting auditing standards is appropriate, and (2) the mechanisms to ensure that these standards are applied and enforced in practice are adequate. There are a variety of ways of providing such oversight, which broadly fall in two different categories: (a) regulation by Government or under Government’s auspices and (b) self-regulation by the accounting and audit profession with an external system of oversight endorsed by Government.

- In some countries, the Government decides to use the expertise available in public bodies such as securities regulators or establish a new specialized body (e.g., the Public Company Accounting Oversight Board in the United States) to deal with these issues, monitor compliance and look after enforcement.
- In other countries, self-regulation is used to secure that the members of the audit profession observe updated legal and professional requirements and standards in performing their tasks. The objective of oversight of the self-regulatory activities of the profession is to ensure that (1) accounting and auditing standards are set in the

interest of the public and (2) the audit profession conducts audits at a high level of quality, which attracts public confidence in statutory auditing, etc.

In the context of Hungary, the ROSC team expresses a preference for a mechanism that combines the benefits of significant accounting and auditing expertise (at the Hungarian Chamber of Auditors) with the benefits in terms of public confidence of independent non-practitioners. Also, the ROSC team advocates the creation of an independent body to ensure flexibility and facilitate the association of different stakeholders and experts to the process.

The ROSC team therefore proposes the creation of an independent oversight body to regulate the audit profession. This body will bring together a number of different structures, including regulators, that currently exist under the umbrella of one organization, thus harmonizing and rationalizing several disparate sets of oversight regimes with the resulting savings in cost and increased consistency, uniformity and predictability of regulation of auditing. The ROSC team recommends that an adequate coordination mechanism between the oversight body and the HFSA should be established.

The oversight body should be independent of the audit profession that it regulates and free from undue political pressure. Therefore, it should be governed by non-auditors who are knowledgeable in the areas relevant to accounting and statutory audit. It should have the authority to engage in cooperative enforcement with other governmental agencies and with foreign regulatory authorities. The scope of the oversight should extend to education, licensing, standard setting, quality control, and disciplinary systems in line with forthcoming changes in the *acquis communautaire*. The oversight body should, among other things, ensure that entry requirements for statutory auditors (licensing), while consistent with the Eighth EU Company Law Directive, are meant to safeguard audit quality and protect consumers. Entry requirements should not constitute a barrier to market entry.

In this context, confidentiality requirements should be reviewed to allow public oversight of the quality assurance system. The legislation should include adequate provisions overriding the auditor's duty of confidentiality to permit adequate public oversight of the quality assurance system. Currently, members of the Chamber of Auditors must keep any and all information and data obtained in connection with their activities strictly confidential.

The European Commission proposed to allow a minority of auditors to participate in the governance of the system of public oversight. However, the proposed EU Eighth Directive states that this option would not apply to the governance of the public oversight system concerning statutory auditors and audit firms that carry out statutory audits on *public interest entities*. The membership of the Committee should conform to the Directive's requirements, when adopted by the Council and Parliament.

48. The Hungarian Financial Supervisory Authority (HFSA) should enhance its monitoring and enforcement arrangements in line with the requirements of Recital 16 in EU Regulation 1606/2002 on the use of IFRS. Enforcement comprises a cascade of different elements, including (1) clear accounting standards, (2) timely interpretations and implementation guidance, (3) statutory audit, (4) monitoring by supervisors and (5) effective sanctions. Each of these must work efficiently, as the system will be only as strong as its weakest part in delivering strong investor and creditor protection. The HFSA has a critical role in ensuring that listed companies comply with financial reporting requirements. There is clearly a major interest in ensuring accurate and consistent application of accounting standards in the securities markets the HFSA oversees. Therefore the financial reporting enforcement role of the Securities Market Agency should be enhanced as follows:

- **Agency's monitoring objectives.** The ROSC team suggests that IFRS compliance by listed companies should be formally adopted in the Agency's monitoring objectives.
- **Coordination at the European level.** While enforcement of accounting standards is arranged at the national level rather than at the European level, enforcement arrangements should provide for an international coordination mechanism in order to create a level playing field across the EU and to ensure consistent decisions. To that end, the ROSC team recommends that the Agency play a more active role in the Committee of European Securities Regulators and adopt/implement the standards on enforcement issued by CESR in March 2003 and April 2004.¹⁴
- **Definition of enforcement.** The completeness, accuracy and truthfulness of the financial information are under the responsibility of the issuer's board of directors. Statutory auditors act as a first external line of defense against misstatements by expressing their opinion on the financial information based on their audit. The Agency should monitor compliance of the financial information presented by listed companies with IFRS, and take appropriate measures in case of infringements discovered in the course of enforcement.
- **Necessary powers.** The necessary powers of the Agency should at least include power to monitor financial information, require supplementary information from issuers and statutory auditors, and take measures consistent with the purposes of enforcement. The Agency must have sufficient authority to have complete, immediate and unfettered access to all books and records of a listed company, including financial records. This access can be had with or without notice to the listed company. The Agency should be responsible for setting up an appropriate due process of enforcement and implementing that due process. The Agency should therefore be provided with resources sufficient to establish and carry out an effective monitoring system. This would include having professionally skilled staff that are experienced with IFRS and the legal implications of enforcement.
- **Issuers and documents.** Financial information should include annual and interim financial statements and reports, prepared on an individual and consolidated basis as well as prospectuses and equivalent documents.
- **Methods of enforcement.** For financial information other than prospectuses, ex-post enforcement is the normal procedure. For prospectuses, ex-ante approval is the normal procedure as specified by the EU Directives, which also identify the nature of the approval. Enforcement of all financial information is normally based on selection of issuers and documents to be examined. The preferred models for selecting financial information for enforcement purposes are mixed models whereby a risk-based approach is combined with a rotation or a sampling approach. Methods of enforcement on selected information cover a wide spectrum of possible checking procedures, ranging from pure formal checks to in-depth substantive in-nature checking. The level of risk should normally determine the intensity of the review to be performed by the enforcers.

¹⁴ Standard No. 1 on "Financial Information – Enforcement of Standards on Financial Information in Europe" issued on March 12, 2003, and No. 2 on "Financial Information – Co-ordination of Enforcement Activities" issued on April 22, 2004 by CESR.

- **Actions.** Where a material misstatement in the financial information is detected, the Agency should take appropriate actions to achieve an appropriate disclosure; and, where relevant, public correction of the misstatement (in line with the requirements of IFRS) should be made. Non-material departures from the reporting framework will not normally trigger public correction even though they normally deserve some action (e.g., statement from the Agency conveyed to the infringer). Actions should be effective, timely enacted and proportional to the impact of the detected infringement.
- **Reporting.** The Agency should periodically report to the public on its activities, providing at least information on the enforcement policies adopted and decisions taken in individual cases including accounting and disclosure matters.

Authorities' response to the assessment:

- In the opinion of the Ministry of Finance, the ROSC report is of high quality and reflects the valuable efforts of the experts who prepared it to present the situation in Hungary in a fair and accurate manner.
- Regarding the issue of material departure from IFRS mentioned in paragraph 33, there is a difference in the professional view of the ROSC team and that of the relevant audit firm. The different views stem from divergent interpretations of certain paragraphs of IAS 8. According to the audit firm, in the cases mentioned in paragraph 33, there were no departures from IFRS; thus, it was not reasonable to qualify the audit opinion.