

**IMPACT OF NOTES TO FINANCIAL STATEMENTS ON THE QUALITY OF
FINANCIAL REPORTING:
SELECTED EVIDENCE OF ISSUERS AT THE PRIMARY STOCK MARKETS IN
CROATIA AND SERBIA**

Branko Z. Ljutić

*CPA, Tenure Professor, University Business Academia
Faculty of Economics & Engineering Management
Cvectorska 2, 21000 Novi Sad, Serbia
e-mail: ljutic.branko@gmail.com*

Sandra Janković

*Associate Professor, University of Rijeka
Faculty of Tourism and Hospitality Management
Primorska 42, 51410 Opatija, Croatia
e-mail: sandrai@fthm.hr*

Dubravka Vlačić

*PhD, Assistant, University of Rijeka
Faculty of Tourism and Hospitality Management
Primorska 42, 51410 Opatija, Croatia
e-mail: dvlasic@fthm.hr*

*"If you can't convince them, confuse them."
Harry Truman*

Abstract

Purpose – The purpose of this study is to investigate the current practice and the quality of notes to financial statements. The focus is on their role in improving the process of financial reporting based on International Financial Reporting Standards (IFRS) of the primary issuers quoted at the local stock markets in Croatia and Serbia.

Design/methodology/approach – In the paper it is used the standard IFRS methodological approach to notes, financial statements and integral process of financial reporting of the leading primary issuers at only two stock markets in these republics, e.g. Zagreb in Croatia and Belgrade in Serbia.

Findings – Research results shall reveal the real information content and quality of notes to financial statements on the Zagreb and Belgrade Stock Exchanges, the materiality aspect, real information content and integration with relevant audit reports, all that in the context of proper informing of the investment community.

Practical implications – The practical implications of the research are to point out to the results of the research that practice of too extensive but not much revealing notes is in the sharp contrast of the concept of IFRS, and mostly notes are translated IFRS without giving any significant insight into the materiality of reporting.

Social implications – On-going process of reforms in financial reporting internationally and on the level of EU is strengthening the importance for transition economies to be the part of these changes regarding some possible form of further more precise and much less extensive approach to the information content of the notes.

Originality/value – Based on our preliminary research the information content of the notes and criteria of materiality shall be one of the main topics of accounting and financial reporting development internationally and in the EU. In this broader context this research should give better insight what is really going in practice in two selected transition economies, one which is the new EU member as Croatia is, and Serbia as a candidate.

The research provides an extensive literature research and a systematic review of recent developments in sustainable performance management systems. The paper also provides background for identifying further research and development of sustainable performance management systems in the area of hotel industry.

Keywords: notes to financial statements, financial reporting, primary issuers.

1. INTRODUCTION

The transition to market economy and development of corporate governance in the Republic of Croatia and Serbia required an accounting transition, which was also prerequisite for capital market development and the investment promotion. This process was also under the impact of global accounting harmonization, which made the accounting regulatory framework global. The process of accounting harmonization in Croatia and Serbia is a long process and there are some important changes that have been done during the last 20 years.

Changing the accounting regulatory framework doesn't mean efficiently participating in globalisation process, which could be realized by acceptance and implementation of IFRS directly or as the basis of national standards. Both countries chose at begin the first alternative, i.e. the direct implementation of IFRS, wherein the Croatia after 15 year of IAS implementation changed in 2007 Law on Accounting and developed its own national accounting financial reporting standards for non-listed companies.

Belonging to the Roman law system, the accounting regulation in both countries is traditionally encompassed by the Law on accounting. Law on accounting is the main accounting regulation that consists of main parts such as entity classification, accounting instruments, financial reporting, auditing of financial statements. Both countries also established accounting boards, usually within the framework of the accounting and auditing associations.

Although both the FASB and IASB stress the importance of high quality financial reports, one of the key problems is how to operationalize and measure this quality.

The research conducted by van Beest, Braam and Boelens (2009) suggest that the measurement tool used in the study is a valid and reliable approach to assess the quality of financial reports. The measurement tool contributes to improving the quality assessment of financial reporting information, fulfilling a request from both the FASB and the IASB to make the qualitative characteristics operationally measurable.

Jara et al. (2011) analyses the quality of financial information using financial and economic ratios, assessing if the quality is affected by financial reporting standards. A group of factors for measuring accounting information quality is determined. They indicate that financial information quality is affected by financial reporting standards, and present a group of factors that show an alternative to analyse accounting information. This study shows that accounting information is affected by financial reporting standards.

This research gives more detailed insight on what is really going in practice of implementation of IFRS and their impact on the notes and quality of financial reporting in two selected transition economies, one which is to become the new EU member as Croatia and Serbia as a candidate.

2. ACCOUNTING REGULATORY FRAMEWORK IN CROATIA AND SERBIA

2.1 Accounting regulatory framework in Croatia

The development of the accounting and auditing profession in the Republic of Croatia began in 1992 with its first Law on Accounting (NN 90/92) and Law on Auditing (NN 90/92). According to the first Law on Accounting, International Accounting Standards were adopted as the national accounting standards for all companies in Croatia (listed and non-listed). In 1992 the Croatian Association of Accounting and Finance Professionals (HZRIFD founded in 1954) became a member of EAA and in 1994 a member of IFAC. In addition Association of Croatian Accountants and Association of Auditors were also founded, with its role to adopt IAS and IFAC's International Standards on Auditing in Croatia. To adjust the accounting regulations to EU directives, Croatian Law on accounting underwent some changes in 2005 (effective from January 2006) and in 2007 (effective from January 2008). Namely, in 2004, the Republic of Croatia was awarded candidate status for the membership in the EU. This reflected on the accounting and auditing profession in Croatia because in order to join the EU the economic and political conditions, known as the 'Copenhagen criteria', would have to be fulfilled. According to these criteria, a prospective member must (Ljutić, Klikovac, Janković 2009):

- ✓ Be a stable democracy, respecting human rights, the rule of law, and the protection of minorities. Fulfilling this criterion is the key for starting of accession negotiations.
- ✓ Have a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the Union.

- ✓ Adopt and enforce the common rules, standards and policies that make the body of EU law.

According to the third criteria stated above, the Republic of Croatia has to consolidate all the accounting and auditing standards with the EU standards. With regard to auditing Croatia complied with the EU's Eight Council Directive on Statutory Audit of annual accounts and consolidated accounts. To achieve this task, a new Law on Accounting and Auditing were adopted in 2005.

New provisions in the Law on Auditing were the following: (Ljutić, Klikovac, Janković, 2009)

- Croatian Auditing Chamber is a professional body that performs quality control over the performance of audit firms and certified auditors and reports it to the Department of Finance every six months.
- Department of Finance performs public oversight over Croatian Auditing Chamber.
- Providing non-audit services to audit clients was prohibited.
- Clearer terms for auditor's independence were set.
- Statutory auditor or audit firm can only be dismissed if there is a significant reason why the statutory auditor cannot finalize the audit, but the Act doesn't require the reasons for dismissal or resignation to be disclosed. The client or an audit firm or an independent auditor can notify the Croatian Auditing Chamber and Department of Finance if unjustified dismissal of an auditor occurred.
- All companies of public interest are required to set up an audit committee with at least one member of the committee with knowledge in accounting and/or auditing. The role and tasks of an audit committee are in line with the requirements of the EU's Eighth directive.
- Audit firms have to be insured for possible damages to the third persons, and the minimum liability is set at 300,000 kunas. Minimum liability for banks, pension and investment funds and insurance companies is set at three million kunas.

For further harmonization of the audit regulation in Croatia with the new EU Eighth Directive, a new changes of the Law on Auditing was enforced in November 2008. New provisions of this law are the following:

- Auditors from the third countries can provide audit services in the Republic of Croatia, based on the reciprocity between the Republic of Croatia and the third countries.
- Department of Finance is no longer performing public oversight over Croatian Auditing Chamber. Instead, public oversight is to be performed by the special body independent of the profession comprising non-practitioners members knowledgeable in the areas relevant to auditing. The public oversight will be performed by the independent Public Oversight Board, and the Board has to publish its report on the findings of the oversight.
- Statutory auditor or audit firm can only be dismissed if there is a significant reason why the statutory auditor cannot finalize the audit. The reasons for dismissal or resignation must be disclosed to the Public Oversight Board.
- Key audit partners responsible for carrying out a statutory audit rotate from the audit engagement within a maximum period of seven years from the date of appointment and are allowed to participate in the audit of the audited entity again after a period of at least two years
- Audit firm and independent auditor must publish on their websites, within three months of the end of each financial year, annual transparency report consisting of all the elements as stated in the EU's Eighth Directive.
- Public Oversight Board cooperates, provides help, transfers information and provides other forms of cooperation with a competent authority of a member state.
- Penalties for audit firms and independent auditors, if they do not publish transparency report, do not rotate key audit partners, and do not confirm their independence to the audit committee, range from 20,000 to 100,000 kunas.

After 15 years of their implementation, according to current Law on Accounting (NN 109/07), IFRS became obligatory only for large companies, listed companies and companies who are preparing itself for initial public offering. Other companies (unlisted - small and medium-sized companies) are using Croatian Financial Reporting Standards. The structure of financial statements is not prescribed by current Law, but by Committee for Financial Reporting Standards that made the Decision regarding the structure of financial reports, following the fourth EU directive. The layout and nature of notes are not prescribed by Decision of Croatian Board. External financial reporting in Croatia is nowadays regulated by:

- Law on Accounting (NN 109/77)
- International Financial Reporting Standards

- Croatian Financial Reporting Standards
- The Corporation Act (NN 111/93, 34/99, 52/00)
- Commercial Court Registry Act (NN 1/95, 57/96, 1/98, 30/99, 45/99, 54/05 and 40/07)
- EU Directives

2.2 Accounting regulatory framework in Serbia

In Serbia the Accounting and Auditing Law (2002) applies to all enterprises, cooperatives, banks, insurance companies, and other financial organisations, as well as sole proprietorships. It requires that all enterprises from the largest listed companies to the smallest unincorporated proprietorships must comply with IFRS from 2004.

The accounting and auditing profession in Serbia has been more or less under the dominant influence of the so called "German tradition" and from the historic point of view accounting and auditing activities were performed almost on the same legislative and institutional framework as in model European countries for Serbia like France and Germany. The period after the Second World War, during the existence of Second Yugoslavia as a communist oriented state, was somehow close to the Russian model. Approaching the end of the 1980's regulation has become closer to the market economics criteria, but surely not adequate. After the break away of Yugoslavia, Serbia was in prolonged isolation from the regional and global cooperation and influences. Reintegration of Serbia as a country and economy into regional and global framework of free market institutions under the rule of law is stressing the new role and significance of the economics of information.

The development of the accounting profession in Serbia has been initiated by two different forces. First, the strengths of the Association itself played an important role in steering the desired changes, but also the entry of foreign investors and funding agencies triggered the speed in development of the profession. The initiation of the South East European Programme for Accounting Development (SEEPAD) played an important role in bringing the accounting profession in different countries in the region together to consider mutual recognition of certificates, enabling the members to practice in different national jurisdictions. It is certain that the accounting profession is there to stay and survive, contributing significantly to changes in the national economies and facilitating professional communication with other countries (Šević, 2008)

Function of financial reporting, availability and transparency is significant for stability of the national financial system and, from early 2009, for existence and survival. Serbia's financial system is more of a concept of growth than a real, system of small numbers of stable, reliable, predictable, transparent and well functioning efficient financial institutions. Prolonged economic and political sanction of the UN Security Council against Serbia has created some form of intellectual "Splendid Isolation". The general impression and prevailing opinion in public and professional debates is that Serbia is much closer to the EU regarding legislature and regulatory reforms and institutional framework that is based on our intuitive assessment. Unfortunately that is not the case. Accounting and auditing standards are adopted from the formal standpoint like International Financial Reporting Standards (IFRS), and International Standards on Auditing (ISA). Full professional implementation of the framework of financial reporting and auditing in Serbia as a country with poor legal system and government regulatory institutions is still in the process of self-creation and institutional reconstruction. There is a general perception and acceptance that the new auditing regulation harmonized with the EU regulatory framework is *sine qua non* of any future reintegration of the country into the regional and global financial and economic institutions. But, from the verbal pledge to the real changes there is a long and bumpy road awaiting Serbia.

Generally, the financial information in Serbia is not of the highest quality and has been characterized by a tradition of unreliable financial reporting for many decades during the socialist economic system. During the period of democracy development government corruption, criminal activities (organized crime, white collar crime, etc.) were more than undermining formal orientation of the government to implement strict financial reporting based on the stringent IFRS and IAS standards. Since any system of standards in accounting and auditing professions is merely the system based on the general social, economic and market order, values and valuation. All those mentioned aspects are more than rudimentary in Serbia. Consequently, the implementation of the IFRS is theoretically more superficial than technical exercise, while the real market valuation is rather distant practical concept and approach. (Ljutić, Klikovac, Janković, 2009)

Economic crisis, illiquidity, tycoons and political patronage is still protecting the largest monopolistic illiquid companies, while profitable and liquid smaller ones and small and medium sized enterprises are carrying most of the burden of economic reforms, taxation and liquidity. For instance, in Serbia larger

companies are not fully obeying the rules for payment settlements, although from the legal point of view analysis would show that the rules are obeyed. Financial regulatory institutions are very liberal regarding the illiquidity of the "big-shots", while the others must cover all liquidity demands, even pay VAT in advance. However, large companies don't pay invoices from 3 to 6 months and even longer. Those are more than significant aspects of the real role of auditing, since this activity is not adequately prepared to audit the complex cross-ownership deals and transaction between banks, insurance companies, real sector and emerging conglomerates. (Gielen, et al., 2005)

The real problem for these two countries is that the process of establishing the public regulatory and self-regulatory institutions and bodies require civil society and citizens with high regard for free market institutions, democracy and the rule of law. That is the only solid foundation to construct the pyramid of audit institutions, since it makes no sense to expect the tycoons to be interested in developing national audit profession and institutions. On the other hand, big international auditing firms also have more than a strong interest to monopolize the market which is a negative impetus to develop a local respected audit profession.

3. CREATION OF METHODOLOGICAL FRAMEWORK

Methodological approach is based on IAS/IFRS framework with an emphasis on the IAS 1 – Presentation of Financial Statements (Summaries..., 2012; SRRS, 2011, Greuning, 2006). Notes to financial statements are enclosing information imposed and standardized by the International Financial Reporting Standards (IFRS) which propagate and stimulate to publicize and present all the necessary information in order to fulfil to main goal of the information content and analysis of financial statements, especially the transparency aspect, which based on our research is predominantly determined by the information quality of the notes itself (IASPLUS Standard 01, 2012; Deloitte, 2012; David, 2008). The role of external auditors is well defined by the International Standards of Auditing (ISA, IFAC, 2012). Financial reporting and external auditing practice do heavily rely on professional standards. There is a long and heavy road from standards to full implementation, much longer and with lots of obstacles in transition economies than in most EU member countries. Financial reports accompanied by the notes are the sole responsible of the reporting company, while the audit report is of the auditor, and this simple statement is more blurred in practice in Croatia and Serbia for many reasons. This demarcation line of who is responsible for what, how and why should be more precise and clear in practice (The Institute of Chartered Accountants of Australia, 2012). Feng and Shroff are pointing out complementary significant aspects of the quality of financial reporting as a sound base of local economic growth, aspect that is not well understood in Serbia particularly (Feng, Shroff, 2009). Our methodology is complementary and eventually more extensive and broader research on the long run could give better insight in the trends of financial reporting in transition economies, with a focus to a west Balkan countries, including Slovenia, Croatia, even Hungary, Bulgaria and Romania (Annual..., 2011). In developing an application of our methodological approach we have noticed significant points that in both countries it is not officially binding and applied the EC approach to presentation of financial statements but only the IFRS stance (EC..., 2011).

Current discussion on how to improve year-end financial reporting communication is leading towards an appealing and useful platform for necessary and unavoidable reforms in the process of corporate financial reporting in EU (EFRAG, 2012). A new trend and way of thinking can be noticed to dismantle and reject all that is unnecessary baggage and real information overload (NZICA, 2012).

In our explanation of the research method focused to measure the quality of information contained in the notes to financial statements we would like to stress few significant insights, that might be helpful to fully grasp the phenomena in two neighbouring transition economies e.g. Croatia and Serbia, with different institutional structures and pertinent financial and accounting regulation, that in turn is not helpful at all to achieve full methodological compatibility, but still leaves enough space for some joint analytical ground and comparative conclusions based on the findings. The only stock exchange in Serbia - Belgrade Stock Exchange (BSE) or BELEX consists of two parts - regulated market (Prime Listing and Standard Listing); and MTP Belex which together form an open market trading platform (Belex, 2012). At the BSE on the Prime Listing only five issuers have listed shares, so we have opted to select all the leading corporate issuers on this stock market. Analysed stocks admitted to the listing complied with all procedure carried out by the Belgrade SE Listing Committee. All analysed issuers have submitted to the Listing Committee Listing Application along with the documentation and evidence set forth by the Rules of Listing. Most of the relevant registration and listing information is based on the annual report, pertinent financial statements and

the audit report, e.g. Information for the Current Year, Stock Market Prospectus, Prospectus for the Securities Distribution, financial reports with quarterly reports, Notes to Financial Statements, Summary Financial Statements, etc. URL internet Web-Sites of issuers are closely and functionally connected to the BSE Portal, and financial information are presented with full regulatory compliance with the Serbian laws and by-regulations, also with the BSE regulation. Combined Codes of Corporate Governance, additional information services to shareholders are provided with the information about General Shareholder meetings, regular and irregular ones.

At the Croatian regulated market of Zagreb Stock Exchange (ZSE) there are three segments: Prime Market, Official Market, and Regulated Market. Highest requirements for quotation exist on the Prime Market where only listed instruments are traded with required Prospectus which is providing the information which may be required for the purpose of instrument evaluation by investors. Official market requires issuer to present only minimum information according to the Law of Capital, while for Regulated as well as aforementioned Prime market there are additional obligations prescribed by Stock exchange rules (Zagreb Stock Exchange, 2012).

The organization of ZSE differs from BSE due to the existing regulation given by HANFA Croatian Agency for supervision of financial services (www.ripe-hanfa.hr). The financial and auditing reports are published at the web site of FINA, leading Croatian financial agency as publicly available reports (www.fina.hr).

The comparison of the comparative sources of data from the two national stock exchanges in Croatia and Serbia, shows that there is no fully coherent methodology, since we have actually applied somewhat different criteria for each of cases studied in Croatia and Serbia. Since results are not fully comparable, the observed limitation is not of a magnitude to influence the results and conclusions.

4. ASSESSMENT OF SELECTED CRITERIA OF THE QUALITY OF NOTES TO FINANCIAL REPORTS

At Belgrade Stock Exchange Primary Issue Market with its official title only in English as a "Belex Index Prime Market" are listed and quoted the leading Serbian companies whose shares are of the prime quality (Belgrade Stock Exchange. 2012). We have selected five leading listed companies which are the only ones listed at the Prime Market. Our decision to select only these listed entities has been based on the fact that these companies have passed the registration process with the Serbian Security and Exchange Commission, although even the mentioned issuers are not rely a fully-fledged primary issue, based on the more stringent and conservative international regulation and standards. Our previous remark would only like to point to the fact that some of these companies are in reality party para-governmental, which is not the focus and goal of our research. The sample consists of the following entities: International Airport Nikola Tesla, Belgrade (Aerodrom Nikola Tesla a.d., Beograd, Belex symbol: AERO), Energoprojekt holding a.d. , Belgrade (symbol ENHL), Serbian Oil Industry Co. (Nis a.d., Novi Sad, symbol NIS), Soja protein a.d., Becej (symbol SJPT), Rubber Tyre Co Tigar (Tigar a.d., Piro, symbol TIGR). We have analysed the primary issue prospects of the selected companies on the primary issue market, and we have named these as a group of five (G5). We have gathered and implanted a proper ex-post compliance audit review of the information supplied in the annual reports for the fiscal and reporting year 2010, as well as the accompanying audit reports. Analytically as relatively homogenous units of observation have been pinpointed the information presented in the stock market prospects of the selected companies as listed issuers. At the Belgrade Stock Market Internet site are listed selected and reclassified processed information from the annual and audit reports, based on the standards and guidelines for stock market trading information requirements. We simultaneously observed the information at the official Web site present URL locations of the selected five companies where full annual reports and complete audit reports have been published for the 2010 (Ljusic, 2012).

At the Table 1 we have been able to observe and analyse information supplied to the public at the BSE Web-Site, while extensively at the web-sites of the individual issuing companies. Financial reports are published at the Zagreb Stock Exchange site, and additionally to them auditing reports and notes to financial statements at FINA and individual enterprise websites.

It is very significant to point out the main characteristics regarding the existence or non-existence of the relationship in the context of the Notes to Annual Financial Statements which are defined in the primary context and goal of our research. As such qualitative descriptive observations do not at all express the views and assessments of team of researchers regarding the intensity and quality of relationship, feedback

mechanisms, or about the quality and other relevant characteristics which imply any form of assessment or expressing definitive judgements, conclusions or recommendation. We have created this methodological approach only as a mean of objective social science research, while the authors do not exclude at all that other points of view, explanations or approaches are possible and most welcome. Previous paragraph should be viewed in the light of privatization process and presence of corruption in late transition economies like Serbia and this area of public and political interaction is highly sensitive and slippery ground in many subtle and not so subtle points of view.

Table 1

Comparative Sources of Information Contained in the Notes to Annual Financial Statements: Belgrade Stock Exchange-Prime Market and Web-Sites of Issuers in Serbia

		Internet Presentation at the Belgrade Stock Exchange Web Site				
No.	Belgrade Stock Exchange: Qualitative Elements of Information	AERO	ENHL	NIS	SJPT	TIGR
1	Information about issuer on the Belex site	1	1	1	1	1
2	Direct Transfer to the official site of the issuer	1	1	1	1	1
3	Information interconnected: Review, Historical Data, Prospect, News	1	1	1	1	1
4	Stock market prospect for the distribution of shares - Timeliness	1	1	1	1	1
5	Information content of the Prospect is easily accessed information to the user	0	1	1	1	1
6	In the annual reported data contained Notes to Annual Financial Statements	0	0	0	1	0
7	Report on the Significant Event: Financial Report for 2010 approved at the General Meeting of Shareholders	1	0	0	1	0
		Internet Presentations at the individual Web Sites of issuers				
Information Supplied by the individual companies on the Internet: Qualitative characteristics		AERO	ENHL	NIS	SJPT	TIGR
1	Report on the Significant Event: Financial Report for 2010 approved at the General Meeting of Shareholders	1	1	1	1	0
2	Annual Financial Report for 2010	1	1	1	1	1
3	Notes to 2010 Financial Reports	1	1	1	1	1
4	Reference in the balance sheet and profit and loss account on numerous notes to financial statements	1	1	1	1	1
5	Notes to 2010 Financial Report are integral part of the report	0	1	1	1	1
	Notes to Financial Report placed after audit report	1	0	1	1	1
6	Clearly denoted number of pages which are strict responsibility of the auditor and which of the issuing company	0	1	0	0	0
7	Extension of the notes, elaboration and information content	1	1	1	1	1
8	Summary of the 2010 financial report	1	1	1	0	0
9	Notes to financial statements are separately revealed as an integral document	1	1	0	1	0
10	Quality of notes to financial statements: Presentation and content	1	1	1	1	1
11	Annual Report of Operations and Doing Business in 2010 as a complementary information to the Annual Report	1	1	1	0	1
12	General assessment on the methodological approach of the whole annual reporting process part which is revealed in notes	0	1	1	1	1

Methodological Note: Number 1 denotes some kind of relationship, while 0 points out that there is no relationship

Source: Belgrade Stock Exchange official web-site (2012) and individual corporate web-sites (2012)

Analytical review (Table 1) has pointed out to a conclusion that at the Primary Market of the Belgrade Stock Exchange, Serbia, it is present and obvious a strong qualitative and functional positive relationship between the official stock exchange Web site related to the publicized financial and operational data for the five companies as listed on the market, that is logically and efficiently connected to the individual web sites of issuers. Financial information is presented based on the IAS/IFRS, on the way easily accessible to the layman user. We also point out that this statement does not qualify at all regarding the quality of the whole financial reporting process vis-à-vis international accounting and reporting standards, subject beyond the area of interest of our research. From the other viewpoint the lack of significant and meaningful information published in the notes to financial information of issuers is obvious.

Financial reports prepared for the local stock markets were fully complied with the pertinent regulation, but since the volume of trade is more than negligible and there is no significant demand for the financial information for trading and investments needs. Only one company (Sojaprotein, Becej) within the reported data at the Stock Exchange have included the Notes to Financial Statements. Analysis of the quality of information at the individual web sites of issuing companies is pointing out to the fact that the most companies reveal information about the significant event, e.g. of the approval of annual accounts and report at the annual general meeting of the shareholders for the year 2010. All the reporting companies have publicized highly structured and more than extensive elaborated notes to the financial statements, with the exact referencing in the balance sheet and profit and loss account. Four out of five companies have structured the notes as an integral part of the annual financial report for 2010 and placed their notes just after the audit report. It is noticeable a significant shortcoming that pages of the annual report which are the sole responsibility of the issuing company have not been clearly marked to be distinctive from the numerated pages of audit reports which are the responsibility of the audit company. Our finding and recommendation is that it is much better to separate consequently the numbered pages which are responsibility of the reporting company with notes to that report, and pages of the audit report and if any notes of the auditor. The average reader and user of financial information could not make any precise distinction which part of the whole report is responsibility of the reporting entity and which of auditor, and who has changed or not changed or altered what and why (Ljutic, 2004). Only CPA or external skilled auditor would make a clear distinction of these sections of the annual financial statements with notes and audit report, with or without accompanying notes of the auditor, based on the different logotypes and graphical design of the memorandum papers, when such reports are printed out on legal memorandums, but taking into an analytical focus that nowadays more and more reports are in the electronic form, or scanned printed out pages, in Serbia where an electronic signature is at its beginnings, is more scholastic discussion than a practically precise approach or a solution. This shortcoming, intentional or not, is even more pronounced when we take into a consideration local managers skills and not so adequate knowledge of accounting, financial reporting and auditing. Average user of financial information in Serbia in the world of business and public life does not at all possesses elementary knowledge and understanding of international financial reporting; Clear recommendation for the regulatory bodies, reporting companies and auditors is to (Ljutic, 2005). In all financial reports the information quality and content of the notes could be assessed as adequate, while the pertinent information in notes has been well presented. Main goal of this research was not to assess the quality of financial and audit reports, adherence and proper application of the IAS/IFRS/ISA but only the form, structure, and methodological creation of the notes, not the accounting procedure for the proper preparation of the notes. Based on the previous obvious limitations the level of credibility and persuasiveness of financial reports and audit reports has not been examined at all. Four out of five companies have publicized the annual report on operations which itself is actively contributing to a quality of information from a financial report, which in turn could only rely heavily on the substantive high information content of the notes based on the concept of materiality.

Croatian enterprises were chosen on the basis of the top 10 net income according to the research conducted by Deloitte on 100 top in the region for 2010 (Adria Top 100 Company Ranking). The sample consists of the following entities: Adris Group, Rovinj - Zagreb (Adris Grupa d.d., symbol: ADRS), Agrokor a.d., Zagreb (symbol AGRO), Croatian Electric Power Co. (HEP d.d., Zagreb, symbol HEP), Croatian Telecom a.d., Zagreb (Hrvatski telekom d.d., symbol HT), Croatian Railway, Zagreb (Hrvatske željeznice d.d., symbol HZ), Croatian Oil Company (Industrija Nafta d.d. Zagreb, symbol INA), Podravka a.d. (symbol: PODR), Vindija a.d. (symbol VIND), VIPNet a.d. (symbol VIPN) and ZG Holding, Zagreb (symbol ZGHol) We have analysed the primary issue prospects of the selected companies on the primary issue market, and we have named these as a group of ten (G10).

Comparative Sources of Information Contained in the Notes to Annual Financial Statements: 10 Selected Croatian Corporate Issuers at ZSE.

No.	Descriptive Qualitative Criteria of the Notes	Internet Presentation at the Official Public Internet Portal FINA, Zagreb, Croatia									
		1 - ADRS	2- AGRO	3 - HEP	4 - HT	5 - HZ	6 - INA	7 - PODR	8 - VIND	9 - VIPN	10 - ZGHol
1.	Number of pages of the narrative report	0	41	116	63	41	59	45	33	0	36
2.	Number of Pages of the Integral Financial and Audit Report	61	46	116	63	41	135	87	21	36	117
3.	Separated Narrative Report of the Operations	0	1	1	1	1	1	1	1	1	1
4.	Statement of The Responsibility of the Management Board		1	1	1	1	1	1	0	1	1
5.	Consolidated Report for the Group Ltd.	1	1	1	1	1	1	1	1	1	1
6.	Basic Business Activity and Development of the Co.	1	1	1	1	1	1	1	1	1	1
7.	Affiliated Companies	1	1	1	1	1	1	1	1	1	1
8.	Results of Operations and Market Position	1	1	0	1	1	1	1	1	1	1
9.	Risks and Risk Management	1	0	1	0	1	1	0	1	0	1
10.	Staff and Human Resources	1	0	1	0	0	1	0	1	0	1
11.	Corporate Governance Code	1	0	1	1	0	0	1	1	1	1
12.	Corporate Social Responsibility	0	0	0	1	0	0	0	1	1	1
13.	Activities of R&D and Co., Development	1	0	1	0	0	1	1	1	1	1
14.	Environmental Protection and Management	0	0	1	0	1	0	1	1	1	1
15.	Significant Events after the End of Reporting Year	1	0	1	1	0	0	0	0	0	1
16.	Signed and Sealed by the Co.	1	1	1	1	1	1	1	1	1	1
17.	Independent Audit Report on Year End 2010 Consolidated Statements	1	1	1	1	1	1	1	1	1	1
18.	Audit Report Signed and Sealed, on the Memorandum Paper of the Audit Co.	1	1	1	1	1	1	1	1	1	1
19.	Notes of the Auditor as an Integral Part of Audit Report	0	0	0	1	1	0	0	0	0	0
20.	Consolidated Financial Statements Clearly Singed and the Memorandum Paper of the Co.	1	1	1	1	1	1	1	1	1	1
21.	Notes to Financial Statements Clearly Market as an Integral Part of the Financial Report of the Co.	1	1	1	1	1	1	1	1	1	1
22.	Notes to Financial Statements well Referenced	1	1	1	1	1	1	1	1	1	1

Methodological Note: Number 1 denotes some kind of relationship, while 0 points out that there is no relationship

Source: Croatian Financial Agency FINA, Annual Reports <http://rgfi.fina.hr/JavnaObjava-web/pSubjektTrazi.do> (1 to 12 August 2012); individual corporate web-sites (1 to 12 August 2012); Condensed Balance Sheet and Profit and Loss Accounts for Quarters, Half-a-year and a Whole Fiscal Year from 2004 to 2012 on <http://zse.hr/default.aspx?id=36774&ticker1=&Page=198> (accessed 14 August 2012)

The previous data analysis is not intended to give a full valuation of the information content of the notes to financial statements, but only to serve for analyzing accounting trends and techniques of the prime issuers at two comparative leading national stock markets in Croatia and Serbia (AICPA: Accounting Trends & Techniques, 2011). Our research is a form of initial survey of illustrative examples given to us by the selected financial statements of 5 issuers from Serbia and 10 issuers from Croatia. Selected companies do

cover major industries in both countries, and information is compiled and focused on the presence and extend of the notes, with initial insight into methodology of the preparation of notes. In both countries based on our research there are no studies about the obstacles and real results of the IFRS framework application in the practice, since cumbersome and inherited complex legislation and public inertia is not overly supportive environment for this most public consider more than radical approach.

Since annual reports are almost the same but not identical in two analysed countries, we consider as consistent to reflect as much as possible new insights and criteria into our analysis, at the same time fully aware of the limitation of this approach, but we consider that new, and in some matters not fully compatible survey criteria are not inconsistent.

5. RESEARCH RESULTS

Before reaching or even less suggesting any clear-cut and unquestionable conclusion we once again would like to stress the fact that main goal of this initial research is to open up a discussion what should really the notes to financial statements contain, framework of information content, while at the same time balancing the increasing need not to overload the users of information with a heavy useless burden. This angle is stressing an urging and ever increasing need and necessity to reconsider the structure, volume, framework in information quality of the notes in countries like Croatia and Serbia. Our preliminary findings is revealing the simple message that the notes should really be short and explanatory and not some sort of defence of corporate accountants, executives and auditors in the court cases and public hearings. Notes should assist an average users of financial information to grasp and get a clear picture of financial situation and the results of operation, and should be presented in a systematic and consistent way- It should be borne in mind that the form should be serving the content, and not the opposite where there is the impression that the form is primary goal to dissimulate user of financial information to come to better conclusions and decisions. Financial reporting in Serbia and Croatia based on IAS/IFRS could be drastically improved regarding qualitative characteristics via improvement of the notes to financial statements, in a few not so drastically but significant steps. One of these steps is for the international and regional regulatory bodies (more precisely EU regulators) to review the whole segment of reporting within the notes and to follow reforms within IASB more closely and without any administrative delays. National regulatory bodies in Croatia shall be in a much better position in this process since the country is an EU member state, while in Serbia some kind of hesitation and slow down of the process of negotiation for the candidate state shall be probably used by the accounting and audit profession not to follow to international reforms and trends in this area with the speed that is really necessary. The expected slowness in accounting reform process shall be even more pronounced as we expect in the next few years regarding the unfavourable economic climate, slowing down of economic market reforms and the lack of adequate institutional framework in Serbia. Although level of demand for even medium quality financial information from the Statements is not so high in Serbia, but much higher in Croatia, the national regulatory bodies should more energetically and directly influence the practice of financial notes preparation, like some kind of limitation of the size, and even some better pronouncements regarding practical implementation of the IFRS, since we do expect that the needs of users of financial information to increase drastically regarding not only the form but much more the content of the notes (A Descriptive Study..., 1938-1968).

Analysis of annual financial reports of the top corporate issuers at the Zagreb Stock Exchange (Table 2) and their narrative reports of operations, financial and accompanying audit reports gave us more than a valuable initial insight into position of notes in the reports. General conclusions are valid and pointing out that we preliminary see somehow higher quality of financial and audit reports, that is logical and expected as Croatia is more institutionally developed and very soon EU full member state. This obvious integration into financial institutional framework of EU is also a strong support for a better and higher quality of financial reporting. Generally in both countries Croatia and Serbia we have noticed that notes are too extensive, in many instances only a mere retyping or copying of the IFRS standards without any obvious need for such an approach. We consider that such a practice does not at all contribute to improve the quality of the whole process of financial reporting, just the contrary. Our preliminary results of research are stressing that significant reform and improved standardization of notes is more than necessary not only on the global level of standardization lead by the IASB, IFAC and IOSCO but also at the EU level and on the national regulatory level in Croatia and Serbia. At the same time we are aware of the fact that the processes in Croatia are in a full control of the EU intuitions, and motivation of the Government, professional bodies and

businesses is obvious, while at the other hand Serbia shall face that challenge, and we could not assess what would be the response with this process taking into account the speed of changes and reforms.

6. CONCLUSION

We have come to a certain conclusion that the further development of the national regulatory framework in Croatia and Serbia based on the IFRS shall go towards significant revision and updating of the IFRS framework on the global level, which shall in turn better define the approach to the notes to financial statements, while introduction as a cornerstone the concept of materiality with an only goal that the notes should only contain information on material reporting items. Expected consequence of a such scenario of events shall be probably that the leading global auditing companies shall adjust their practice to a more efficient regulation that is at the same time significant profitability benefit for them, and clear consequence shall be the drastic cut of the volume of notes and their extensity. Some estimates are envisaging the cutting down of the volume of notes even up to 40%, with the parallel increase of financial information which is more useful to the real and potential users of financial information, and better servicing of those information future needs.

It has being relatively easy to make a conclusion that in to imaginary triangle of financial reporting two corners are the set of financial statement and notes, or just we dare to say that the notes are the two corners of that triangle and support of its stability. Regardless whichever line of reasoning it is to be adopted, the notes to financial statements are a fine structure and supporting pillar of complete information which in turn gives to financial statements such needed preciseness, completeness, structure, broad framework and debt of information, with significant feedback relations. High quality notes are connected not only through references in financial statements, but even more to the financial statement is integrative and integral information. Such notes are also serving as a form of information highway in the process of financial reporting, revealing true and fair picture on all important material aspects. We accept such an approach that the materiality is first of all an approach which is reflecting professional judgement of reporting accountants and auditors, primarily based on the facts and specific circumstances. The specific threshold or standard rules for the materially does not exist and it is even more impractical to introduce anything that would standardize common sense and logic of a human being. This approach we are in favour of is balanced and taking into account a significant fact – the information glut should be avoided at any cost in the notes with the intentional over-supply of the information in the notes with a more than insignificant and useless data. The common goal of reforms of notes to financial statements on all levels (international, regional, national, profession, businesses, etc.) should be only the consistent structuring, size and information content of the notes based on the concept of materiality, the concept this paper is trying to support and make it favourite.

REFERENCES

1. AICPA (2011). *Accounting Trends & Techniques*. New York: American Institute of Certified Public Accountants
2. Annual Financial Reporting 2011. *Value Accounts Special Purpose 2011. Fresh Insights for Financial Reporting in 2011*. <http://pwc.com.au/assurance/ifrs> (accessed 12 March, 2012), 17-118.
3. A descriptive study of the notes to financial statements in the annual reports of 75 selected Canadian public companies, 1938-1963 <https://circle.ubc.ca/handle/2429/37110?show=full> (accessed 12 March 2012).
4. Belex (2012). *Procedures of Admission to the Market*. http://www.belex.rs/eng/trzista_i_hartije/procedura (accessed September 20, 2012)
5. David, G. (10 July 2008). *What High Quality Financial Reporting and Auditing Mean to the Investor Community? Evolution of Financial Reporting*. http://sias.org.sg/index.php?option=com_content&view=article&id=124:what-high-quality-financial-reporting-and-auditing-mean-to-the-investor-community&catid=93:speeches&Itemid=81 (accessed 26 April 2012)
6. EC Staff Consolidated Version as of 18 February 2011, For Information Purposes Only. International Accounting Standard 1 Presentation of Financial Statements. http://ec.europa.eu/internal_market/accounting/docs/consolidated/ias1_en.pdf (accessed 12 March 2012).

7. EFRAG European Financial Reporting Advisory Group, January 2012. EFRAG_Update_January_2012.pdf www.EFRAG.org (accessed 8 February 2012), 1.
8. Feng, Li; Shroff O. Nemit (December 2009) Financial Reporting Quality and Economic Growth. Summaries of International Financial Reporting Standards. IAS 1 Presentation of Financial Statements. <http://www.iasplus.com/standard/ias01.htm> (accessed 23 February 2012).
9. Greuning H. V. (2006). *International Financial Reporting Standards: A Practical Guide*. (Međunarodni standardi finansijskog izveštavanja (Translated from English by: Prof. dr Branko Ž. Ljutić), Beograd: Mate.
10. IAS PLUS, <http://www.iasplus.com/standard/ias01.htm> (accessed 24 February 2012)
11. IFAC, <http://www.ifac.org/auditing-assurance/clarity-center/clarified-standards> (accessed 12 August 2012).
12. Jara, E.G., Ebrero A. C., Zapata, R.E, Effect of international financial reporting standards on financial information quality (2011), *Journal of Financial Reporting and Accounting*, Vol. 9 *Iss. 2*
13. Ljutic, B. (2012), "Impact of Notes to Financial Statements on the Quality of Financial Reporting in Serbia", Editorial Board. 43rd Annual Conference: Economic and Financial Crisis and Accounting System (Uticaj napomena na kvalitet finansijskog izveštavanja). Zlatibor, 24-26 maj, 2012, 43 Savetovanje: Ekonomsko - finansijska kriza i racunovodstveni sistem. Beograd: Savez racunovodja i revizora Srbije.
14. Ljutic, B., Klikovac, A., Jankovic, S., The Challenges in Complying with European Union's Audit Regulation in Two Non-EU Countries, ICAFT-2009 7th INTERNATIONAL CONFERENCE ON ACCOUNTING AND FINANCE IN TRANSITION - EUROPEAN & ASIAN EXPERIENCE, AND PUBLIC POLICY CONSIDERATIONS.
15. Ljutic B. (2005). *Auditing: Logics and Principles. (Revizija: Logika i principi)*, Beograd: Magistar biznis administracije – MBA Press Inc., 453-466.
16. Ljutic, B. (2004). *Banking and Stock Exchanges Operations: Investments, Institutions, Regulation*. (Bankarsko i berzansko poslovanje: Investicije, institucije, regulative), Beograd: Magistar Biznis Administracije – MBA Press Inc., 15-38.
17. NZICA. *Losing the Excess Baggage. Reducing disclosures in Financial Statements to What's Important.* <http://www.nzica.com/reducingdisclosures.aspx> (accessed 14 March 2012).
18. The Institute of Chartered Accountants in Australia. Addressing Unit 3BAC Accounting & Finance. *The Role and function of external auditors.* www.chartered-accountants.com.au (accessed 12 March 2012), 2.
19. SRRS-Serbian Association of Accountants and Auditors (2011). *International Financial Reporting Standards. 24 Volumes*. (SRRS (2011) Međunarodni standardi finansijskog izveštavanja. Komplet 24 knjige. Savez računovođa i revizora Srbije, Beograd: SRRS.
20. Šević, Ž. (2008), A Reemerging Professional in an Emerging Market: The story of the Modern Serbian Accountancy Profession, in *Accounting Reform in Transition and Developing Economies*, Ed. Robert W. McGee, Springer.
21. Van Beest, F., Braam, G., Boelens, S., (2009) Quality of Financial Reporting: measuring qualitative characteristics, NICE Working Paper 09-108, Nijmegen Center for Economics (NiCE), Institute for Management Research Radboud University Nijmegen, available at <http://www.ru.nl/nice/workingpapers> (accessed August 08 2012)
22. <http://www.fina.hr> (accessed September 20, 2012)
23. <http://www.ripe-hanfa.hr/regulativa/trziste-kapitala/> (accessed September 20, 2012).
24. <http://zse.hr/default.aspx?id=36796> (accessed September 20, 2012)