Borbély, Katalin

Széchenyi István University (Győr, Hungary)

Financial performance under pressure – A case study of a Hungarian company from the first half of the 20th century

Keywords: accounting, history, Hungary, profitability

Abstract

The paper aims to introduce the financial performance (profitability) of a Hungarian company in the first half of the 20th century. The research interests are its activity and the economic history in the background. In the examined period there were two world wars and two changes of the currencies which were the legal tender in Hungary. Under these conditions, the expected performance of the entity could be falling profitability but the financial reports and ratios of the company show a very different outcome.

The paper is based on primary research but it uses the results of the professional literature as well. There are also limitations of the investigation concerning the deeper introduction of its activity, evaluation methods and contemporary accounting regulation.
However, the result of the research can be unexpected, it proves that good financial performance does not depend only on the historical and economic conditions but the recognition of the decision-makers in the given situation.

Introduction

'History is fundamental to an understanding of accounting. The practices and issues of today inevitably have a past' (Walker, ed. Humphrey, 2004, p.5.).

The paper aims to introduce the financial performance of a Hungarian company in the first half of the 20th century. It is necessary to highlight a short economic background and the most relevant points of the accounting regulation in Hungary in the examined period.
In Hungarian history, the period between 1867 and 1914 was a 'golden era'. The outbreak of the 1st World War brought a war economy rationing and centralized stockpile in the field of weapons. There was high inflation in Hungary at the end of the war. The government could stop it by overprinting the currency but only for a short time. Hungary lost a remarkable part of its inhabitants and its territory due to the peace-treaty after the war. The structure of the economy and its infrastructure changed radically and it became worse to do or to go on business. Under these conditions, Hungary became a country with an export-oriented economy. In addition, the country had to pay a huge war reparation for all the damage done. The economic and financial reconstruction due to the offer of the League of Nations deficiency fell and many investments came into the country. The government introduced a new currency at the end of this process in 1927. Industrial production reached the level before the war in 1929 but the disadvantageous effects of the Great Depression were very perceptible. After this period began a slow growth. Hungary started a great armaments program which generated an industrial boom from 1939. The war economy rationing and centralized stockpile in the field of industrial and agricultural products took effect again in 1941. The outcome of the 2nd World War was on the one hand a huge depopulation and, on the other hand, enormous losses in industry, transportation and agriculture (Draskóczi et al. 2003).

The contemporary Hungarian accounting regulation – A literature review

Hungary imported its accounting regulation in the first half of the 20th century because of its history and geography. Being in Austro-Hungary until 1918 the legislation was mostly collective. Although the country was independent after the 1st World War the traditions of codified law and the social-economic conditions were settled. Consequently, the Austrian and German accounting regulations were the prototypes of Hungary.
The demand for standardization of annual reports arose at the beginning of the century due to the 2nd industrial revolution (Honvári, 2006). Germany was getting stronger through the industrial growth of the country and it meant the strengthening of German accounting's role nationally and internationally as well (Borbély and Lukács, 2018). Schmalenbach's professional activity influenced the Hungarian regulation determinative. His work on 'Betriebswirtschaftslehre' brought a new approach to accounting and his chart of accounts was the mapping of his professional attitude of mine (Richard, 1995). Most of the Hungarian bookkeepers, accounting and financial experts spoke the German language at that time and knew the timeous problems and methods and they used them, too.

The first rules about bookkeeping and financial reports were provided by the Commercial Code in 1875. There was no requirement to give a true and fair view of the financial position and performance. It was in force until the end of the forties and the only accounting regulation until 1925. The so-called Golden Balance Rule applies first of all to stock companies. Kuncz (1941) remembered the enactment of the Act on Limited Liability Companies (1930) which enabled the establishment of a company simply. The importance of the law was outstanding. It provided obligations for the financial report's presentation and the audit and gave flexible rules at the same time (Horváth, 2006). This law was used by the legislators again after the change of regime in 1990 (Sárközy, 2005).

The contemporary Hungarian profession focused on two questions between the two world wars. One of them was the so-called 'organization' joining the 'Betriebswirtschaft'. Erdély (1931) defined it as the coordinated and practical organization of the companies' activity, accounting and especially cost accounting to get the most information to support the decisions. The phenomena affected the cost calculation and the content of the profit and loss account (PLA). The experts in their studies recommended charts of accounts for several industrial activities.

The other important question analysed the evaluation of the assets and liabilities. At that time the companies had more possibilities to create hidden reserves for lack of strict written rules on the recognition and measurement of assets and liabilities. However, the most important expectation of stakeholders was obvious to get a true and fair view of financial position and performance.
Kuntner (1924) gave principles to use in the accounting practice, such as true and fair view and continuity. The latter applies to consistent evaluation. This question was stressful because of the property. The balance sheets reported as little as possible information according to the intent of owners. The companies disclosed their balance sheet and a profit and loss account without notes eight days before their general assembly. Consequently, the stakeholders did not know the methods of their evaluation and therefore their hidden reserves. There was a balance sheet for tax purposes which had a prescribed content but it was not disclosed.

The introduction of the new legal tender brought the possibility of providing stricter evaluation rules in 1925. Szende (1926) highlighted the complicated situation of the stakeholders. The investors did not receive reliable information due to the very high inflation and the lack of evaluation rules. The golden rule for balance sheets gave principles to the revaluation of assets and liabilities in cases of several entrepreneurial forms. The assets were maximized by ordinance at the value of the balance sheet day of the new currency and the liabilities were shown at the contract value of the same day. This general prescription joined the principle of conservatism and meant the break of continuity. This latter caused a restart of business in effect. The detailed provisions of the golden rule gave possibilities to create a hidden reserve. László (1929) introduced the possible aims to do it such as to hide the actual capital structure which supports a more flexible financial activity for the company, to influence the dividend policy of the company and to have a tax evasion. Kuncz (1939) emphasized at the same time that the hidden reserve helped the companies to survive the world war, the inflation, maybe the valorization, in other words, the breakdown.

Erdély (1931) pointed out an important problem of evaluation despite the golden rule. The purchase price at the initial recognition was not defined and he emphasized that there were disclosed balance sheets which contained the net value of an asset. Consequently, the stakeholders could not check the implementation of the prescription. He concluded the most important rules of the balance sheet's presentation. It should match the provisions. It should be confirmed by documentation. It should be based on continuity in the point of evaluation. The profit and loss account should be detailed and avoid offsetting.

Zwierina (1949) compared the Commercial Code (1875) and the Golden Balance Rule (1925) to characterize them. The Commercial Code gave short and liberal provisions. Consequently, it was unreliable because of the estimation of the result and the hidden reserve. In his opinion, the Golden Balance Rule yielded advance prescribing the maximized value of assets and pactional the value of liabilities.

Until the 2nd World War, the above-mentioned rules were in force but due to the extremely high inflation put them out of action.

Methodology

This paper is based on primary research and it joined a comprehensive research which focused on the Hungarian accounting history in the last 150 years. The aim was to find a company to know and prove the effects of accounting regulation in practice and which could reflect the social-economic environment of the country (Flesher and Samson, 1990).

There were several viewpoints to choose an entity which had a common activity and reflected the changes in the market's conditions. In addition, it should have complete or partly complete bookkeeping and financial reports for the longest time.

The catalogues of the National Archives of Hungary contain several companies which fulfilled these aspects. Investigating the source of primary information and considering the above-mentioned aspects the textile mill 'Kistext' seemed the best one among them. There is correct and obvious documentation with the

annual reports from the establishment (1907) until 1934 every year and henceforward there are similar data and reports from several years, but not from all until 1947. Consequently, its financial documentation was almost all-purposed to examine the accounting practice in the first half of the 20th century.
The paper also uses secondary research (see the literature review) which gives an interpreter background to know Kistext's financial position and performance thereby relating the primary information and the specific areas of the national accounting regulation (Parker and Coffman, 1990, Table 1. p.142).

Financial position and financial performance of a textile mill 'Kistext'

The factory was established as a family business by brothers Popper in 1907 in a suburb of Budapest. The special machines were bought by their father-in-law from Germany and England. The firm became profitable in a very short time and it was the second greatest textile mill in Hungary in 1921. Kistext's products were well-known also abroad in the twenties and thirties. To avoid the effects of the Great Depression from 1929 and to keep its profitability the company dismissed almost 1700 employees. The management of the firm changed in 1939 and this fact meant the end of the family business. During the 2nd World War, there was no heavy damage to its equipment. Kistext was reprivatized in 1948.

Erdély (1931) highlighted in his work the importance of the profit and loss account and its content. The contemporary rules did not provide its structure and content. The bookkeeper kept the used accounts and prepared documentation about the financial performance. Its form was two-sided similar to the balance sheet. It was part of the book's closing every year.
The examined company used the same accounts and structure in its bookkeeping between 1908 and 1924 but Kistext did not disclose the PLA only the balance sheet without notes.
The used classes of accounts matched to activity. The classification of the expenses was mixed. At the calculation of the operating earnings was recognized by function and the income and related expenses were offset. The detailed operating incomes and expenses (selling, cost of sales) could be detected only in the books. Additional incomes were from interest and discounts.
The overhead costs that were not directly related to the production of goods were recognized by nature. There are expenses in the period 1918-1924 connected to depreciation, amortization of capitalised value of enterprise foundation, written-down of the war bonds, general costs of the administrative staff (exactly detailed from 1915), salary, interest, written-down of doubtful assets, given discount, maintenance work. Although the bookkeeping reflected the operating events exactly, the financial report of the company was not usable due to the hyperinflation for the investors.

Table 1. The Profit and Loss Account of Kistext between 1908 and 1924

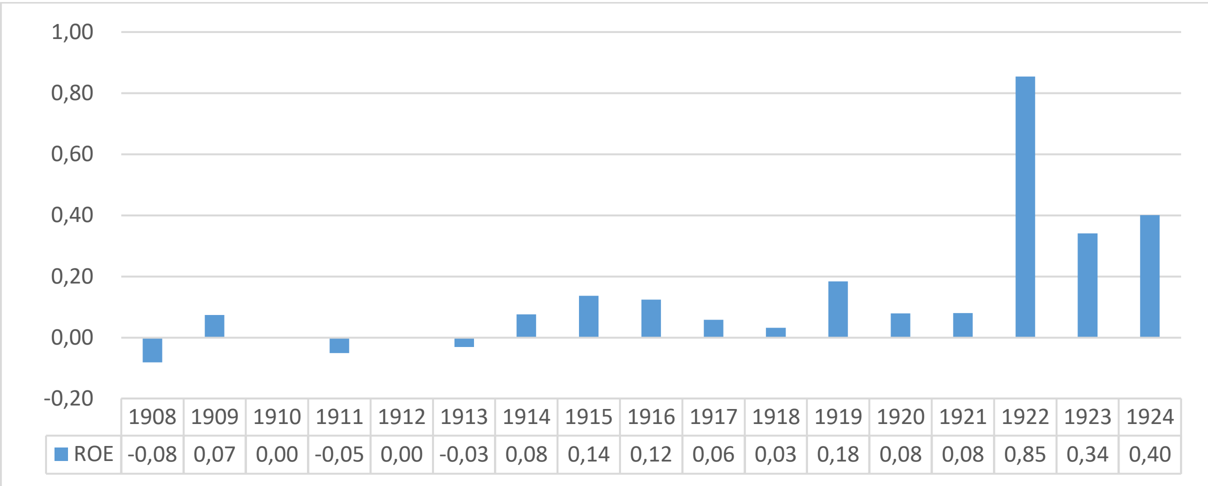
PLA	**1908**	**1909**	**1910**	**1911**	**1913**	**1914**	**1915**	**1916**
operating profit	158 023	581 021	513 700	402 036	482 805	1 036 225	1 197 723	1 161 516
net profit	**-115 184**	**118 613**	**879**	**-83 798**	**-52 639**	**146 733**	**347 835**	**398 214**

PLA	**1917**	**1918**	**1919**	**1920**	**1921**	**1922**	**1923**	**1924**
operating profit	569 524	1 013 134	3 571 612	3 207 226	491 783	32 091 855	487 769 491	3 237 099 432
net profit	**211 771**	**124 368**	**942 350**	**422 667**	**451 572**	**32 038 133**	**331 823 366**	**789 311 500**

Source: Compiled by the authors based on data of Kistext

Table 1. shows the quick acceleration of the Hungarian currency 'korona'. The most practical solution in this case is to calculate such a ratio which eliminates the effect of inflation. The Return on Equity shows Kistext's profitability reliably.

Figure 1. The ROE ratio, 1908-1924



Source: Borbély (2019, p.48.)

Examining the ratio of Figure 1. is conspicuous that the company's activity was lucrative during the 1st World War. Kistext got many government orders to produce the textile of uniforms. The proportion of short-term trade receivables and total assets had increased because of the war economy and the difficulties of budget.

The ROE shows not only the increasing order but the position of Hungary during these four years, the war boom in the first three years and after that a falling profitability. There is no explanation in the contemporary documentation of the raised operating profit in 1922 but the accelerating inflation is obvious in 1923 and 1924 after the cross-checking on Table 1. and Figure 1.

The new Hungarian currency 'pengő' was introduced in 1927 but it meant two years before this year in accounting to disclose two years of data in the financial reports. The changing of currency went hand in hand with new evaluation rules. The company had to prepare an inventory and a balance sheet based on this ordinance and the hesitancy of investors disappeared (Szende's 1926). The inflation could not cover the real financial position and performance.

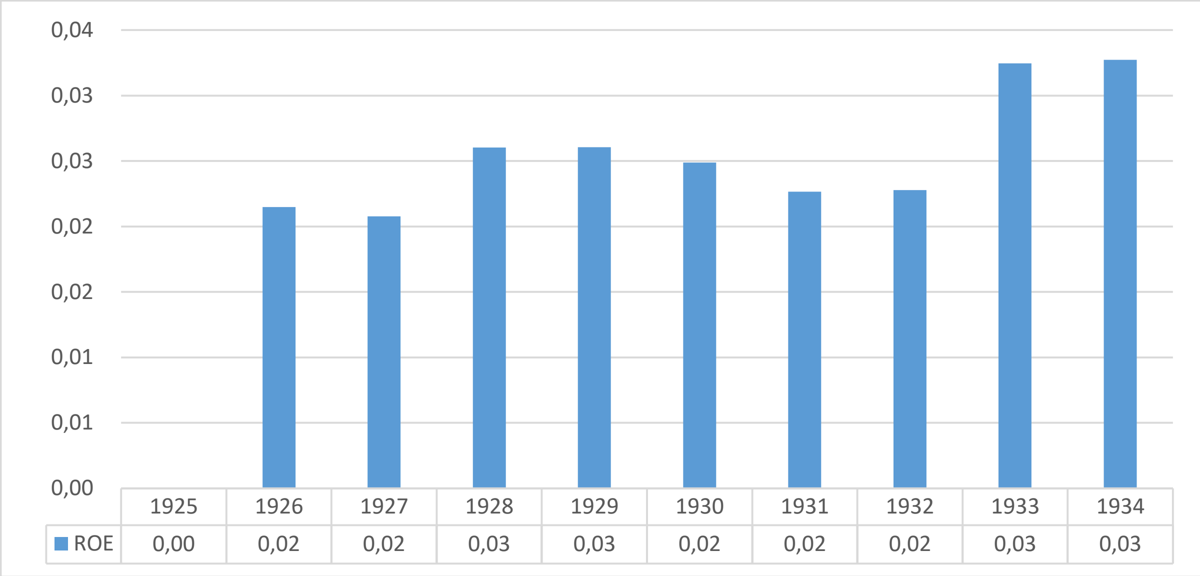
Table 2. The Profit and Loss Account of Kistext between 1925 and 1934

PLA	**1925**	**1926**	**1927**	**1928**	**1929**	**1930**	**1931**	**1932**	**1933**	**1934**
operating profit	132 567	607 251	651 789	896 105	1 107 233	1 034 481	1 023 483	1 008 265	1 932 127	2 551 064
net profit	**67 292**	**67 444**	**87 912**	**92 502**	**92 652**	**87 880**	**92 303**	**140 156**	**181522**	**214 830**

Source: Compiled by the authors based on data of Kistext

Cross-checking on Table 2. and Figure 2. shows the restarting of business activity at a continuous production. The net profit and the ROE ratio reflect a gainful activity. It seems that despite the difficulties of the war and the reorganization of the Hungarian economy the management of the company made adequate decisions to have profit. It improved not only its financial performance but also its financial position. The company started a big project of housing for employees in 1923 and built a new office building in the city centre of Budapest in 1926.
The firm had difficulties during the Great Depression. Although it was profitable its orders fell dramatically. Consequently, the management had to decrease the expenses as well.

Figure 2. The ROE ratio, 1924-1934



Source: Borbély (2019, p.49.)

In the middle of the thirties, the textile mill raised the export activity and its profitability at the same time. The factory manager was proud of dividend payments in the most difficult years.

Although the accounting profession pushed the disclosure of financial reports with more information (see Erdély, 1931) the companies, lacking regulation, used the offsetting of incomes and expenses and minimized the disclosed information on their financial performance. The Kistext's books contained the above-mentioned expenses but the printed booklet in 1929 gave only the operating profit, depreciation and net profit for the shareholders. The transparency of the financial report was not defined. Every firm tried to give not too much but enough information.

Conclusion and limitations

The examined period and company of the Hungarian accounting history raise more issues which can be edifying for the present profession.

There are obvious facts in the investigation. The effect of the social-economic environment is very intense. In our case, there were two world wars and two changes in the currencies which were the legal tender in Hungary (in 1927 and 1946) after hyperinflations and the Great Depression. The examination of the professional rules is crucial and reveals one of the most important questions of the present regulation: lack of enough rules versus over-regulation. Which can be the adequate solution to fulfil the requirement of the financial report? How shall we find a good balance between them?

There are also limitations of the short study concerning the deeper introduction of the company's activity, evaluation methods and contemporary accounting regulation. However, the result of the research may be unexpected under these conditions, it proves that good financial performance does not depend only on historical and economic conditions but the recognition of the decision-makers in the given situation.

Bibliography

Borbély K. (2019) Mérlegvilágosság Tanulmányok a Magyar számvitel történetéről, magánkiadás, Győr

Borbély K. - Lukács L.I. (2018) Schmalenbach munkássága és hatása a magyar számvitelre, *Controller Info, VI. évf. 1. szám pp. 21-27.*

Draskóczi I. - Búza J. - Kaposi Z. - Kövér Gy. - Honvári J. (ed) (2003) Magyarország gazdaságtörténete a honfoglalástól a 20. század közepéig, Aula Kiadó, Budapest

Erdély S. (1931) Organizáció, Grill Károly Könyvkiadó Vállalata, Budapest

Flesher, D.L. – Samson, W. D. (1990) What is publishable; Accounting history research: An editorial view, *Accounting Historians Journal Volume 17 Issue 1 June 1990 Article 1, pp.1-4.* https://www.jstor.org/stable/40698002 (accessed: 22 May 2023)

Horváth A. (2006) A magyar magánjog történetének alapjai, Budapest, Gondolat Kiadó, 557. o.

Honvári J. (2006) Európa gazdaságtörténete, Készült a HEFOP 3.3.1-P.-2004-09-0102/1.0 pályázat támogatásával, https://doksi.hu/get.php?lid=15525 (accessed: 4 July 2023)

Kuncz Ö. (1939) Küzdelem a gazdasági jogért Királyi Magyar Nyomda, Budapest

Kuncz Ö. (1941) Küzdelem a gazdasági jogért (II. kötet) Királyi Magyar Nyomda, Budapest

Kuntner R. (1924) Könyvviteltan III. rész Társaságok számvitele. Különös ügyletek. Athenaeum, Budapest

László B. (1929) A titkos tartalékok, Magyar könyvviteli folyóirat, XX. évfolyam, 1929/3-4, 62-73.o.

Parker, L.D. – Coffman, E. N. (1990) An Accounting Historiography: Subject Matter and Methodology, *ABACUS. Vol. 26. No. 2.pp.136-158.* https://onlinelibrary.wiley.com/doi/abs/10.1111/j.1467-6281.1990.tb00250.x (accessed: 4 July 2023)

Richard, J. (1995) The evolution of accounting chart models in Europe from 1900 to 1945. *The European Accounting Review, (4),1, pp.87-124.*

Sárközy T. (2005) A társasági és cégjog fejlődésmenete és stratégiai fejlesztési koncepciója in: A rendszerváltozás gazdasági joga Sárközy Tamás (ed) 2005, MTA Társadalomkutató Központ, Budapest

Szende Péter Pál (1926) A pengőmérleg 7000/1925 P.M. rendelet a pengőmérlegek valódiságának helyreállításáról, Grill Károly Könyvkiadó Vállalata, Budapest

The Real Life Guide to Accounting Research a Behind-The- Scenes-View of Using Qualitative Research Methods (2004) (ed) Humphrey, Ch. Manchester School of Accounting & Finance, University Manchester, UK – Lee, B. Sheffield University Management School, Sheffield, Elsevier https://www.sciencedirect.com/book/9780080439723/the-real-life-guide-to-accounting-research (accessed: 4 July 2023)

Zwierina J. (1949) Mérlegtan és mérlegbírálat, Pantheon Irodalmi Intézet, Budapest