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CONSOLIDATED FINANCIAL STATEMENTS APPLYING NATIONAL AND INTERNATIONAL FINANCIAL REPORTING REGULATIONS

Review Article

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Abstract

Multinational companies operating in the global market have a diverse system of relationships. These companies form relationships through investments and cross-border transactions that bring them into a relationship of interest, ownership and dependence with each other. It is important for stakeholders to access a statement on these groups of companies that provides an adequate, realistic picture of the enterprises. Based on separate statements, the presentation of a realistic picture cannot be ensured. The widely accepted tool that can be used to provide stakeholders with combined statements excluding internal relations of the groups of companies is consolidated accounting. This study presents the application of the European Union's mandatory accounting regulations in Hungary in accordance with the alteration of Hungarian regulations. Despite the obligations, it is also shown that the major reasons motivating these companies to transition from Hungarian to IFRS reporting are their parent companies.

INTRODUCTION

In recent decades, there has been a change in terms of the way companies operate in countries both within and beyond Europe. They do not exclusively operate domestically, but they also have connections of international level (Böcskei, Dékán Tamásné Orbán, Bács & Fenyves, 2017). Multinational companies operating in different economic and legal environments in the global market have a diverse system of relationships. These companies form relationships through investments and cross-border transactions that bring them into a relationship of interest, ownership, and dependence with each other (Jakus, 2015). The resulting groups of companies, although consisting of legally separate enterprises, are controlled by a single company. Individual companies cannot be called economically independent; their operational decisions in many cases serve the interests of the controlling company or the group (Madarasiné Szirmai, Kovács & Mohl, 2019).

Members of the company groups prepare their separate annual statements independently of each other, in accordance with their own national regulations or one of the international accounting systems. However, it is mandatory for each parent company to prepare consolidated financial statements that present group members as a single entity, which is free from any accumulations that may result from transactions between them. In the presented study, the significance of the consolidated annual statement is briefly described, together with the range of companies covered by the domestic and international rules.

CONSOLIDATION ACCOUNTING

It is of great importance for stakeholders (creditors, owners, investors, governments, etc.) to be able to access financial statements (mainly IFRS financial statements) on these groups of companies that provides an adequate, realistic picture of the operations, assets, financial and income position of the enterprises (Jakus, 2015; Szekeres & Dékán Tamásné Orbán, 2019). Due to the interests and shared relationships, the companies are typically under unified management, which presumably affects their economic decisions, therefore the presentation of the real picture cannot be ensured based on their separate annual statements (Fridrich, Simon & Sztanó, 2008). The emerging lack of information means an increase in risk especially for investors and creditors (Fenyves, Bács, Zéman, Böcskei & Tarnóczi, 2018). Due to of intra-group relationships, the loan obtained or the assets of investors may be transferred from the company that obtained the original external funding to companies that would not be able to obtain these resources to finance their operations based on their own separate data. Therefore, it is of paramount importance that market stakeholders analyse not only the separate, but also the consolidated report of the company group and make their decision on the establishment or continuation of the relationship based on the favourable assessment of the two statements reports (Simon & Kresalek, 2017).

According to Simon (2009), in order to present a reliable and realistic picture, it is necessary to consider the companies with shareholdings as a single group of companies and to apply the methods of consolidation accounting. Consolidation accounting is suitable for assessing the real market position, assets, financial and income position by eliminating the internal relations of the groups of companies. Consolidated accounting can be classified as a tool that can be used to achieve the goal to explore and thus demonstrate the power and influence of the group (Simon, 2009).

It is emphasised by Ujvári (2004) that parent companies should not perform a mechanical “aggregation” of separate notes, but should preferably include information that help the reader of the statement understand and assess the real assets, financial and profitability position of the group and consistently interpret the lines of the consolidated balance sheet and profit and loss account.

LEGAL BACKGROUND TO THE PREPARATION OF THE CONSOLIDATED STATEMENT

In the European Union, the regulation of accounting at Community level began in the 1970s. Its starting point is the First Council Directive (EEC, 2020a), which regulates the obligation of companies to provide information in the context of the freedom of establishment (Majoros, 2010). From an accounting point of view, the most important directive is the Fourth Council Directive 78/660/EEC on the annual statements of certain types of companies Regulation No. 4 on the annual financial statements of companies (EEC, 2020b) and Seventh Council Directive (EEC, 2020c) on consolidated annual statements (Bartha, Gellért & Madarasiné Szirmai, 2013). These two directives were amended by Directive 2013/34/EU (European Union, 2020) on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, adopted by the European Parliament and the Council in 2013 (Madarasiné Szirmai, Kovács & Mohl, 2019).

In the legal system of the European Union, the application of regulations is mandatory in each Member State and they become directly part of national law. As of 2005 (except those companies which are trading only their debt securities on the stock exchange were granted an extension until 2007), Regulation (EC) No 1606/2002 of the Council (EC, 2020) on the application of international accounting standards has stipulates for listed companies in the European Union (and the European Economic Area) to prepare their consolidated annual financial statements in accordance with IFRS (Bartha et al., 2013).

Under the EU Regulation, Member States may allow or require the above-mentioned listed companies to prepare their separate annual statements and non-listed companies to prepare their consolidated and/or separate annual statements in accordance with international accounting standards. Thus, Member States have no choice in terms of the consolidated statements of listed companies, but in all other cases, they can decide when and for which group of companies they allow or require the application of international standards at separate and/or consolidated level and which companies they choose to leave in their national accounting system.

As already mentioned above, direct application of EU regulations is obligatory for Member States, thus the regulations should not be transposed into Hungarian law (I1, 2020). After the 2005 amendment of the Hungarian Accounting Act (Act C of 2000 on Accounting, 2020), which was adopted before the accession of Hungary to the EU, states that an enterprise falling within the scope of Article 4 of the Decree “meets its obligation to prepare its consolidated financial statement by doing so in accordance with IFRS". In this case, therefore, the parent company is exempted from the obligation to draw up consolidated statements in accordance with the Accounting Act. Pursuant to the mentioned amendment to the Accounting Act, as of 2005, non-listed companies can choose to remain in the system of domestic regulations or choose to prepare consolidated financial statements in accordance with IFRS. If companies make use of this possibility, it is also not necessary to prepare consolidated financial statements in accordance with Hungarian regulations.

APPLICATION OF IFRS TO SEPARATE FINANCIAL STATEMENTS

Although the presented study focuses on the consolidated financial statements and the companies that prepare them, it is also worth mentioning the extension of IFRS to separate financial statements. In Hungary, the scope of application of standards has further expanded. In 2015, the expansions planned for the following years were included in a government regulation, and then by amending the related legislation, it became mandatory or optional for numerous companies to prepare their separate reports in accordance with IFRS. It is emphasized that this does not mean parallel accounting and reporting in accordance with both systems, as the transition to IFRS, regardless of whether it is an own decision or that of the parent company or a result of legal requirement, constitutes an exemption from accounting under the Hungarian accounting system. Table 1 shows the multi-stage introduction of the IFRS system.

Subsidiaries that prepared their financial statements in accordance with Hungarian accounting rules but provided data to their parent company in accordance with IFRS were subject to a significant administrative burden for the joint management of the records under the two systems (Madarasiné & Szőllősiné, 2018). This is also supported by Deloitte Hungary's survey on the transition to IFRS conducted in 2017 and 2018 (Figure 1), as in both years more than half of the surveyed companies justified the transition to IFRS with the decision of the parent company (I2, 2020).

In 2016 only 11, in 2017 – 142, and in 2018 – a total of 202 companies (National Tax and Customs Administration, 2017; 2018; 2019) prepared separate IFRS statements, but the number of those that choose to prepare their statements according to IFRS is expected to increase further.

CONSOLIDATED FINANCIAL STATEMENTS IN ACCORDANCE WITH THE ACCOUNTING ACT AND IFRS

If there is a need for consolidation, it should be examined whether there is an obligation to prepare consolidated financial statements and which companies should be included in the scope of consolidation. According to the Accounting Act, the investments of the parent company in certain companies are classified on the basis of the voting ratios and the ownership share. However, when IFRS are applied, the definition of a group of companies is based on which other companies the parent has control over based on its current capabilities and possibilities.

Thus, in the system of IFRS, the ownership of 50% + one vote is not a condition for the establishment of the parent-subsidiary relationship (Dékán T-né, 2019). A parent company, if it prepares and publishes its consolidated financial statements in accordance with Hungarian regulations, owns more than half of the shares and business shares of the subsidiary/ies included in the consolidation. In the case of lower voting ratio and ownership share, parent-subsidiary relationship is not established. As the existence of control in IFRS is the most important condition for determining the relationship between companies within a group (Gluzová, 2015), during the transition to IFRS, companies that are excluded from consolidation in the Hungarian system may also be included in the consolidation because the investment of the parent company does not exceed 50%, but the parent-subsidiary relationship is established otherwise. Control can be gained e.g. by exercising a contractual option, a right of veto, or acquiring additional rights under a contract with other owners. In case the other shares are fragmented compared to the parent company, the ability to manage may also be realized in the system of IFRS (Dékán T-né, 2019).

As of the balance sheet date between 1st January 2018 and 31st December 2018, 165 parent companies published consolidated financial statements in accordance with the Accounting Act and 74 parent companies in accordance with IFRS (Company Information Service of the Ministry of Justice, 2020). In the case of those that opted for the Hungarian system, this means 43 sectors, and in the case of the international system, 23 sectors (Company Information Service of the Ministry of Justice (2020) based on the main activity according to the Hungarian NACE classification (TEÁOR)). Table 2 shows the sectors in which most parent companies operate; these companies cover more than half of the companies preparing consolidated financial statements.

It is reasonable to divide the companies dealing with financial intermediation into separate sub-sectors, as due to the legal requirement, credit institutions and financial institutions have switched to IFRS. Some of the holding companies in the same sector dealing with asset management remained under Hungarian regulation. They are not subject to mandatory IFRS reporting, as holding companies are companies that do not only own a controlling majority of the shares of their subsidiaries operating in the financial field (I3). In the field of the pharmaceutical sector, companies are divided between the two regulations, because if the companies dealing with the wholesale of pharmaceutical goods are taken into consideration, they 50-50% divided between the domestic and international system. The situation is similar for companies operating in the field of energy supply, and 20-25% of companies engaged in real estate transactions and wholesale of various products have already converted to IFRS at the consolidation level.

It can be observed that in the field of agriculture and food production, numerous parent companies prepare consolidated financial statements, but none of the companies have opted for IFRS reporting. The reason behind this, the possible later transition of these companies and groups of companies as well as the special rules applicable to them could be examined in the framework of another study.

SUMMARY

In the scope of the study, the significance of the consolidated annual report and the range of companies covered by the domestic and international rules were briefly presented.

Members of companies and groups of companies with international relations prepare their separate annual statements separately in accordance with their own national or one of the international accounting rules. Based on these separate annual statements, the presentation of a realistic picture cannot be ensured. However, the combined asset, financial and income position of the groups of companies can be judged based on the consolidated financial statements, excluding internal relations.

Companies listed on stock exchanges in the European Union must prepare their consolidated financial statements in accordance with IFRS (International Financial Reporting Standards). In all other cases, Member States may decide which companies to include in the IFRS system at separate and/or consolidated level. In Hungary, non-listed companies can also prepare consolidated financial statements in accordance with the standards, and it is mandatory or optional for a growing number of companies to switch to IFRS at a separate level. Financial institutions and credit institutions have transitioned to IFRS due to legal requirements, but the parent companies of numerous sectors (pharmaceutical sector, energy supply, etc.) have also taken the opportunity, and more and more companies are expected to opt for IFRS consolidated financial statements in the future.

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Table 1
Application of IFRS in Hungary for separate financial statements

Year/force	Involved sector or business entity
Optional as of 2016	• with the exception of institutions supervised by the MNB (Hungarian National Bank), enterprises the stocks of which are traded on a regulated market of any state of the European Economic Area • an enterprise the direct or indirect parent company of which prepares its consolidated financial statement in accordance with IFRS
Mandatory as of 2017	• with the exception of institutions supervised by the MNB (Hungarian National Bank), enterprises the stocks of which are traded on a regulated market of any state of the European Economic Area
Optional as of 2017	• insurance company • a financial undertaking, monetary institution, electronic money issuer institution, investment company, central depository, central contracting party, stock exchange, occupational pension provider under the supervision of the MNB acting in its area of responsibility for the supervision of the financial intermediation system • a credit institution and a financial undertaking subject to prudential regulation equivalent to a credit institution • a financial market intermediary and insurance intermediary included in the consolidated financial statements prepared in accordance with IFRS, as well as a fund and fund manager subject to an act on collective investment schemes and their managers and amendments to certain financial laws • Hungarian branch of a foreign-based company • a company subject to an audit obligation based on sales and employee number criteria
Mandatory as of 2018	• a credit institution and a financial undertaking subject to prudential regulation equivalent to a credit institution
Mandatory as of 2019	• a cooperative credit institution and another credit institution involved in the integration of cooperative credit institutions

Source: Madarasiné & Szőllősiné (2018)

Table 2
Number of companies preparing consolidated annual statements in various sectors (2018)

Sector (NACE classification)	Accounting Act	IFRS	Total
01 Crop and agricultural production, hunting and related service activities	7	0	7
10 Manufacture of food products	7	0	7
21 Manufacture of pharmaceutical products	4	2	6
35 Electricity, gas, steam and air conditioning	4	5	9
46 Wholesale trade (except for motor vehicles and motorcycles)	19	6	25
Of which: Wholesale of pharmaceutical goods (4646)	1	3	4
64 Financial service activities (except for insurance and pension funding)	30	29	59
Of which: Activities of holding companies (6420)	30	10	40
Other monetary intermediation (6419)	0	18	18
Other credit granting (6492)	0	1	1
68 Real estate activities	16	4	20

Source: Own compilation based on data from the Company Information Service of the Ministry of Justice

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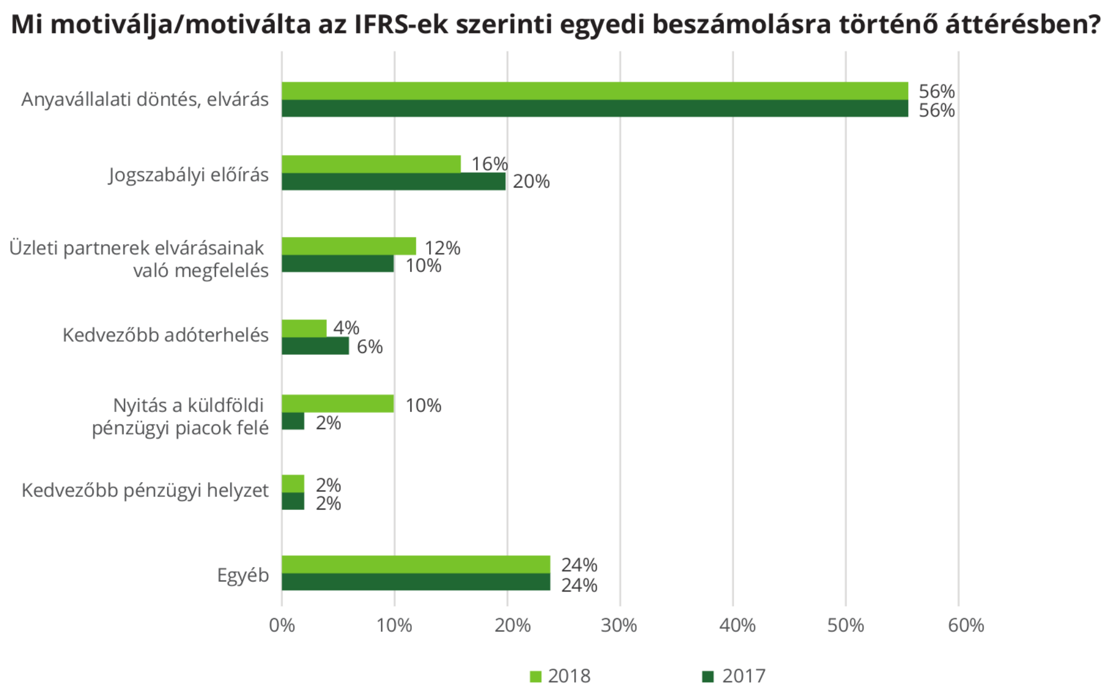

Parameters (from the top to bottom):

- Parent company decision, expectation
- Legal requirement
- Meeting the expectations of business partners
- More favourable tax burden
- Opening towards foreign financial markets
- More favourable financial situation
- Other

Figure 1

What motivates/motivated you to transition to separate reporting in accordance with IFRS?

Source: Deloitte (2018)