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Accounting

Via E-Mail to

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Cologne, 30 April 2009

## **Consultation Paper on Review of the Accounting Directives – Cutting Accounting Burden for Small Business / Review of the Accounting Directives**

Dear Sirs,

on behalf of the Cologne Discussion Group on International Accounting Law (registered association) I am writing to comment on the Consultation Paper on Review of the Accounting Directives. We appreciate the opportunity to comment on the Consultation Paper.

*We are:* a private organization of academics, preparers, accountants and auditors.

*Name of the organization:* Cologne Discussion Group on International Accounting Law (“Kölner Gesprächskreis Internationales Bilanzrecht e.V.”).

*Short description of the general activity of your organization/company:* We are a non-profit organization made up of members working in various fields linked to accounting (academics, preparers, legal and tax counsels, accountants and auditors). Our objective is to enhance the interdisciplinary exchange on accounting related topics between academics and practitioners with very different perspectives on accounting.

*Country where your organization/company is located:* Germany.

*Contact details incl. e-mail address:* see letterhead.

### **General remarks**

#### ***The future role of the Accounting Directives***

We strongly support the European Commission in its objective to modernise the Accounting Directives. These Directives form the common accounting basis for EU-entities. The main objectives of the Accounting Directives – i.e. coordination of national provisions concerning the

presentation and content of annual accounts and annual reports, the valuation methods used therein and their publication in respect of certain companies with limited liability and thereby enhancing comparability of information set out in financial statements throughout the EU – are still valid today. Different accounting rules for companies doing cross-border business in the EU conflict with the concept of an internal market. A set of coordinated European accounting rules is still an essential issue for cross-border trade and, therefore, is still needed. On the other hand, the current IFRSs cannot adequately fulfil the functions of the Accounting Directives: First, without modifications IFRSs are not suitable as a basis for distribution purposes in a capital maintenance system; second, they are much too complex and too expensive to follow for small- and medium-sized entities (SME); third, in many cases they just do not fit the needs of companies which do not act as players on capital markets. And, last but not least, the overall aim of deregulation can definitely not be achieved by implementing the current set of IFRSs as “the” accounting standards for all European companies.

Revising the Accounting Directives in a way that provides suitable solutions for *all* European companies, including SME, remains as a genuine objective of European Law. This project presents the opportunity to develop a set of European accounting principles that is comprehensive and a real alternative to IFRS, but cheaper and simpler to apply than IFRS.

In summary, the need for a separate European accounting regime besides IFRS is still high.

If the revision of the Accounting Directives aims at developing a real alternative to IFRS, it is not recommendable to implement a Member State option whereby Member States may authorize or require application of the *IFRSs for Small and Medium-sized Entities* (as currently discussed) instead of national GAAP based on the Accounting Directives. The IASB has no “European mandate” with regard to accounting rules for Non-publicly traded companies. Such rules should, on the contrary, be genuinely designed by the European Law to ensure that the needs of European SME are adequately met. On the other hand, a Member State option to authorize or require the application of the *IFRSs for SME* would result in a “Self-Endorsement” of IFRSs for SME. Hence, the EU would not only lose its political influence in the process of designing the IFRS for SME, but also would future amendments by the IASB automatically form part as EU Law. We strongly recommend not taking such a step.

### **Responses to the questions**

We understand that Member States shall be granted an option to exempt “*micro*” entities from the requirements of the Fourth Directive. Hence, accounting rules for small entities need no longer be justified as being also appropriate for “micro” entities. Our following statements are based on this assumption.

#### ***Question 1: Do you agree with the approach described above? (Basic principles – qualitative characteristics concentrated in one dedicated section)***

Yes. Such revision would emphasize the importance of these principles and enhance the clarity of the Accounting Directives.

***Question 2: Are there any other principles that should be included in the "General principles" section? Should any of the current principles be clarified?***

Yes. We recommend including at least three further principles in the "General principles" section:

- "Reliability"
- "Cost Efficiency"
- "Economic consequences of legal arrangements have to be presented truly".

Modernisation of the Accounting Directives should be based on the principles of reliability (objective accounting) and cost efficiency. Reliability is a key factor for users of accounts. This, in our opinion, can really be learned by the current financial and economic crises. On the contrary, IFRSs tend to over-emphasise the principle of relevance. Hence, presentation under IFRS often relies on future perspectives and is therefore uncertain and prone to manipulation. Learning from this experience, the Accounting Directives should offer a principle-based approach that is simple, cost-efficient and minimises the risk of manipulation.

We are aware that such a conceptual debate can exceed the given timeframe of the project. Nevertheless, we think that these issues have to be discussed (at least in a future step) to further develop the Accounting Directives into a true alternative to IFRS for European SME.

***Question 3: Do you believe that a restructured Directive following a bottom-up approach would be useful to Member States in creating more simplified and straight-forward rules?***

Yes. This would improve the systematic order and enhance the clarity of the Accounting Directives. In addition, such restructuring would underline the "think small first" approach.

***Question 4: Do you think that current rules for small, medium and large companies are appropriate? Please indicate in broad lines what the minimum requirements for small entities should be according to the bottom-up approach***

In our opinion, some regulations in the Accounting Directives relating to small entities are too burdensome. In particular the data that has to be disclosed in the notes often includes sensible information, e.g. information about transactions with related parties. However, we are aware that this information should be disclosed in the notes in certain cases (e.g. holding companies). It might be recommendable to implement further criteria with regard to disclosure requirements in the notes.

***Question 5: Please provide reasons why Member States did not make full use of the options available in the current Accounting Directives.***

No comment.

***Question 6: What can be done to further simplify the Directives in respect of Member State options?***

The large number of Member State options in the Directives should be reduced. These options form one of the main obstacles on the way to true European coordination of the accounting prin-

ciples. Further, accounting options are generally rejected in the international debate on the development of accounting standards. Having said that, it becomes clear that the number of options needs to be drastically reduced if Europe wants to play an important role in that international debate. See also our remarks to question 31.

***Question 7: Do you think the current criteria (balance sheet total, net turnover, average number of employees) have worked well?***

Yes.

***Question 8: Do you believe that the current thresholds for small, medium and large companies are appropriate?***

No. In our opinion the threshold levels should be increased by 25-30%.

***Question 9: In your opinion, would it be appropriate to reduce the number of company categories in the Directives?***

No. In our opinion the current categories have worked well.

To merge the medium-sized category with the small category (option 1) would be very problematic because that would exempt medium-sized companies from the auditing requirement. Audits are useful to increase the reliability of the given information. Medium-sized companies have reached a size which justifies the auditing requirement.

***Question 10: Do you see any other approaches to reduce the number of company categories?***

No.

***Question 11: Regarding the table above, do you see additional room for simplification, e.g. eliminating the requirement for annual reports for medium-sized enterprises?***

No.

***Question 12: Do you believe that cash-based information should be explicitly required in the Directives?***

Cash-based information is a useful tool for internal management decisions as well as for external analysis. In addition, constant review of the company's cash situation is part of the management duties of care. Therefore, it seems to be appropriate that accounting rules are linked to such figures. Furthermore, such a requirement would adjust the Accounting Directives to the requirements of IFRS (IAS 7) and strongly emphasise the EU's intention to improve the quality of information presented in financial statements.

However, cash-based information should be required only from large companies.

***Question 13: Should the requirement be for a cash-flow statement based on a minimum layout defined by the Directive, e.g. requiring operating, investing, financing cash flows?***

If the Accounting Directives require cash-based information, a minimum layout for the presentation should be defined to achieve comparability. IAS 7 could be used as a starting point.

***Question 14: If you are a preparer, have you provided a cash-flow statement in the past years?***

No comment.

***Question 15: If you are a bank or credit provider, how useful would a cash-flow statement be?***

No comment.

***Question 16: Is there currently a requirement in your jurisdiction to provide a cash-flow statement?***

Yes (for consolidated financial statements according to § 297 I HGB and for separate financial statements of publicly traded companies according to § 264 I HGB).

***Question 17: Do you think that small companies should be exempted from the requirement to publish their accounts?***

Yes. The requirement to publish accounts is traditionally seen as “the cost” of limited liability, i.e. it is a part of creditor protection. However, the legal system of creditor protection consists of several components, of which publicity is not the most important one. Capital maintenance rules, management liability rules and further regulation provide sufficient creditor protection without mandatory publicity. The economic benefit of the publication requirement is therefore marginal. On the other hand, publishing the accounts often leads to competitive disadvantages for small- and medium-sized companies – thereby generating significant (indirect) costs. This is especially true with regard to European companies that have to publish their accounts via Internet (accessible for anyone worldwide!); their foreign competitors can rely on this information without being obliged to publish correspondent information under their national law. In summary, the cost-benefit-ratio of mandatory publication seems to be unbalanced.

An exemption from the requirement to publish accounts for small companies would have another benefit: Such regulation would result in equal treatment of partnerships and incorporated companies in the EU. Partnerships, being the major legal form of organization for small companies in Germany, are generally not required to publish their accounts (save for specific German provisions applicable to partnerships exceeding a certain size). As the major legal form of organization of small companies in other Member States seems to be the incorporated company, a general exemption of small companies from the requirement to publish accounts would result in equal treatment of small companies throughout the EU with regard to publication requirements. As explained above, creditor protection would not be materially affected by such an exemption.

***Question 18: Do you think there should be a Member State option to allow small companies only to prepare abridged accounts only?***

This was a controversial issue in our discussion; the majority view in our group is that abridged accounts provide less useful and understandable information than complete accounts. Furthermore, we doubt that the preparation of abridged accounts would bring a significant simplification for the companies; detailed invoices etc. have to exist for the calculation of combined positions anyway.

***Question 19 – 21***

No comment.

***Question 22: Do You believe that the Directive should provide prescriptive formats (layouts) for the balance sheet and the profit and loss account?***

Yes.

***Question 23: Should the number of available layouts be reduced?***

No.

***Question 24: Would it be sufficient to provide for a minimum structure for each, the balance sheet and the profit account?***

This was a controversial issue in our discussion; the majority view is that a minimum structure would not be sufficient to meet the information needs of users.

***Question 25:***

No comment.

***Question 26: Do you have comments on the idea to require only a limited number of key financial data from small enterprises instead of a fixed balance sheet and profit and loss account structure?***

This was a controversial issue in our discussion; the majority view is as follows: We do not see a significant simplification to be achieved by doing so. In order to calculate key figures, a balance sheet and profit and loss account have to be prepared in the first place anyway.

***Question 27: Do you believe that the separate line items for extraordinary effects should be removed? If you are a preparer, can you please indicate how often you used the separated line item “extraordinary items” during the past years?***

Yes, but information about income and expenses of extraordinary character should be required in the notes.

***Question 28:***

No comment.

***Question 29: Are there any other items that should be disclosed for small entities? Can you please indicate additional disclosure requirements for medium-sized and large entities?***

No. We refer to our answer to question 4. On the contrary, one should consider exempting small companies as far as possible from the requirement to file notes (as is possibly implied in the table under 4.5 of the consultation paper in the line “annual report” and column “small”).

When defining accounting criteria and disclosure requirements, more attention than in the past has to be paid to creating a balanced ratio between information interests of relevant addressees of the accounts and the legitimate non-disclosure interests of the companies (competition protection). Not all information, which may be interesting for the individual addressees of the accounts, has to be given in the public annual report and for this reason to be made accessible to possible competitors. Creditors and shareholders should be considered to be the main addressees of the accounts and disclosures for SME. On the contrary, the need of investors and competitors should not be taken into account when designing rules on accounts and disclosures for SME.

***Question 30:***

No comment.

***Question 31: Can you please indicate whether other disclosure requirements in the Directives are not useful and relevant? Can you also provide indications of costs of their preparation?***

In our opinion the options stipulated in the Directives should be abolished as far as possible or be changed to binding rules. The Accounting Directives should contain as few options as possible both at company and Member State level.

In particular, the following options should be abolished:

- Art. 20 II
- Art. 34 I (a)
- Art. 39 I (c)

The following option rights should be amended into binding rules:

- Art. 35 I (c) (aa) (preference: obligation to write-off a decrease in value of financial assets)
- Art. 37 II (preference: typified depreciation period for an activated goodwill; a period of 5 to 15 years seems to be appropriate).
- Art. 41 (preference: duty to activate, including a so-called disagio)

However, the revised Directives should grant an option to activate internally generated intangible assets (since a duty would result in substantial additional expenses particularly for SME and, factually, such rule would grant an option anyway)

The parts of an activated value above acquisition costs and the full values of internally generated intangible assets or deferred taxes recognised on the assets side should not be distributable to the shareholders.

It should be considered to abolish the position “deferred taxes” for small entities. Apparently it is a widespread practice of banks to set off deferred tax assets against equity because these “assets” are not seen as being reliable. If that is true, at least small companies should be relieved from this burdensome requirement. A cost-benefit analysis does not justify this requirement.

With regard to the consolidated financial statements (7<sup>th</sup> Directive) there should be consistency with IAS 27/SIC 12.

***Question 32: Do you see any potential for modernisation and simplification in the area valuation rules?***

Modernisation and simplification can be achieved if the revised Directive follows

- the historic cost principle,

The historic cost principle should be maintained. The IFRS trend towards fair value should be resisted. Especially for SME historic cost accounting is an important simplification. The so-called fair value is, if at all, appropriate only if realisation on an active market can be guaranteed and fair market prices are available. Fair value accounting is definitely not recommendable in all other cases. Actually, being a conceptually based statement this is true for all companies, including large companies.

- the principles of prudence and realisation according to Art. 31 I (c),
- the principle of typified depreciation of a capitalized goodwill and other intangible assets (an impairment only approach should not be allowed).

***Question 33:***

No comment.

***Question 34: Do you agree with the idea of integrating the 7<sup>th</sup> Directive into the 4<sup>th</sup> Directive?***

We do not see any additional benefit in such integration. On the other hand it would do no harm.

***Question 35:***

No comment.

***Question 36:***

No comment.

***Question 37: Do you have any comments relating to the long-term role of the EU Accounting Directives?***

In our opinion the European Accounting Directives should retain their importance in the future as a framework for accounting within the EU. The EU may not and should not give up completely the responsibility for accounting principles. The principles of accounting are part of pub-



lic law; the setting of these rules has to remain within the responsibility of the legislative bodies of the EU and may not be left completely to private standard setters. The IFRSs show, amongst other things, some undesirable developments regarding non-listed SME. The Accounting Directives should set a counterpoint thereto.

In addition, we refer to our general remarks at the beginning of this report.

If you would like to discuss our comments further, please do not hesitate to contact me.

Yours sincerely,

Prof. Dr. *Joachim Hennrichs*  
(Vorstandsvorsitzender)