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B-1049 Brussels

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Re.: Consultation on the International Financial Reporting Standard for Small and Medium-sized Entities

Dear Mr Hooijer,

The Institut der Wirtschaftsprüfer in Deutschland [Institute of Public Auditors in Germany], the professional organisation representing public auditors in Germany, appreciates the opportunity to comment on the above mentioned Consultation on the International Financial Reporting Standard for Small and Medium-sized Entities.

1. The current legal situation in Europe and desire for harmonisation

As the Consultation points out the development of EU legislation has, so far, not lead to a satisfactory degree of harmonisation in the financial reporting of SMEs within the Member States of the European Union.

The Fourth and Seventh Company Law Directives (the „Accounting Directives“) have, for some three decades now, provided a general framework and a common set of accounting principles for financial reporting in the European Union; the Fourth Directive dealing with the presentation and content of annual financial statements including recognition and measurement principles, their publication and audit for entities with limited liability, and the Seventh Directive coordinating the various national laws relating to consolidated financial statements. In

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addition, the Second Company Law Directive regulates distributions to shareholders and stipulates certain capital maintenance requirements. Whilst the Second Directive provides that the amount of a distribution to shareholders may not exceed the amount of the profits available for distribution, the original calculation of these profits is regulated within the Fourth Directive.

Together, these Directives were originally intended to harmonise accounting legislation within the various Member States. Whilst they govern the current accounting laws of individual Member States, numerous explicit (Member State and entity) options as well as hidden options within the Directives mean that harmonisation of the Member States' national accounting requirements for non-listed companies has not been achieved to a satisfactory degree.

Pursuant to the IAS Regulation listed companies have been required to prepare their consolidated financial statements in accordance with IFRSs endorsed by the EU since 2005. Furthermore, the IAS Regulation allows Member States the option of either extending the IFRS requirement to other entities or allowing other entities to apply IFRSs voluntarily in their annual and/or consolidated financial statements. Thus, the IAS Regulation has created further variety in European financial reporting.

In our view, if a higher degree of harmonisation of the Member States' national financial reporting frameworks is desired to improve the comparability of financial statements at EU level, the introduction of an (Member State or entity) option to adopt the IFRS for SMEs is not an appropriate solution. We suspect that an additional option could even worsen the current situation.

In order to achieve a higher degree of harmonisation in principle, we envisage two alternatives: In the long term, the solution could mean that the Accounting Directives would be abolished and companies would be required to apply IFRS or IFRS for SMEs. However, this solution would have to be supplemented by new requirements governing the determination of distributable profits. As a short or medium term solution we favour a modernisation of the Accounting Directives as explained below.

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2. Appraisal of the IFRS for SMEs

2.1. Need for an adequate analysis of the specific information needs of the users of the financial statements of SMEs

In developing the IFRS for SMEs, the IASB used the fundamental concepts from the Framework and the principles from full IFRSs as a base and considered modifications that – according to the IASB’s own declaration – seem to be appropriate in the light of SME-specific users’ needs and cost-benefit considerations. Therefore, the full IFRSs constituted the starting point for the development of the IFRS for SMEs (BC95). As we had previously commented in a letter to the IASB dated 2 October 2007, in our view, the identification of users of SME financial statements and their information needs should have formed the starting point for the development of the SME-standard. This would also have provided a benchmark for the evaluation of the proposed requirements, including consideration of cost-benefit aspects.

In our view, it would be reasonable to assume that informational requirements and cost-benefit considerations will differ proportionate to the size of an entity, the internationalisation of its business relationships and its (national or international) investor profiles.

We remain concerned that the IASB has failed to address these aspects sufficiently in finalising the IFRS for SMEs.

2.2. Relevance of annual financial statements for other purposes

The additional use the EU and individual Member States have established for a company’s individual annual financial statements is also a significant aspect that needs to be taken into account in any consideration of the potential application of the IFRS for SMEs.

In contrast to consolidated financial statements, the annual financial statements of an individual company not only serve informational purposes, but as mentioned above, form the basis for determining that individual company’s distributable profits under EU legislation. Given this very significant aspect, it is essential that full consideration be given as to whether the application of the SME-standard for annual financial statements would be appropriate to the capital maintenance requirements of the Second Directive. For example, accompanying the existing link between the Second and Fourth Directive by a solvency test

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might be one possibility, provided a practicable and reliable method for carrying out such a solvency test can be found. Alternatively, it might be appropriate to use the annual financial statements prepared in accordance with the IFRS for SMEs as a starting point for further calculation reconciling to the amount available for distribution to shareholders.

In addition, in some Member States there is a close link between taxation and a company's individual annual financial statements. Thus, allowing or requiring a company's annual financial statements to be prepared in accordance with the IFRS for SMEs, i.e., replacing national financial reporting requirements, would, at the present time, cause new complexities or additional burdens for SMEs in these Member States. In this context, the outcome of discussions as to a common consolidated corporate tax base (CCCTB) in Europe will play an important role.

2.3. Improvements already made in developing the Standard

Based on our preliminary assessment, the final SME-standard appears to us to be an improvement compared to the Exposure Draft issued in 2007. We note that various critical issues raised regarding the Exposure Draft have been addressed in developing the final IFRS for SMEs. We would like to comment on these improvements as follows:

- We support the International Accounting Standards Board (IASB)'s decision to move towards a "stand-alone document" by removing all but one of the cross-references to full IFRSs.
- In the final IFRS for SMEs most of those complex options available under full IFRSs that were included in the Exposure Draft, have been withdrawn. This leads, in principle, to a welcome increase in the comparability of financial statements prepared in accordance with the IFRS for SMEs and to a decrease in the complexity of the standard. We particularly support the removal of the revaluation model for property, plant and equipment as well as for intangible assets.
- We welcome the fact that in the final IFRS for SMEs goodwill and other intangible assets, whose useful lives can not be reliably estimated, are subject to amortisation, based on the presumption of a useful life of ten years.

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- The former problem that partnerships, co-operative societies and entities with similar legal status would be unable to present equity on their balance sheets, has been largely removed by introducing the exception analogue to IAS 32, according to which a puttable instrument with specific features is classified as an equity instrument.
- We support the reduction in measurement categories pertaining to financial instruments. However, we note that the IFRS for SMEs continues to allow the application of IAS 39. We view the inclusion of this cross reference somewhat critically, as it precludes the standard from being a stand-alone document and also inhibits comparability.
- The extent of the notes to the financial statements has been further reduced in comparison to both the Exposure Draft and full IFRSs. Whether this reduction will lead to a sufficient relief for preparers and users has yet to be determined by conducting further studies on the application of the SME-standard.
- Overall, in comparison to full IFRSs, the level of complexity has been reduced substantially by the removal of several options, the simplification of recognition and measurement principles and the reduction of notes in particular. In case a specific transaction or event is not addressed in the IFRS for SMEs, an appropriate accounting policy has to be developed using judgement, i.e. consideration of the relevant requirements in full IFRSs is not mandatory now. However, there is a danger that if a particular matter is not covered by the SME-standard, there will be a de facto fall-back to full IFRSs.

3. Proposals as to the way forward

3.1. Analysis of user needs

As noted in section 2.1. above, in our view, the IASB has not analysed the specific information needs of users of SMEs' financial statements sufficiently. The need for this analysis remains, not least to provide a basis for the ongoing modernisation of the Fourth and Seventh Directives. However, modernisation of the Directives, whilst responsive to such needs, also has to take account of related cost-benefit considerations.

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The weighting of users' information needs differs between entities with publicly traded securities and SMEs:

- The (anonymous) investors and creditors of entities with publicly traded securities need information, in particular, relevant to their decisions to buy, hold or sell the equity or debt instruments of the entity. For these ongoing investment decisions information on short-term changes in the financial position, performance and cash flows of the entity is important. At the same time, the financial statements should enable their users to assess the entity's ability to generate future (net) cash flows. For entities with publicly traded securities, the qualitative characteristics 'relevance' and 'reliability' rank equally, as a matter of principle.
- For users of SME-financial statements ongoing investment decisions with regard to the equity and liability instruments issued by the reporting entity are less relevant. Such users attach a higher importance to the long-term stability of an entity's earnings, provided that the entity retains sufficient liquidity, since they mostly enjoy long-term business relationships. Therefore, the presentation of short-term fluctuations in earnings, e.g., because of regular adjustments of the carrying amount of assets to current market prices, is of minor importance, as long as these fluctuations do not influence the sustainable development and liquidity of the entity. With this in mind, financial statement users' interest in forecasts subject to regular update may be limited. Moreover, typical users in an SME-environment are often able to obtain the information they need for their decisions from sources other than financial statements. Therefore, it is less important that the financial statements convey information primarily suitable for forecasts. A further feature common in SMEs is that investors are frequently involved in managing the business. This proximity of ownership and management may cause conflicts of interests and hence risks for the financial statement users. Therefore, from their viewpoint, reliable information for stewardship purposes takes priority over information suitable for forecasts for the purpose of investment decisions.

In respect of cost-benefit considerations, both the limitations in, and the cost of, the accounting expertise available to SMEs have to be taken into account. This will only be possible if an analysis is made as suggested above.

Furthermore, certain users may not perceive a need for internationally comparable information. This is particularly likely to be the case for small or medium-sized entities that are not, or not to any significant extent, active internationally,

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where the benefits to be derived from internationally comparable financial statements based on the IFRS for SMEs will probably not exceed their own costs associated with the preparation of such financial statements.

3.2. Identification of issues relevant to the potential modernisation of the Accounting Directives

In addition to the need for a proper and in-depth analysis of users' information needs, as discussed above, while considering the modernisation of the Directives involving a reduction in options available, a second criterion ought to be the existing international comparability of the financial reporting in individual jurisdictions and the potential to enhance this comparability through amending the Directives. The relative attractiveness of the IFRS for SMEs in Europe will depend upon the extent to which the existing respective national financial reporting frameworks already lead to a sufficient degree of international comparability in financial reporting, or could do so with certain amendments, and, at the same time, whether they provide a less cost-intensive equivalent alternative to the SME-standard.

The benefits of increasing the international comparability of financial statements will generally apply equally to both a company's individual annual financial statements and its consolidated financial statements, where applicable. However, greater international comparability of information will not lead to a benefit if the information does not sufficiently satisfy the information needs of the users.

3.3. Modernisation of the EU Directives including a reduction in options and an increase in the precision of certain requirements

The modernisation of the Directives should be aimed at increasing the degree of harmonisation of Member States' national financial reporting frameworks, so as to enhance the comparability of financial statements prepared in accordance with these national financial reporting frameworks at EU level. In order to attain this, we believe that it is crucial to reduce the number of explicit (Member State and entity) options as well as hidden (implicit) options within the Directives even further. These hidden options – which, admittedly, are unavoidable to a certain extent – allow the reporting entities some discretionary judgement when applying the requirements of the Directives concerning recognition and measurement.

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In modernising the Directives, each option within the Directives should be reviewed to establish whether the application of one of the currently available alternatives would lead to financial statements that meet both user needs and are acceptable from a cost-benefit perspective. Where this is the case, the option should be withdrawn and the relevant alternative made mandatory. In those cases, where, based on these criteria, there are two or more alternatives, the one that complies with the SME-standard should become mandatory. This would lead to a further (partial) convergence of the Directives with the IFRS for SMEs. We recognise that certain deviations from the IFRS for SMEs may have to be retained, in particular in respect of capital maintenance requirements relating to a company's individual annual financial statements. The development of the Directives should be such as to retain their character as a cost-efficient accounting framework, providing a less cost-intensive equivalent alternative to the IFRS for SMEs.

In addition to reducing the number of options, we would like to suggest additional specifications in some parts of the Directives:

- Certain recognition and measurement requirements such as those relating, for example, to provisions, deferred taxes and foreign currency translation should be substantiated. Such requirements, while remaining in line with the principles-based character of the Directives, should, at the same time, be made more precise in order to foster comparable national financial reporting frameworks in the Member States. Using the example of provisions, the Fourth Directive only requires that the measurement of provisions for liabilities and charges may not exceed the sums which are necessary (Art. 42). In our opinion, the Fourth Directive should include a more precise requirement stipulating that provisions have to be measured at the present value of the expected cash outflows using a market-derived discount rate.
- Revised versions of the Fourth and Seventh Directives should retain the formats (layouts) prescribed for the balance sheet and the profit and loss account, which are, in our view, one important advantage European accounting law has in comparison to the IFRS for SMEs. The more detailed prescriptive formats for the balance sheet and the profit and loss account enhance the scope for comparability and therefore provide more useful information to stakeholders.

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- The Directives should be amended to explicitly require cash flow statements, at least for large entities. In our opinion, such a requirement for a cashflow statement should be based on a minimum layout defined by the Directives, e.g. requiring operating, investing and financing cash flows.
- We recommend amending the Seventh Directive such that so-called special purpose entities (SPEs) have to be consolidated under certain conditions and cannot remain off-balance sheet.
- Finally, we would support the inclusion of a comprehensive substance over form-principle – corresponding to the one implemented in section 2 (Concepts and Pervasive Principles) of the IFRS for SMEs – within the "General Principles".

As previously outlined in our responses submitted on 30 April 2009 to the European Commission's Consultation Paper on Review of the Accounting Directives of 26 February 2009, the possible revision of the Directives should, ideally, implement a bottom-up approach. This would encourage the Member States to restructure their national accounting legislation which, in turn, may contribute to a higher degree of user-friendliness and a better understandability of the national regulations. These would first be tailored to small companies, and additional requirements to address those entities falling within the definitions of larger companies would be added. However, from a cost-benefit-perspective a restructuring of the Directives towards a bottom-up approach could only be justified, if this change were accompanied by substantive changes to the recognition, measurement, presentation or disclosure requirements. If the Directives were to be restructured towards a bottom-up approach, the basic principles and the recognition and measurement requirements would have to be applicable to all entities. More complex requirements regarding presentation, disclosures and publication can be justified for medium-sized and large entities. In this context, we recommend considering exempting micro entities – as defined by the European Commission – from the obligation to prepare notes to their financial statements and to publish their financial statements.

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3.4. Application of the SME-standard in line with the EU Directives?

Should the proposed modernisation of the Directives not be feasible for political reasons, in our opinion, it will be necessary to analyse in detail the differences between the extant Fourth and Seventh Directives and the SME-standard.

Were such analysis to reveal that there are no appreciable conflicts between the Directives and the IFRS for SMEs, we believe it would be appropriate for each Member State to determine whether it would allow or require IFRS for SMEs to be applied in the preparation of financial statements.

However, our preliminary analysis reveals that differences exist between the provisions of the Accounting Directives and the SME-standard which fall into two categories; those that can be “eradicated“ by the application of one particular option available within either the Directives or the SME-standard, and “unavoidable” differences. Examples of such conflicts include the following:

- There is an unavoidable conflict concerning the presentation of "extraordinary items". Under the IFRS for SMEs, an entity shall not present or describe any items of income and expense as "extraordinary items" in the statement of comprehensive income or in the notes (para. 5.10). The Fourth Directive, however, stipulates: income and charges that arise otherwise than in the course of the company's ordinary activities must be shown under 'Extraordinary income and extraordinary charges' (4th Directive, Art. 29). In our opinion, the separate presentation and disclosure of extraordinary effects is useful for users of financial statements, particularly for analysts, and therefore should be required. However, it is necessary to ensure that income or expenses are only reported as extraordinary items in specific and exceptional cases and also that these items are explained in the notes.
- Another unavoidable conflict concerns the measurement base for investments in associates, if a published price quotation exists for the associate. In principle, the IFRS for SMEs allows three alternative methods (cost model, equity method or fair value through profit or loss, para. 14.4). However, an investor shall measure investments in associates for which there is a published price quotation using the fair value model (para. 14.7, 14.9-14.10). According to the Seventh Directive, investments in associates shall be – with some specific exceptions – ac-

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counted for in the consolidated financial statements using the equity method (7th Directive, Art. 33).

- Furthermore, the IFRS for SMEs requires that an entity shall recognise any negative goodwill (remaining after a reassessment, if applicable), immediately in profit or loss (para. 19.24 (b)). However, according to the Seventh Directive, negative goodwill can be recognised immediately in profit or loss only in so far as it corresponds to a realised gain or where the difference corresponds to the expectation at the date of acquisition of unfavourable future results in that undertaking, or to the expectation of costs which that undertaking would incur, in so far as such an expectation materializes (7th Directive, Art. 31).

Given the incidence of conflicts between the Directives and the IFRS for SMEs that cannot be eradicated by the selection of one or more alternatives within either the Directives or the IFRS for SMEs, adaptation of the Directives to be in line with the SME-standard would be acceptable if the particular requirements of the IFRS for SMEs in question are, mainly, capable of giving the true and fair view required by the Fourth and Seventh Directive, and complying with user needs. In this context, it needs to be borne in mind that whilst both the annual financial statements and the consolidated accounts have an informational function, the annual financial statements of the individual company also have an additional legal function (capital maintenance).

We would be pleased to answer any questions that you may have or discuss any aspect of this letter.

Yours sincerely

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