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Alignment of accounting for SMEs and handicraft enterprises

Criteria, scope and limits for their regulation in the European context

Ludwig-Fröhler-Institut

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Edited by Toni Hinterdobler and Hans-Ulrich Küpper

Foreword

The national, European and international accounting regulations are changing. The German legislator has modernised the regulations of the German Commercial Code – the Handelsgesetzbuch (HGB). During the final consultations on the draft law for the BilMoG, however, the changes originally planned in line with the International Financial Reporting Standards (IFRS) were not adopted in the HGB. The European Commission is working on a project of deregulation, based on directives that have applied since the 1980s. On the other hand, the G-20 summit in April unanimously decided to stick to IFRS, but also to make them resistant to crisis. Finally, the IASB first put forward the draft of a standard for small and medium-sized enterprises for discussion and has now published its final version.

The current controversial question for the legislator in Europe is whether it wants to adapt Continental European law beyond regulations for group accounting to international regulations, develop the European regulations so that they are future-proof, or even implement new European regulations. On top of this, two systems are in conflict here: the proven formal Continental European lawmaking via European directives and national laws and the Anglo-American practice of determining standards by boards that are occupied by the market participants.

The SMEs and handicraft enterprises are also affected by this development. For new accounting regulations affect them either directly, or at least indirectly by the reporting transparency often demanded by the market.

This work intends to make a contribution towards showing the impact of regulations in accordance with IFRS on SMEs and handicraft enterprises. It is not restricted to the economic consequences, but discusses also the legal obstacles to such a regulation in constitutional and European law. In so doing, it wants to help economic organisations and policy decision-makers to determine their position on this important issue for SMEs. Its most important results are summarised in core propositions.

Munich, October 2009

Toni Hinterdobler Prof. Dr. Dr. h.c. Hans-Ulrich Küpper

Contents

Foreword IV

Contents VI

List of abbreviations VIII

Core Propositions 1

Part I

SMEs and handicraft enterprises as accounting objects 7

Andreas Conrad Schempp

Part II

Accounting in accordance with IFRS and assessment, in view of the requirements for SMEs and handicraft enterprises 33

Thomas Schildbach

Part III

Legal framework for accounting regulations detrimental for non-capital-market-oriented SMEs and handicraft enterprises 79

Joachim Kormann

Part IV

Economic problems of applying IFRS to SMEs and handicraft enterprises 107

Klaus Dittmar Haase

References 142

List of abbreviations

AG	Aktiengesellschaft (Public Limited Company)
AktG	Aktiengesetz (German Stock Corporation Act)
AO	Abgabenordnung (German Tax Code)
Art.	Article
BaFin	Bundesanstalt für Finanzdienstleistungsaufsicht (Federal Financial Supervisory Authority)
BDI	Bundesverband der Deutschen Industrie (Federation of German Industries)
BGB	Bürgerliches Gesetzbuch (German Civil Code)
BGBl.	Bundesgesetzblatt (Federal Law Gazette)
BilMoG	Bilanzrechtsmodernisierungsgesetz (Act to Modernise Accounting Law)
BilReG	Bilanzrechtsreformgesetz (Act to Reform Accounting Law)
BiRiLiG	Bilanzrichtliniengesetz (Accounting Directives Act)
BT	Bundestag (German Parliament)
BVerfG	Bundesverfassungsgericht (German Federal Constitutional Court)
BVerfGE	Decisions of the Bundesverfassungsgericht, published by the members of the Bundesverfassungsgericht
CFR	Charter of Fundamental Rights of the European Union
DIHK	Deutscher Industrie- und Handelskammertag (German Chambers of Industry and Commerce)
DPR	Deutsche Prüfstelle für Rechnungslegung (German Financial Reporting Enforcement Panel)
DRSC	Deutsches Rechnungslegungs Standards Committee (German Accounting Standards Committee)
EC	European Community/Communities
ECJ	European Court of Justice
ECJD	Collection of Decisions of the European Court of Justice
ECT	European Community Treaty
ED	Exposure Draft
EP	European Parliament
EStG	Einkommensteuergesetz (German Income Tax Law)

EU	European Union
FASB	Financial Accounting Standards Board
FAZ	Frankfurter Allgemeine Zeitung (newspaper)
GbR	Gesellschaft bürgerlichen Rechts (Partnership under the German Civil Code)
GG	Grundgesetz für die Bundesrepublik Deutschland (Constitution of the Federal Republic of Germany)
GmbH	Gesellschaft mit beschränkter Haftung (Limited Liability Company)
GoB	Grundsätze ordnungsmäßiger Buchführung (Principles of Proper Accounting)
HGB	Handelsgesetzbuch (German Commercial Code)
HGB o.v.	Handelsgesetzbuch (German Commercial Code), old version
HGB n.v.	Handelsgesetzbuch (German Commercial Code), new version
HwO	Handwerksordnung (Crafts Code)
IAS	International Accounting Standards
IASB	International Accounting Standards Board
IASC	International Accounting Standards Committee
IASCF	International Accounting Standards Committee Foundation
IDW	Institut der Wirtschaftsprüfer in Deutschland e.V. (Institute of German Auditors)
ifh	Economic Institute for Small Business at the University of Göttingen
IfM	Institut für Mittelstandsforschung Bonn (Institute for SME Research Bonn)
IFRS	International Financial Reporting Standards
IFRS for SMEs	International Financial Reporting Standards for Small and Medium-sized Entities
IHK	Industrie- und Handelskammer (Chamber of Industry and Commerce)
IOSCO	International Organization of Securities Commissions
KG	Kommanditgesellschaft (Limited Partnership)
KGaA	Kommanditgesellschaft auf Aktien (Partnership Partly Limited by Shares)
LFI	Ludwig-Fröhler-Institut für Handwerkswissenschaften (Ludwig Fröhler Institute for Handicrafts)

Ltd	Private Company Limited by Shares
MoMiG	Act to Modernise the GmbH Law and to Combat Abuse
NYSE	New York Stock Exchange
oHG	Offene Handelsgesellschaft (General Partnership)
P&L	Profit and Loss Statement
para.	Paragraph
PartGG	Partnerschaftsgesellschaftsgesetz (Partnership Act)
PwC	PricewaterhouseCoopers
PublG	Publizitätsgesetz (Disclosure Act)
SEC	Securities and Exchange Commission
SFAS	Statement of Financial Accounting Standards
SME	Small and Medium-sized Entities
STA	Securities Trading Act
StGEG	Draft of a law for determining taxable profit
TEU	Treaty on European Union (Maastricht Treaty)
UG	Unternehmergesellschaft (Entrepreneurial Company with limited liability)
US-GAAP	United States Generally Accepted Accounting Principles
WpHG	Wertpapierhandelsgesetz (Securities Trade Act)
ZDH	Zentralverband des Deutschen Handwerks (German Confederation of Skilled Crafts)

Core Propositions

Part I: SMEs and handicraft enterprises as accounting objects

Proposition 1.1:

Handicraft enterprises, which are an important branch of SMEs, face **specific difficulties in the area of accounting**. In Germany they use in principle the rules of the German Commercial Code (HGB) as a basis for standard balance sheets, which meet both commercial and tax regulations.

Proposition 1.2:

The BilMoG represents a comprehensive **reform of the HGB in the right direction**. Despite some shortcomings, in the view of small and medium-sized enterprises it is welcome because of its deregulated measures; in particular, the forgoing of the obligation to keep books for the smallest enterprises.

Proposition 1.3:

The size of the enterprise, the legal form and in particular the distribution of power and ownership in SMEs and handicraft enterprises represent **three significant features** which are relevant to the quality of an accounting system. The **size of the enterprise** is of great importance for the form of the annual financial statements of SMEs and handicraft enterprises, because these statements tie in with a range of accounting characteristics such as the widespread preparation of the annual financial statements by tax consultants. The basic **legal forms** in the SME and handicraft sector are, first, sole proprietorship and second, the GmbH (limited liability company), which is by far the most common form. Finally, the **power relationships** in handicraft companies as in SMEs are often shaped by the central position of the entrepreneur. Most enterprises are **family enterprises**.

Part II: Accounting in accordance with IFRS and assessment in view of the requirements for SMEs and handicraft enterprises

Proposition 2.1:

IFRS aim solely to meet the **information requirements of anonymous financiers** in international capital markets with assets being reported by element. This requires an ongoing time assessment of the assets with major drawbacks. Profit is greatly influenced by changes in value that are driven by chance, which might not only completely consume the informative operational core profit, but also intensify cyclical swings. In particular, the **calculation of current fair values** creates **great problems**. As the financial crisis of 2008 has shown, they can only be continuously monitored in a small number of markets and even then they are not free from the risk of being seriously distorted. The market price estimates that are normally required are not linked

to operational performance. This creates **great scope for discretion**, but also for massive manipulation!

Proposition 2.2:

The **alignment of the IFRS** solely towards the information requirements of anonymous financiers in international capital markets **contradicts in every respect the accounting requirements for SMEs and handicraft enterprises**. Relying on informative results to control the enterprises and on different combinations of disclosure and secrecy, IFRS are no longer suitable for providing them with information. The for them much more important tasks of calculating profit distribution for owners and income taxes can, according to the view which is widespread in literature, in no way be met by IFRS. The views of equity of **IAS 32 threaten their existence** and show successes in business policy as losses. Independent empirical studies emphatically show that SMEs in Germany recognise the lack of advantages and the threat of the disadvantages of IFRS, as well as the almost always much **higher costs**, compared to the benefits of IFRS.

Proposition 2.3:

IFRS for SMEs were created because 'full IFRS' are not suitable for SMEs and handicraft enterprises. This shortcoming can in no way be resolved, however, only by reducing the rules to a few core statements while fully maintaining the concept of 'full IFRS'. In this manner, **IFRS are not fully adapted to the different needs of the SMEs**. The true scope for the regulations only appears to be reduced, for only the 'full IFRS' make the content and spirit of the concept, which is only outlined for SMEs, in the IFRS understandable; '**mandatory fallback**' arises from the decision to hold on to the very specific concept of 'full IFRS'. The improvements promised by the IASB are mostly non-existent or disadvantage the SMEs: they are refused options, disadvantageous reports become mandatory or rules with shortcomings are specified. Because the notes in financial statements provide a much deeper insight for SMEs, they will, if anything, be more heavily – rather than less – burdened by the only moderate reduction in 'disclosures'.

Part III: Legal framework for accounting regulations detrimental to non-capital-market-oriented SMEs and handicraft enterprises

Proposition 3.1:

International accounting standards need to be implemented by the national legislator in German law or by the supranational standard-setter in directly applicable, mandatory EU community law.

Proposition 3.2:

The rules of **IAS/IFRS and IFRS for SMEs are not suitable** as a legally binding basis for the accounting of non-capital-market-oriented SMEs and are not reasonable for them.

Proposition 3.3:

The **mandatory provision of IAS/IFRS or IFRS for SMEs** by the German legislator would therefore **not be consistent** with Art. 12 para. 1 of the German Constitution (GG).

Proposition 3.4:

The **mandatory provision of IAS/IFRS or IFRS for SMEs** by the German legislator would also be **in breach of** Art. 3 para. 1 of the German Constitution (GG).

Proposition 3.5:

Applicable community law **neither obligates non-capital-market-oriented SMEs** directly to apply **nor member states** to implement IAS/IFRS or IFRS for SMEs.

Proposition 3.6:

Appropriate mandatory community law would be **inconsistent with primary community law** (the principle of proportionality, the principle of democracy, entrepreneurial freedom and the principle of equality).

Proposition 3.7:

Efforts at international, community or national level to increasingly implement international systems with comparable goals to IAS/IFRS (mandatory or optional) for non-capital-market-oriented SMEs are also **mistaken in relation to legal policy**. Rather, the **deregulation and simplification** of applicable accounting regulations remains **urgent for SMEs**.

Part IV: Economic problems of applying IFRS to SMEs and handicraft enterprises

Proposition 4.1:

The financial crisis of 2008 has made the **shortcomings in the concept of IFRS** transparent. The easing of ‘fair value assessment’ reduced accounting-related risks in the financial markets, however, at the same time it created serious, new kinds of **uncertainties** for the medium- and longer-term outlook of balance sheets, which might accelerate the turning away from IFRS.

Proposition 4.2:

The diverging legal systems (case law versus code law) rule out a compromise, also in respect of internationally binding accounting principles. As a result there is the **risk** that the in many areas **unsystematic and contradictory accounting practice according to IAS/IFRS** (with the even less systematic US-GAAP in the background) will become the **sole standard** for capital-market-oriented enterprises and also binding for commerclal and tax balance sheets for medium-sized enterprises in continental Europe.

Proposition 4.3:

The privatisation of the development and setting of legal standards, which is widespread in the Anglo-Saxon legal system, means that accountable enterprises can play an important part in the development of accounting standards. Therefore, a legislation that is **independent from vested interests and geared to the common good is threatened** by democratically legitimate parliaments; at the same time, the efficiency of standards for accounting and profit calculation, which should serve the interest of users of balance sheets and the general public, is diminished. For the purposes of taxing profit, regulations for calculating profit that are oriented to IFRS are therefore rejected.

Proposition 4.4:

Accounting standards that are independent of size and (largely) independent of legal form conflict with the requirements of proportionality and equality as they abstract from how the accountable enterprises are affected differently; the IFRS for SMEs are also in breach of this principle, because their rationality and understanding are often only developed by studying the extensive 'full IAS/IFRS', and the IFRS for SMEs also conflict with the established German regulations for determining the taxable profit of smaller enterprises, such as the determining of profit and the net income method. **Accounting regulations** for SMEs and handicraft enterprises should be **systematically geared to the peculiarities of smaller enterprises** in the sense of a '**bottom-up approach'** and contain appropriate additional regulations for larger enterprises.

Proposition 4.5:

Accounting in accordance with IFRS primarily serves the information requirements of anonymous financiers (shareholders and bondholders) on the future earnings of the enterprise borrowing the capital. Commercial and tax balance sheets, on the other hand, inform about the results of completed periods in the sense of reporting objective period-end dates. A **standard balance sheet**, which SMEs can currently prepare in the form of a tax balance sheet, would be made **much more difficult based on the IFRS for SMEs**.

Proposition 4.6:

The **accounting goal of a capital holding** in the enterprise is achieved in commercial and tax law by limiting the reporting of profits to profits which arise in accordance with the strict realisation principle from transactions that have been completed. These profits form the assessment basis for dividends, bonuses and taxes. This elementary goal is **missing completely in the IFRS**. As is also proven in Proposition 4.7, the determining of **profit under IFRS** suffers from a **tendency to report an inflated profit**, which is of particular importance and regularly neglected in the literature; this effect contributes to the depletion of enterprises which prepare balance sheets in accordance with IFRS. The regulations of the **IFRS therefore constantly require an additional HGB balance sheet** to counter the risk of the assets being depleted by dividends being distributed, bonuses awarded and tax being paid for profits that have not been realised. For non-capital-market enterprises the

HGB balance sheet completely meets requirements and at the same time provides more appropriate information.

Proposition 4.7:

IFRS accounting contradicts established German commercial and tax law because it does **not ensure** that the **comprehensive income of the enterprise is reported appropriately**. Therefore, it does not comply with the constitution's requirement for taxation equality (art. 3 of the German Constitution [GG]) and is also in breach of § 4 para. 1 of the German Income Tax Law (EStG).

Proposition 4.8:

The goal of IFRS accounting emphasises in particular the advantages of decision and expected values, which are different to the traditional evaluation at historical acquisition and production costs. In so doing, though, **IFRS accounting** provides varied **additional scope for evaluations with subjective and speculative elements**, whose impact can be offset with actual performance in later periods in a way which does not affect profit or loss.

Part I

SMEs and handicraft enterprises as accounting objects

Andreas Conrad Schempp

Outline

1. The idea behind this study

2. SMEs and handicraft enterprises in Germany

3. Handicraft enterprises: different accounting regulations, different intentions and thus different problems

3.1. Accounting according to the HGB
3.2. The 2009 reform of the HGB: the BilMoG
3.3. Accounting according to the IFRS

4. Characteristics of SMEs and handicraft enterprises as determinants of financial reporting

4.1. A reference framework
4.2. Size as a fundamental parameter of financial reporting
4.3. Analysis of the legal form of SMEs as a parameter of financial reporting
4.4. SMEs: structure of ownership and distribution of power

1. The idea behind this study

As early as 2005 the International Accounting Standards Board (IASB) discussed the issue of a possible need for an accounting standard designed especially for non-capital-market-oriented [1] enterprises. [2] This project was pursued by the IASB and the preliminary stage was concluded in July 2009.[3] This standard targets non-capital-market-oriented ‘Small and Medium-sized Entities’ (SMEs). Which companies belong to this target group is to be determined by user-countries.[4]

From the outset, the potential adoption of such an SME standard by the European Union (EU), and hence an improved acceptance and propagation of this standard, was pivotal in the development of the ‘International Financial Reporting Standards for Small and Medium-sized Entities’ (IFRS for SMEs). In spring 2008, however, the European Parliament (EP) disapproved a possible acceptance of the IFRS for SMEs as a standard for European non-capital-market-oriented enterprises.[5] This decision slowed down the process of further developing the standard; however, the IASB continued to pursue the project.[6] Thus, although the creation of a consistent standard for all EU members has been dismissed, the question of the direction in which the accounting regulations for German and European SMEs will develop remains.

More than a quarter of German SMEs are enterprises of the handicraft sector,[7] and this question is as important for this subgroup as for all SMEs. Although the handicraft sector plays an important part in Germany’s economy, the intersections between financial reporting and handicraft enterprises are rarely the subject of academic research. [8] Before going on to define handicraft enterprises in particular and SMEs in general as accounting objects we shall look briefly at why the former, as a subgroup, represent a cross-section of the latter.

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1 ‘Non-capital-market-oriented’ means that the company has not issued any securities in an organised capital market. In Germany this term has been defined in § 2 para. 1 s.1 and para. 3 WpHG.

2 It was originally planned to approve such a standard in 2007 (cf. Knorr, 2005, p. 63 f).

3 Cf. International Accounting Standards Board, 2009a.

4 Cf. Knorr, 2005, p. 63.

5 Cf. Radwan, 2008.

6 Cf. International Accounting Standards Board, 2009d.

7 In 2007 there were 3.58m SMEs in Germany (99.7% of all businesses), of which 967,201 were handicraft enterprises; cf. Institut für Mittelstandsforschung Bonn, 2009.

8 There are numerous projects in the handicraft sector which show this; see, e.g. one of the projects in strategy development launched by the Bavarian Ministry for Economics (Bayerisches Staatsministerium für Wirtschaft, Infrastruktur, Verkehr und Technologie, 2008).

2. SMEs and handicraft enterprises in Germany

Proposition 1.1:

Handicraft enterprises, which are an important branch of SMEs, face specific difficulties in the area of accounting. In Germany they use in principle the rules of the German Commercial Code (HGB) as a basis for standard balance sheets, which meet both commercial and tax regulations.

Reason:

For reasons of simplification, handicraft enterprises in Germany are mostly included in the broader category of 'SMEs'. Often this simplification may be reasonably acceptable; the question, however, is to which extent it is justified.

Generally, the term 'medium-sized business' describes a company that has relatively few employees, all of whom are personally known to the company's owner. This highlights a distinct difference between businesses of this size and larger enterprises of the industrial sector.[9] In the relevant literature, the category of **SMEs** comprises medium-sized businesses, together with small and very small businesses.[10] In other words, the term 'SME' refers to every company which is 'not sizeable', so to speak. The more general definition of SMEs is based on qualitative rather than quantitative criteria. An example of such qualitative criteria is that SMEs tend to have a centralised management; in other words, that the company-owner plays a decisive role.[11] Legislators and researchers usually define SMEs on the basis of quantitative criteria.[12] We shall now look briefly at both methods of defining SMEs.

Quantitative definitions of SMEs, of which there are several, mostly take into account the number of employees in a company or the amount of annual

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9 Empirical research furthermore suggests different value orientations in medium-sized businesses and industrial companies; cf. Küpper, 2005, p. 51.

10 Cf. Thürbach/Menzenwerth, 1975, p. 5.

11 Cf. Thürbach/Menzenwerth, 1975, p. 5, or Daschmann, 1994, p. 56 ff.

12 See also Chapter 3.

sales.[13] As can be seen in Table 1, the German Federal Bureau of Statistics (Statistisches Bundesamt) uses these two criteria to classify SMEs in three groups: micro-, small- and medium-sized businesses.

Category	Employees		Annual sales
Micro	**up to 9**	**and**	**up to €2m**
Small-sized	**up to 49**	**and**	**up to €10m**
Medium-sized	**up to 249**	**and**	**up to €50m**

Table 1: Classification of SMEs according to the Statistisches Bundesamt (German Federal Bureau of Statistics)[14]

The definition on which this classification is based is quite similar to the one adopted by the European Commission[15] and includes all companies in the group of SMEs that have fewer than 250 employees as well as less than €50m in annual sales. According to this definition, fewer businesses qualify as SMEs than, e.g. according to that adopted by the Institute for SME Research in Bonn (IfM). The IfM's classification allows for a greater number of employees: an SME is a company that has fewer than 500 employees as well as less than €50m in annual sales.[16]

The European Commission's definition of SMEs is similar though expanded by the additional criterion of the company's balance sheet total: a 'micro' enterprise has up to €2m in annual sales *or* up to €2m as a balance sheet total, while a 'small' enterprise has up to €10m in each case. For 'medium-sized' enterprises the limits are €50m in annual sales *or* €43m in the balance sheet total.[17]

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[13] The European Commission, as well as several institutions and organisations in Germany (e.g. the Federal Bureau of statistics, the Institut für Mittelstandsforschung (Institute for SME Research) in Bonn [IfM], the German Commercial Code [HGB], or the Disclosure Act [PublG]) use a number of similar definitions.

[14] Cf. Statistisches Bundesamt, 2008, p. 491.

[15] This means specifically Recommendation 2003/361/EG of the European Commission of 6 May 2003; cf. Statistisches Bundesamt, 2008, p. 491.

[16] Cf. the definition of an SME on the IfM-website: http://ifm-bonn.de/index.php?id=89 (accessed November 2008). Here, the criteria for SMEs are much more restrictive (e.g. only twenty employees; cf. Pleitner, 1984, p. 145).

[17] Cf. European Community, 2006, p. 14.

If we apply the Statistisches Bundesamt's classification, we see that in 2005 only 9,345 of a total of 3.5m companies in Germany had €50m or more in sales. Also, in the same year only 10,862 had 250 employees or more.[18] According to the Statistisches Bundesamt, the percentage of companies that can be classified as SMEs is as high as 99.3%, therefore, the fraction of big businesses is 0.7%. This illustrates dramatically the outstanding importance of SMEs for German economy.

In the HGB, § 267 specifies implicitly another quantitative criterion of SMEs, in that it defines three different classes of incorporated companies. The legislator's purpose is to facilitate financial reporting (i.e. balance sheet and income statement) dependent on the company's size.[19] However, through this classification system we can identify another set of criteria for defining SMEs.[20]

Quantitative definitions such as the ones mentioned above entail two major problems. First, the exact numbers tend to suggest discriminatory power. It is, however, hard to justify that a company with 250 employees and exactly €50m in sales should count as a large business, whereas another company with the same sales figure but only one employee less should count as an SME. Furthermore, it is hard to compare companies from different regions (or companies with other distinct differences): a business in the countryside – e.g. the Bayrischer Wald – may well be considered large for local standards but comparatively small (i.e. count as an SME) for national standards.

Qualitative definitions of SMEs have neither of these disadvantages. Using qualitative criteria to define an SME seems to be much less common in the field of accounting.[21] The IASB, however, attempts to apply such criteria: the new standard IFRS for SMEs[22] is addressed to companies that meet qualitative definition requirements.[23] According to the IASB, SMEs must fulfil two criteria.[24] First, they cannot have public accountability. This excludes from

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[18] All figures, including those for 'Freiberufler' (self-employed freelancers), are drawn from the German register of companies (Statistisches Bundesamt, 2008, p. 493 f).

[19] Regarding balance sheets, see § 274a HGB; regarding income statements, see § 276 HGB. Further facilitations dependent of the company's size can be found in the HGB.

[20] The German legislator offers a quite different concept of SMEs when not referring to incorporated companies. This can be seen in the regulations of the Disclosure Act (PublG); cf. § 1 para.1 PublG.

[21] Concise dictionaries, such as the *Handwörterbuch des Rechnungswesens* usually define SMEs solely by size; cf. Kahle in *Handwörterbuch des Rechnungswesens,* 1993, col. 1406.

[22] The standard itself as well as the exposure drafts; cf. International Accounting Standards Committee Foundation, 2007, p. 4.

[23] In an early discussion paper 'Preliminary Views on Accounting Standards for Small and Medium-sized Entities' (June 2004) the IASB writes: 'The Board should describe the characteristics of the entities for which IASB Standards for SMEs are intended. Those characteristics should not prescribe quantitative "size tests".' International Accounting Standards Board, 2004, Preliminary View 3.1.

[24] Cf. International Accounting Standards Committee Foundation, 2007, part 1, p. 14.

SMEs mainly two groups of firms: companies that have debt or equity instruments traded in a public market (as well as companies planning to do so), and companies whose primary business is the holding of assets in a fiduciary capacity for outsiders, e.g. banks or insurance companies. Second, they must publish financial statements of general purpose for external users.

Such a definition raises some obvious problems with relation to interpretation and specification. For example, the following companies are not SMEs: a business that has a single equity holder who demands a financial statement according to the regulations of the IFRS, a business that has public duties of supply, or a business of overriding national importance.[25] Where SMEs that have two owners are concerned, one may wonder why it is not allowed for one of the owners to demand an IFRS financial statement. It remains unclear why in that case such a company would have to use the accounting regulations that apply to large firms (the 'full IFRS'). Thus, the qualitative specification of an SME given by the IASB might turn out to be rather inappropriate. In any case, the target group of companies is insufficiently described.[26] Of course, it would be possible to distinguish SMEs on the basis of other qualitative criteria, such as the coincidence of ownership and management, management style, organisational structure and the like.[27] Nevertheless, one major problem persists: the practical implementation of qualitative criteria seems to be much more difficult than that of quantitative ones. A combination of the two alternatives appears to be a reasonable solution.

A **handicraft enterprise** in Germany has on average about five employees and around €500,000 in annual sales, i.e. most of such companies are of relatively small size.[28] Nearly all handicraft enterprises in Germany are SMEs in terms of the definition adopted by the Statistisches Bundesamt.

Most handicraft enterprises also meet certain qualitative requirements for SMEs: nearly all represent an SME in the sense of the IASB definition. Few companies are subject to public accountability. Equity is held by owners with full liability to a similar degree as in the case of all non-handicraft-SMEs.[29] Furthermore, empirical research has provided evidence that handicraft enterprises hardly ever take part in an organised public capital market.[30] Also,

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[25] Cf. Lüdenbach/Hoffmann, 2004, p. 599 f.

[26] Cf. Ballwieser, 2006, p. 9.

[27] Many of these criteria could be rather easily quantified; cf. Pfohl, 2006, p. 4 f.

[28] See the figures available on the website of the Zentralverband des Deutschen Handwerks (ZDH) at http://www.zdh.de/daten-und-fakten/beschaeftigte-umsaetze.html (accessed in May 2009); cf. also Mugler, 2006, p. 4027.

[29] The distribution of different legal forms in the handicraft sector is very similar to that in the general SME sector; cf. Chapter 3.3.

[30] Cf. Burger, 2007, p. 77.

these companies never hold assets in a fiduciary capacity as one of their primary businesses.[31] Finally, there is hardly a handicraft enterprise that has public duties of supply or is of overwhelming national importance.[32]

In the majority of handicraft enterprises there is no owner who explicitly wishes a disclosure according to IFRS. This is because there is no apparent usefulness of an IFRS financial statement for such owners.[33] One reason for this is the absence of any international orientation[34] of many companies; another reason is that most loans are granted by local and regional banks (such as 'Sparkassen', 'Volksbanken', and 'Raiffeisenbanken').[35]

In summary this study's object of investigation – the handicraft enterprises – can be understood as a cross-section of German SMEs, both from a quantitative as well as a qualitative perspective. In the following chapters the terms 'handicraft enterprise' and 'SME' will be used as synonyms: both terms will refer to companies that are either 'micro-', 'small-' or 'medium-sized', according to the definition of the Statistisches Bundesamt, and meet the relevant qualitative criteria.

Before analysing the major characteristics of SMEs with regard to accounting, the next chapter will present an overview of the relevant accounting regulations, concentrating on the extent to which these regulations are suitable for SMEs and the handicraft sector. It will also look briefly at international regulations, which will be extensively analysed in the rest of the book.

3. Handicraft enterprises: different accounting regulations, different intentions and thus different problems

Proposition 1.2:

The BilMoG represents a comprehensive reform of the HGB in the right direction. Despite some shortcomings, in the view of small and medium-sized enterprises it is welcome because of its deregulated measures; in particular, the forgoing of the obligation to keep books for the smallest enterprises.

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[31] The German Crafts Code – the 'Handwerksordnung' (HwO) – lists all those branches that are legally defined as 'Handwerke', i.e. 'handicraft enterprises'.

[32] There are some exceptions – e.g. in the building and construction sector – that have some influence on the national economy. In 2002, for example, the construction firm Philipp Holzmann AG had to be rescued by the Federal Government; cf. *FAZ*, 2002. However, these cases are rare (especially since Philipp Holzmann was a stock company).

[33] Cf. Chapter 2.3.

[34] An example of the handicraft sector in Saxony is presented in Glasl, 2002, p. 8 ff.

[35] Cf. Burger, 2007, p. 28.

Reason:

3.1. Accounting according to the HGB

The German Commercial Code – the 'Handelsgesetzbuch' (HGB) – focuses on **creditor protection**: because of the significantly slower development of organised public capital markets in Germany, this has been an 'overriding principle' for German commercial laws from the very beginning.[36] Other features include:

- the principle of embedding accounting regulations in national law
- the principle of equal treatment of the commercial and tax accounting laws in accordance with § 5 para. 1 of the German Income Tax Law (EStG)
- the principle of first drafting general rules, then breaking them down into more specific regulations, which is a direct consequence of the German legal tradition

Also, various legal principles are tied up to the HGB regulations – e.g. those concerning minimum or maximum dividend payout.[37]

Accounting according to the HGB basically pursues three purposes (reflected in the three respective functions of financial statements). The first major purpose is providing **information** to all stakeholders; in other words.[38] The important question here is who counts as a stakeholder. The HGB's second major purpose is the **assessment of payments**, such as dividends or taxes.[39] These two major purposes are specified in the so-called 'Generally Accepted Accounting Principles' – in German: 'Grundsätze ordnungsmäßiger Buchführung' (GoB). Not all such principles are codified in the HGB; some exist merely in the form of documentation of legal practice. The German terms that describe these two purposes reflect their respective aims: the first one is 'Informations-GoB' (purpose: information), while the second one is 'Gewinnermittlungs-GoB' (purpose: assessment of payments).[40] The HGB's

[36] Cf. Pellens, 2007, col. 1547.
[37] See Pellens, 2007, col. 1548.
[38] Cf. Moxter, 2003, p. 4.
[39] Also called the measuring of claims on profit; cf. Moxter, 2003, p. 3.
[40] Cf. Böcking 2007, col. 1536 f. For detailed accounts of 'Gewinnermittlungs-GoB' see Ballwieser, 1987, and of 'Informations-GoB', see Ballwieser, 2002.

third purpose is that of **documentation**,[41] which can be considered to support the aims of the other two purposes.

Since 1 January 1986, financial statements – consisting of a balance sheet and an income statement – have to be drafted by anyone who runs a business. This applies both to sole proprietors and commercial partnerships.[42] For incorporated companies there exist stricter and more extensive rules from §§ 264 ff. HGB on. According to the so-called (also in Germany) 'true and fair view'[43] the purpose of information is much more emphasised where incorporated companies are concerned. This means that the HGB obliges every 'mercantile trade' to do proper accounting, but distinguishes between rudimentary duties that concern sole proprietors and commercial partnerships[44] on the one hand, and tighter rules that concern incorporated companies on the other.[45] In the case of the latter, the emphasis that the HGB places on the purpose of information is dealt with extensively in the notes.[46]

SMEs exist as sole proprietorships and commercial partnerships, as well as incorporated companies.[47] One common aspect of all SMEs, however, is the creation of a balance sheet that meets both commercial and tax regulations – in German this is called 'Einheitsbilanz'.[48] For many primarily smaller companies this constitutes a significant advantage since they do not have to do accounting twice: they need to produce one balance sheet according to the HGB and one balance sheet according to tax laws.[49]

3.2. The 2009 reform of the HGB: the BilMoG

The 2009 reform of the HGB, the 'Gesetz zur Modernisierung des Bilanzrechts' (BilMoG), had a great impact on German accounting regulations.[50] Many of the modifications are of particular importance for the financial statements of SMEs.

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41 Cf. Coenenberg, 1997, p. 11.
42 Cf. § 242 para. 1 and 2 § 1 HGB.
43 Cf. § 264 para. 2 HGB.
44 Cf. e.g. § 238 Abs. 1 S.1 HGB.
45 Cf. e.g. § 264 Abs. 2 S.1 HGB.
46 Cf. § 264 para. 2 s.2 HGB. For the impact on balance sheet analysis cf. Küting/Weber, 2006, p. 397 ff.
47 See Chapter 3.3.
48 In an empirical study of the Accounting Standard Committee of Germany (DRSC) 79% of all companies (some of which were SMEs) replied that such a type of balance sheet would have the highest priority. For SMEs we can assume that the percentage would be even higher; cf. Deutsches Rechnungslegungs Standards Committee e.V., 2007, p. 10.
49 This is why there is an ongoing discussion about the future of this possibility in Germany; see Dehler, 2008.
50 The promulgation was on 25 May 2009, cf. BGBl, 2009, p. 1102.

Consequently, one of the reform's goals is 'to turn HGB accounting into a persistent and, compared to international accounting standards, adequate, cost-efficient and straightforward alternative'.[51]

With the help of different measures the informative value and explanatory power should be enhanced.[52] This implies e.g. modifying the approach to accrual, which could be seen now as more realistic than previously. In any case, the modifications concerning accrual indicate a general shift towards IFRS.[53]

Another goal the legislator pursued with the BilMoG was to deregulate German accounting rules and to make accounting according to the HGB simpler and thus more affordable. More particularly, this entailed adjusting the size constraints that define businesses small enough to be exempt from having to keep books, as well as the constraints of tax laws: sole proprietors of businesses with less than €500,000 in annual sales and less than €50,000 in profit for two consecutive years do not have to create financial statements at all.[54] This means that in the future cash-basis accounting (according to § 4 para. 3 s. 1 EStG) will be sufficient for many SMEs. In general, however, the question remains to what extent the goal of achieving better information value and the goal of deregulation (or better: simplification) are compatible. A modification that does not seem to help either deregulation or simplification is the abolishment of the reverse authoritativeness principle (in German: 'umgekehrte Maßgeblichkeit'). This means that in some cases tax rules can become relevant where pure accounting issues are concerned (i.e. HGB).[55] Besides other modifications, which make it harder to set up the 'Einheitsbilanz',[56] the abandonment of the reverse authoritativeness principle can be perceived as a step towards the complete segregation of commercial law and tax law.

Basically the HGB offers SMEs familiar regulations and tries to embrace also the approximately 70% of sole proprietors[57] by severely reducing accounting duties for that group. Especially for the smallest businesses (smaller than 'micro' SMEs) the BilMoG can be evaluated positively. The effort that this

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[51] Deutscher Bundestag, 2008, p. 1 (translated by the author). Furthermore, the BilMoG should implement the European Community Directives 2006/43/EG and 2006/46/EG.

[52] For details, see Deutscher Bundestag, 2008, p. 1.

[53] This tendency is evident in e.g. the ban on the so far allowed provisions for expenses or the different interest calculation for accruals for pensions; cf. BGBl Nr. 27, 2009, p. 1103.

[54] Cf. BGBl Nr. 27, 2009, p. 1102.

[55] Cf. BGBl Nr. 27, 2009, p. 1106.

[56] There will be more differences between commercial law and tax law (cf. Dehler, 2008, p. M1). However, there are also tendencies to create identical regulations in both fields, e.g. concerning voting rights, see Küting, 2008, p. 1334.

[57] Cf. Statistisches Bundesamt, 1995; see also Chapter 4.3.

group has to put into accounting issues should become considerably less in the future. On the other hand, there will probably be fewer opportunities for SMEs to create an ‘Einheitsbilanz’ and at the same time meet the requirements of commercial and tax laws. Regarding the handicraft sector, this development is rather negative as the average company is of very small size.[58]

3.3. Accounting according to the IFRS

Unlike the HGB, the IFRS centre on **investor protection**. Also, unlike the German Commercial Code, the IFRS **do not concentrate on the assessment of payments**.[59] Instead, financial statements are primarily meant to provide information that can help (actual and possible) investors make decisions, as can be read in F.12, IFRS framework. The IASC foundation explains more precisely that the aim is

> to develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial statements and other financial reporting to help participants in the world’s capital markets and other users make economic decisions.[60]

This provides a clear indication of the IFRS’s target group.[61] In this context the words ‘in the public interest’ suggest that this concerns companies of considerable size and importance. This becomes even clearer in the phrase ‘to help participants in the world’s capital markets and other users’. The message seems to be that the typical user of financial statements according to the IFRS is the investor on an international and organised public capital market.[62]

Given the focus on an organised public capital market and on corporate groups, there is no convincing argument for the use of IFRS by SMEs or handicraft enterprises. On the contrary, the definition of the IFRS’s target group means that SMEs face certain disadvantages. These disadvantages will be analysed in the following three chapters. There it will be argued among other things that IFRS are too cumbersome and complex for companies that did not have to deal with them so far. What is more, because IFRS have their roots in case law – which is rather unknown to German companies – coping

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58 Cf. Chapter 4.2.
59 Cf. Ballwieser, 2005b, p. 35.
60 IASC Foundation: Part A, Name and Objectives.
61 Only the target group of the ‘full’ IFRS.
62 Cf. Ballwieser, 2006, p. 8.

with them demands a profound knowledge of a different legal system as well as dealing with more than 2000 pages of text. This is especially important as IFRS tend to be modified in comparatively short intervals. Thus, the cost for the creation of financial statements is higher if IFRS are applied than it would be if the HGB were applied.[63]

A further problem German enterprises (not only SMEs) have with IFRS is the connection between German tax laws and commercial accounting. The financial statements of SMEs are heavily influenced by this connection because of the widely used ‘Einheitsbilanz’.[64] Many SMEs fear that they might be forced to apply three accounting regulations: the HGB, in order to fulfil the legislator’s requirements, the EStG in order to meet the requirements of the tax authorities (especially if the segregation of commercial law and tax law continues), and the IFRS to meet the requirements of creditors such as banks.[65] In the long run this fear seems to be more substantiated than at first glance. Even if the IFRS become more widely accepted (e.g. by the German register of companies): it is unlikely that a company will be able to submit an Einheitsbilanz according to HGB which satisfies both the legislator and the tax authorities.

Legal problems will be subject of Part III of this book. Such problems are e.g. the nature of the IASC as a private association. Even the European Commission does in principle not have a possibility to interfere in the due process.[66] Furthermore we may assume that this due process is dependent on different lobby groups, and there are no signs that these lobby groups are representing SMEs. It appears plausible that particularly large companies have the necessary capacities to address wishes to the Board during the due process.[67] Ballwieser points out that the design of IASB’s regulations is ‘justified by dubious arguments’.[68]

4. Characteristics of SMEs and handicraft enterprises as determinants of financial reporting

Proposition 1.3:

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[63] Cf. Buchholz, 2002, p. 1282.
[64] Cf. Schleyer, 2008, p. 409.
[65] Cf. Coenenberg, 2005, p. 112.
[66] Cf. Böcking, 2008, p. 86 f.
[67] Cf. Reuther, 2007, p. 320.
[68] Ballwieser, 2005a, p. 729 (translation by the author).

The size of the enterprise, the legal form and in particular the distribution of power and ownership in SMEs and handicraft enterprises represent three significant features which are relevant to the quality of an accounting system. The size of the enterprise is of great importance for the form of the annual financial statements of SMEs and handicraft enterprises, because these statements tie in with a range of accounting characteristics such as the widespread preparation of the annual financial statements by tax consultants. The basic legal forms in the SME and handicraft sector are, first, sole proprietorship and second, the GmbH (limited liability company), which is by far the most common form. Finally, the power relationships in handicraft companies as in SMEs are often shaped by the central position of the entrepreneur. Most enterprises are family enterprises.

Reason:

4.1. A reference framework

There are several characteristics that could be included in the definition of SMEs and handicraft enterprises. In the following, we will choose three such characteristics that are of particular importance:

- Size
- Legal form
- Structure of ownership and distribution of power.

This study's reference framework shall be developed on the basis of these three characteristics. Although the choice of these criteria is rather intuitional they cover many of the peculiarities of handicraft enterprises. The preparation of standard balance sheets that meet both commercial and tax regulations, for example, is characteristic of the financial reporting in handicraft enterprises. Whether this instrument is used or not, however, depends largely on the enterprise's size.[69]

Furthermore, size and legal form are characteristics that are used both by the legislator and the leading literature. In the handicraft sector, structure of ownership and distribution of power play an important role in defining to whom financial reports are addressed. In addition, all three characteristics can be rather easily quantified.

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[69] Cf. Chapter 4.2.

4.2. Size as a fundamental parameter of financial reporting

Size as a characteristic refers solely to *quantitative size*. Small and medium-sized enterprises (SMEs) and handicraft enterprises usually have a small number of employees[70] – five on average – who tend to be handicraft professionals. Small size indicates that only limited financial resources could be used for financial reporting and dealing with accounting regulations. Such companies often do not employ an in-house accounting expert, let alone run a specialised (reporting) department. This suggests that accounting legislation for SMEs should be neither complex nor voluminous.[71]

Many SMEs engage a tax consultant to do their accounting so that they meet the requirements of both commercial and tax laws. As a result, the employer does not always acquire a first-hand understanding of accounting regulations. Also, SMEs rather seldom use accounting figures for the purpose of corporate management.[72]

From the viewpoint of a cost–benefit analysis another aspect of company size must be addressed: just slight increases of cost may prove threatening for the company's survival. Because of that, SMEs often prefer to submit an 'Einheitsbilanz' if possible[73] – the balance sheet according to both commercial and tax regulations.[74] In practice the tax counsellor usually first prepares the tax balance sheet. If necessary, this will be slightly remodelled into a balance sheet according to the HGB. In view of that, most SMEs and other companies in the handicraft sector need to have a good grasp of the HGB.[75]

Furthermore small companies tend to have a limited international business activity. Few handicraft enterprises and other German SMEs export their products. This means that for the most part there are no foreign investors who could have an interest in the usage of international accounting rules, i.e. the IFRS.[76] Instead, the equity is normally held by domestic investors. The vast majority of SMEs are family-owned enterprises and debt capital also generally comes from within Germany. Typical creditors are local and regional banks

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70 Cf. Chapter 2.

71 Simplicity is often mentioned favourably in the literature on accounting for SMEs; cf. Pellens, 1993, col. 1406, or Ballwieser, 2004, p. 14 f.

72 Due to this many SMEs cannot (or do not want to) 'admit' a surplus value of accounting. Instead they have a rather negative attitude towards it. See Schempp, 2006.

73 Cf. Deutsches Rechnungslegungs Standards Committee e.V., 2007, p. 10.

74 The possibility to submit an 'Einheitsbilanz' is open more often to SMEs than to larger companies, because smaller companies tend to have less problematic issues, e.g. provisions for contingent losses, which are obligatory by commercial but prohibited by tax laws.

75 See Chapter 3.1.

76 See Chapter 3.

such as ‘Sparkassen’, ‘Volksbanken’, and ‘Raiffeisenbanken’.[77] Oftentimes, a company will have strong ties to a single house bank.[78]

Company size partly depends on the branch to which an SME belongs. However, a company’s ability and will to grapple with accounting varies among companies of comparable size but active in different sectors.[79] As a concluding remark it can be said that size affects the way in which SMEs and other handicraft enterprises deal with the requirements of accounting regulations.

4.3. Analysis of the legal form of SMEs as a parameter of financial reporting

There is little data on the distribution of legal forms in the handicraft sector. The last complete inventory count of German handicraft enterprises by the Federal Bureau of Statistics dates as far back as 1995.[80] This survey draws a very distinct picture: almost 70% of all handicraft enterprises are listed as sole proprietorships. Just over 24% are incorporated companies, nearly all are limited liability companies (GmbH) or limited partnerships with a limited liability company as the general partner (GmbH & Co. KG). Only around 6% of handicraft enterprises are commercial partnerships. Hardly any are public limited companies (stock corporations or partnerships limited by shares).

These percentages can be seen as representative of all German businesses, which means this distribution of legal forms also applies to SMEs.[81] There seems to be just one exception worth mentioning: the percentage of limited liability companies (GmbHs) is a bit higher among handicraft SMEs than among non-handicraft SMEs. Conversely, there are fewer commercial partnerships among handicraft enterprises. In the following we shall look at the implications an SME’s legal form has for accounting, focusing on three groups:

a) sole proprietorships

b) commercial partnerships

c) incorporated companies.

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[77] See Chapter 4.4.

[78] Cf. Burger, 2007, p. 28, or Pellens, 1993, col. 1407.

[79] Many studies focus on these differences. E.g. Thürbach and Menzenwerth distinguish the following groups: industry, handicraft, wholesale, retail, transport, information, and service providers (Thürbach/Menzenwerth, 1975, p. 7).

[80] The figures have been calculated on the basis of that survey; cf. Statistisches Bundesamt, 1996, p. 91. Current empirical studies on SME topics suggest that not much has changed since then; cf. Burger, 2007 or Lahner, 2004.

[81] Cf. Bizer/Becker, 2008, p. 10: they cite similar figures.

a) Sole proprietorships: businesses belonging to a sole proprietor (in German: 'Einzelkaufmann') are the most common type of business in Germany. This includes startups.[82] According to § 1 HGB, in principle each mercantile trade is associated with a natural person who is liable for any loss. The German legislator conceives of a mercantile trade ('Handelsgewerbe') as every business whose activities are 'commercial'.[83] Although there are other criteria on the basis of which a business is classified as a 'Handelsgewerbe',[84] this criterion is central to all regulations in the HGB.

The sole proprietor thus represents the smallest or most fundamental economic unit, where one businessman can fulfil the entrepreneur's functions: that of being a bearer of risk, an innovator and a manager of information.[85] An aspect of this legal form that is important for accounting is that a sole proprietor is responsible for the full risk of all of his or her actions. The sole proprietor has full access to the books and therefore is thoroughly informed about the business's economic situation. This legal form is not hampered by the problems associated with 'new institutional economics' since there are no other owners.[86] Since the owner bears the full risk, he or she is typically the manager of the company.[87]

In general, every sole proprietorship in Germany has to keep books and to submit financial statements. The latter consist of a balance sheet and an income statement as regulated by § 242 HGB. Sole proprietorships with less than €500,000 in annual sales and less than €50,000 in profit will be excluded from these duties in the future.[88] This exemption indicates the convergence of commercial laws to tax laws[89] and only applies for non-capital-market-oriented sole proprietorships. Consequently, the smallest businesses need not be considered in this study: for such businesses, it will be sufficient to determine tax payments by means of cash-basis accounting.[90] However, if accounting regulations aspire to address SMEs in general, they should offer solutions also tailored to this class of companies.

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[82] Cf. Bizer/Becker, 2008, p. 16.
[83] Cf. § 1 Abs. 2 HGB. If of the opinion, the business's activities do not have to be run in a commercial way, the owner has to prove it.
[84] See § 2 HGB ff.
[85] Cf. Bizer/Becker, 2008, especially p. 8 ff.
[86] In particular there are no problems of high transaction, agency costs, or asymmetric information. This, however, is based on the assumption that the owner deals with the company's management; cf. Böcking, 2008, p. 77 f.
[87] Cf. Bizer/Becker, 2008, p. 13.
[88] A major modification brought by the BilMoG; see Chapter 3.2.
[89] Specifically the numbers of § 141 AO.
[90] See § 4 para. 3 EStG.

b) Commercial partnerships include (i) 'offene Handelsgesellschaften' (oHG), which could be best described as 'ordinary partnerships', (ii) 'Kommanditgesellschaften' (KG), which could be translated as 'limited partnerships', (iii) 'Gesellschaften bürgerlichen Rechts' (GbR), which are a type of a civil law association, and (iv) 'Stille Gesellschaften', which are silent partnerships. The latter two shall not be considered in this chapter as they are not 'mercantile trades' on the basis of the HGB's definition and thus are not obliged to submit financial statements.[91]

Although ordinary partnerships (oHG) and limited partnerships (KG) account for only 6% of SMEs, they are often perceived as exemplary legal forms of SMEs. Having a sole proprietor, unlimited responsibility is a feature common to both. The person who actually bears this responsibility is usually a natural person (or more than one).[92] Typically, this person is also in charge of the company's management.[93] For both legal forms it is possible to have at least two (often more) proprietors or shareholders. However, there are differences between such cases and sole proprietorships that are important for accounting issues.

In general, it can be said that, as in sole proprietorships, in commercial partnerships too the level of self-information is adequate. The differences between such companies and sole proprietorships regarding this point centre on 'new institutional economics': in the former category there is more than one owner, so transaction costs occur, because the different shareholders have to control each other as well as each other's financial position. For example, if a shareholder with limited private funds causes damage to the firm, the partners with more funds will have to cover the damage.[94] Furthermore, the purpose of information in accounting matters has a different emphasis in the case of commercial partnerships: for those shareholders who actually manage the company, self-information should be plain sailing. For non-managing shareholders, e.g. a partner in an oHG who does not participate in management or the limited partner in a KG, matters are different. Regarding the first group, the degree of access to information depends on the deed of the partnership's design;[95] the second group is excluded from management at any

[91] If a civil law association (GbR) is registered in the German register of companies it will automatically be classified as either an ordinary (oHG) or a limited partnership (KG). There are several types of commercial partnerships in Germany which, however, will not be considered in this study.

[92] If not, the limited responsibility has to be indicated in the trade name; cf. § 19 para. 2 HGB.

[93] Cf. Wagenhofer, 1993, col. 1705.

[94] Cf. Bizer/Becker, 2008, p. 11.

[95] Cf. § 114 Abs. 2 HGB. Partners of an oHG can be explicitly excluded from management. How many would actually accept such a clause in the deed of partnership is a different question.

rate.[96] Thus, these two groups' right to full access to information is restricted: they have to rely more or less on the information given by the accounting figures.

This severely changes the situation for the accounting of commercial partnerships. In view of this, in the cases of multiple proprietors information plays an important role, especially for limited partners. Accounting would have to fulfil the same purpose also for a silent partner. However, information plays a different role for the way in which commercial partnerships deal with their accounting issues than it does in the case of incorporated companies, where there is a higher degree of anonymity among shareholders with relation to accounting matters.

Compared to incorporated companies, commercial partnerships tend to have a lower equity ratio.[97] The reason for this might be that they are of smaller size. The lower equity ratio, however, has certain implications for the design of accounting regulations. Equity is meant to have different functions: it should finance the company, influence the management, it should assume risk and it should assume liability.[98] If a commercial partnership has a relatively low equity ratio, these functions cannot be fulfilled to the same degree as in e.g. incorporated companies. This implies that there are fewer financing possibilities. This is because, first, self-financing obviously becomes more difficult, and second, because a lower equity ratio means fewer opportunities of debt financing. Of course, one could say that in commercial partnerships it is the partners who bear financial responsibility, however, low equity is often seen as a negative sign. This applies especially if a rating, e.g. by a bank, is conducted.[99]

Furthermore, the less strict regulation of commercial partnerships could be important for accounting matters.[100] Although this is definitely a positive facilitation for the fully liable partners, on the other hand the company may face greater risks.

c) Incorporated companies: the majority of incorporated companies in the handicraft sector as well as among SMEs are limited liability companies (GmbH). A few are organised as limited partnerships with a limited liability company as the general partner (GmbH & Co. KG); these can be compared to a GmbH. Other, less common legal forms of incorporated companies can also be found among SMEs.

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[96] Cf. § 164 HGB and § 166 Abs. 1 HGB.
[97] Cf. Siegel, 1993, col. 489.
[98] Cf. Siegel, 1993, col. 482 f.
[99] Cf. Massenberg/Borchardt, 2007.
[100] Only incorporated companies have to apply §§ 264 ff. HGB.

Since the reform of the German Stock Companies Act – the 'Aktiengesetz' (AktG) – in 1994[101] it is also possible to found a so-called 'small stock corporation'.[102] In principle, this legal form has to follow the same regulations as a standard stock corporation – what is known as an 'Aktiengesellschaft' (AG) in German. The small stock corporation, however, can be founded by just one person as a single shareholder.[103] Accounting insolvency does not commit the management to file for bankruptcy, and – as important – equity does not have to be presented differently in the balance sheet.[104] These and other advantages are important modifications that make the 'big size' legal form of stock corporations more attractive for at least some SMEs, and thus an alternative worth considering.

As a consequence of the so-called Centros decision[105] of the European Court of Justice (ECJ) in 1999, and, even more so, of the Überseering-decision in 2002[106] there have been changes in the German jurisdiction over a company, depending on that company's administrative centre: today, companies of a legal form of another EU country but with an administrative centre in Germany have a legal capacity in Germany.[107] This has opened up the possibility for German companies to adopt the legal forms of other European countries. Following those decisions, the British private company limited by shares (Ltd) became particularly popular. The startup cost of this legal form is considered rather low – lower than the equivalent cost for founding a German GmbH: a share capital of only £1 is needed, reporting duties are regarded as less strict, and there is no need for notarial forms or acknowledgements. All these reasons made the Ltd the most popular of all non-German legal forms.[108] During the first five months of 2008 a total of 2,211 Ltd companies were founded in Germany – compared to 24,873 GmbHs.[109]

To halt this development, the German Ministry of Justice implemented a reform of the German Limited Liability Companies Act (GmbHG) called 'Gesetz zur Modernisierung des GmbH-Rechts und zur Bekämpfung von Missbräuchen' (MoMiG). Among other measures, a new trade name for this legal form has been introduced, the 'Unternehmergesellschaft (haftungsbeschränkt)' (UG).

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[101] Cf. 'Gesetz für kleine Aktiengesellschaften und zur Deregulierung des Aktienrechts', 2 August 1994.
[102] Cf. Industrie- und Handelskammer zu Köln, 2008.
[103] This need not be a natural person; cf. Hierl/Huber, 2008, p. 48.
[104] Cf. Wagenhofer, 1993, col. 1706.
[105] ECJ court decision C-212/97, GewArch 1999, pp. 375–378.
[106] ECJ court decision C-208/00, GewArch 2003, pp. 28–32.
[107] Cf. court decision of Bay. ObLG, (19 December 2002), Az.: 2Z BR 7/02.
[108] Cf. Heinz, 2006, p. 23.
[109] Cf. Bundesministerium für Wirtschaft und Technologie, 2008, p. 2. Foreign legal forms, however, will not be the subject of this study, because their accounting has to follow the regulations of the country in which they originated; e.g. for Ltd companies this would be Great Britain.

The requirements for founding an UG can now be more easily met; e.g. it is not necessary to have a certain share capital, there are fewer formalities for startups and the entire process of founding the company is faster. If certain standards are met, the company can easily change its name to a 'GmbH'.[110] There are, however, some changes that might dampen the advantages of this 'new' type of GmbH to some extent: for example, under certain circumstances, if the company delays filing a petition for insolvency the shareholders may become liable.[111] This could be interpreted as an increased incentive for both, shareholder and director (where they are not the same person), to look carefully into their company's accounting figures and financial statements. Furthermore, this could spark interest in financial statements, which actually give a true and fair view of the company's situation and thus adhere to the principle of decision usefulness.

In Germany, small incorporated companies[112] are not subject to annual statutory audits. Because of this facilitation (among others) many of the financial statements published in Germany are not audited, e.g. those of SMEs that are small but incorporated companies. This indicates a significant constraint, because it implies that the (anonymous) public capital market is not seen as an addressee for the financial statements of small incorporated companies. As the owner of a small company – i.e. an SME – an anonymous shareholder is highly dependent on the figures published in a balance sheet or income statement.

Despite this restriction the financial statements of SMEs that are incorporated companies, such as a GmbH, are addressed to owners with limited responsibility. The chief difference in accounting between such companies and commercial partnerships is the lack of a fully responsible natural person as a shareholder. Consequently, it is more likely for the shareholder of an incorporated company (above all, a GmbH) to forgo his or her right to manage than for the shareholder of a commercial partnership. This is why in the first category of companies the agency dilemma of incomplete and asymmetric information is usually much more prevalent.

4.4. SMEs: structure of ownership and distribution of power

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[110] It should be stressed that the UG is not a legal form as such. It just denotes a 'young' GmbH.
[111] Cf. Bundesministerium der Justiz, 2008.
[112] These are defined in § 267 para. 1 HGB.

The capital structure of SMEs, and in particular of handicraft enterprises, is marked by a high percentage of debt and a low equity ratio, respectively.[113] Such enterprises include also a smaller proportion of entirely self-financed companies. If we take a closer look at equity and its structure, we discern more characteristics of SMEs: for instance, it is far more uncommon for the shares of SMEs than for those of large companies to be owned by diverse shareholders. As a result the problems that arise if ownership and controlling rights fall apart seem to be less acute for SMEs.[114] A prominent characteristic of SMEs is the dominance of family-owned businesses. This is especially the case for companies with low annual sales.[115] With regard to accounting regulations this means that for a large proportion of SMEs of any legal form, the owner and the director are one and the same person. The definition the IfM uses for a family-owned business describes very well the connection between ownership and directorship. According to this definition a family-owned business is a company where:

- at least 50% of its shares are owned by up to two natural persons (or their families) and
- the natural person (or persons) and the director(s) are one and the same.[116]

Strictly speaking, this definition has the problem that it also includes companies that are not normally considered family-owned businesses. An example of this could be a company that only has two owners (two natural persons) and both are directors of the company at the same time. This problem is solved if the definition is modified to apply, not to family-owned businesses, but to companies whose directors are shareholders. According to this interpretation of the IfM's definition, 95.1% of all companies in Germany would be covered.[117] This indicates that for the bulk of German businesses the shareholders participate at least to some degree in the company's management.

This point is important because it shows that a company's equity structure does not necessarily reveal much about the actual allocation of authority with regard to decision-making. A coincidence of these two may be given in case of a sole proprietor. In this context it must be said that German law prohibits self-contracting, so the shareholder cannot conclude a contract with himself or

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[113] Cf. Schempp, 2006.
[114] Cf. Ballwieser, 2004, p. 14.
[115] Depending on the exact definition, more than 90% of family-owned businesses can be classified as SMEs; cf. Emmerich, 2008, p. 733 f.
[116] See the IfM website: http://ifm-bonn.de/index.php?id=68 (accessed August 2009).
[117] Ibid.

herself. This, in turn, leads to the complete amalgamation of the company's profit and the owner's income as 'company director'.[118] A strong leadership personality can be assumed for many family-owned businesses and thus for many SMEs.[119]

In a commercial partnership controlling and voting rights are basically consistent with the shareholder structure. It is, however, possible to exclude shareholders from the company's management in the deed of partnership.[120] In that case, the only reliable information on which the excluded (but fully liable) shareholders can base their decisions when exercising their controlling and voting rights comes from the company's financial statements At this point it should be added that often the wife, husband or children become shareholders just for e.g. tax reasons.

For a limited liability company – a GmbH – the situation is different. In those cases there may also be multiple partners; nevertheless, usually not all partners double as directors. Because of their limited responsibility, partners tend to delegate directorship (and managing tasks in general).

Furthermore, in the typical 'family-owned business' the wish to ensure the company's survival in the long run is probably much stronger when a family owns the enterprise and wishes to pass it on to the family heirs one day. This contrasts with the prevalent tendency of the capital market as a whole to focus on short-term results and has direct consequences also on financial statements, e.g. the treatment of unrealised profits or the valuation of long-term investments. Even though both a family-owned business and a listed stock corporation can be an incorporated company, the focus of each on the long-term and short-term survival of the business respectively can be the source of several differences in the accounting regulations of these two types of enterprises.[121]

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[118] Cf. Daschmann, 1994, p. 56 ff.
[119] Cf. Emmerich, 2008, p. 752.
[120] See Chapter 4.3.
[121] Cf. Emmerich, 2008, p. 736 ff.

Part II

Accounting in accordance with IFRS and assessment, in view of the requirements for SMEs and handicraft enterprises

Thomas Schildbach

Outline

1. IFRS as a global approach for accounting and the starting points for including SMEs and handicraft enterprises

2. The idea of fair value statics and its limits

2.1. The new approach of synthetic asset reporting
2.2. The loss of a meaningful performance variable
2.3. Fair value in our imperfect world
  2.3.1. Conceptual cutbacks and surrogates as a necessary concession
  2.3.2. The problem of prices in active markets as fair values
  2.3.3. The broad area of 'mark to model'
  2.3.4. The practicality and acceptance of fair value

3. Accounting in accordance with IFRS or IFRS for SMEs in the light of the requirements of SMEs and handicraft enterprises

3.1. Shortcomings of IFRS from the viewpoint of non-capital-market-oriented enterprises and their reasons
3.2. Requirements of SMEs and handicraft enterprises of accounting for information purposes
3.3. The lack of suitability of IFRS as a basis for assessing income taxes
3.4. Consequences of the inability of IFRS to calculate payouts to the owners
3.5. The from the viewpoint of SMEs and the overall economy questionable views of IFRS on equity
3.6. The surprisingly profound knowledge of IFRS among SMEs

4. IFRS for SMEs – a contribution towards solving the problems of SMEs and handicraft enterprises?

4.1. Prospects of relief from IASB with IFRS for SMEs

4.2. Alignment of IFRS for SMEs towards the old concept, which is unsuitable for SMEs and handicraft enterprises

4.3. Consolidation of the regulations a disadvantage for SMEs

4.4. Disadvantages for SMEs disguised as simplifications

4.5. Discrepancies between the standard IFRS for SMEs and the associated Fact Sheet

4.6. ‘Substantially fewer disclosures’?

5. Conclusion

1. IFRS as a global approach for accounting and the starting points for including SMEs and handicraft enterprises

Globalisation not only considerably increases the capital requirement of major companies, it also means these companies are no longer fixed to national capital markets. In order to meet the challenge of competition, companies have to look in the capital markets of the world for the best ways to procure capital. However, capital can only be allocated sensibly all over the world if the companies seeking capital can persuasively inform capital markets all over the world. It is precisely this point the IFRS should be addressing. They are seen as valuable accounting standards which, if implemented consistently all over the world, produce comparable annual financial statements for information purposes that are understood everywhere and in this way should promote the allocation of capital. In this function and as a promising European competitor to the American US-GAAP in the battle for the 'World Standards of Accounting', they were adopted by the European Union as a new nucleus for its strategy to harmonise accounting standards in Europe.

Using IFRS to implement global accounting standards in fact distracts not only from the principle limits of harmonising accounting standards worldwide, but also from the problem that only competition between different bodies of regulations provides a realistic prospect of sensibly adapting to the changing requirements and of improvements. Any regulation of accounting standards also interferes, due to changes in levels of information, in part even due to the definition of direct entitlement to, for example, profit distribution or bonuses, with the distribution of assets between economic entities. The private panels of experts, which create IFRS as specialised standards, lack the required legitimacy for such far-reaching interference in the ownership rights of citizens. Only democratically legitimised political bodies and courts can claim such rights. The IFRS are in no way living up to their noble claims; plenty of evidence of this is still being provided, while there is also growing scepticism and criticism, not least as a result of the financial market crisis.

With their goal of wanting to make a contribution towards improving and standardising information in capital markets across the world, the IFRS have capital-market-oriented companies in mind. In Great Britain, the home of the IFRS, this concerns – unlike in Germany – wider circles of the economy. In the process, companies that are not global players also have to surrender to globalisation. If IFRS can provide access to competitive accounting standards for young nations striving to share in the world's economic development, and if they replace poor regulations in the other states with better ones, it would be incomprehensible to exclude such companies and nations from possible improvements. The nice wish of letting all companies share in the hoped-for benefits of IFRS and in the process of saving the young nations from having to develop their own contemporary accounting regulations cannot, however, eradicate the problems of such a plan. Information for capital markets where a limited number of owners and banks are providing capital is not only needed

less urgently, but is entirely surplus to requirements. Shareholders and banks can be informed to a more sophisticated degree, and where necessary also much more extensively than the capital market, especially as private information, unlike capital market information, rules out harmful use by competitors. The IFRS which the current accounting standards are based on, the so-called ‘full IFRS’, are, even in the view of the board that makes these regulations, not suitable for SMEs. For this purpose, the regulations are way too extensive, too complex, too dynamic with their many changes, and too demanding. The experience of the Deutsche Prüfstelle für Rechnungslegung (German Financial Reporting Enforcement Panel), with almost 20% of financial statements being incorrect, supports this view. ‘The main reason for the surprisingly high number of detected errors, however, is the scope and complexity of the IFRS regulations, which obviously ask too much of the SMEs and also the auditors’ (translation of original quote).[122] With ‘IFRS for Small and Medium-sized Entities’ (IFRS for SMEs) the IASB believes it can counter such objections and meet the requirements of the SMEs and handicraft enterprises. To what extent the basic concept by which the two versions of IFRS are influenced, and the special IFRS for SMEs provide room for such hopes will be reviewed in detail in the following section.

2. The idea of fair value statics and its limits

Proposition 2.1:

IFRS aim solely to meet the information requirements of anonymous financiers in international capital markets with assets being reported by element. This requires an ongoing time assessment of the assets with major drawbacks. Profit is greatly influenced by changes in value that are driven by chance, which might not only completely consume the informative operational core profit, but also intensify cyclical swings. In particular, the calculation of current fair values creates great problems. As the financial crisis of 2008 has shown, they can only be continuously monitored in a small number of markets and even then they are not free from the risk of being seriously distorted. The market price estimates that are normally required are not linked to operational performance. This creates great scope for discretion, but also for massive manipulation!

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[122] Berger, 2008, p. 511; in the same sense as Meyer, 2009.

Reason:

2.1. The new approach of synthetic asset reporting

The concept of annual financial statements whose primary task was to establish the profit for a period dominated in Anglo-Saxon circles as well as in Germany up until some years ago. This profit should not only enable conclusions to be made on the ability of a company to achieve further surpluses in future, it should also by specifically comparing previously held expectations support management in its decisions and shareholders or other control bodies in their monitoring of management. This concept lives on in the Framework and in many older detailed regulations of IAS and IFRS. For some years, IFRS have been changing in line with US-GAAP, which heralded the start of this change towards a concept where annual financial statements focus on asset-reporting with SFAS 109 in 1991 and the first asset-oriented interpretation of deferred taxes.[123] The new approach is to comprehensively report the assets of the company or group as the balance of the values of all of the assets and all of the liabilities. Theoretically, this approach is based on the possibility of monitoring prices in an ideal world of in particular perfect and complete commodity and capital markets that are in equilibrium, and homogenous expectations with regard to uncertainty, and calculating the value of the company by synthetically combining these.[124] Although such ideal conditions, where the company value can only tell the market what it has already long known, do not exist in reality, the concept relies on the existence of suitable fair values and on the comprehensive valuation of all assets with a wider consideration of intangible assets.

2.2. The loss of a meaningful performance variable

Even if the assets of the companies or groups can be reported appropriately over time on the basis of the new fair value static, this gain in information

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[123] Cf. Wagenhofer, 2009, p. 98.
[124] Cf. Barth/Landsman, 1995.

would be necessarily linked to the loss of meaningful performance variables.[125] That is to say, if the fair values in the markets are in line with or even only close to the prices in the markets, which, in the interest of accurate reporting of assets, take into account all influences on their value, the changes in prices reflect the impact of a large number of factors, which on top of this are always anticipated correctly by the market. Even actual deviations from correctly anticipated expectations, even more, though, the balance of a range of individual deviations, follow a process of chance and are therefore not meaningful.[126] The change in value that the company's management has brought about with its business policy is consciously hidden by the comprehensive consideration of all of the other impacts on the fair value of the company's assets, so that profit, which is purely a variable of chance, does not allow any conclusions on either the future changes in value of the company's assets or on the performance of management. Only the assets are still meaningful. As a replacement for profit, the interest on the value of the assets with a suitable interest rate for risk can be used, whereby the latter can only be determined with difficulty. With the falling efficiency of the markets and increasing necessity to estimate fair values, the relationships are changing. As the later analysis of these problems will show, however, any less impact of chance, especially for less well-informed readers, is at the expense of more discretionary dependence on and influenceability of prices.

For those companies which, in addition to accounting and the annual financial statements, cannot afford a completely independent, sophisticated information system – for example, in the form of independent cost accounting – the loss of a meaningful performance variable has nasty consequences. Management loses an important guide for aligning its business policy. At the same time, the central principle of management accountability towards the financiers and supervisory bodies is ruined. For capital-market-oriented companies and groups, the question has to be asked: how can the market develop expectations on the value of the assets of such units, if it does not receive any indications on their future earnings-power?

2.3. Fair value in our imperfect world

2.3.1. Conceptual cutbacks and surrogates as a necessary concession

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[125] Cf. Nissim/Penman, 2008, p. 13 f.
[126] Cf. ibid. and Samuelson, 1965.

In reality, with the imperfections of the markets and with the heterogeneity of expectations and talents of economic entities, both the imperative correlation between value and price in the ideal world, and the existence of appropriate prices for all commodities at all times disappear.[127] Valuation at fair value brings great problems. It has to be decided whether the fair value should primarily be aligned to the market price or to the intrinsic value of assets and liabilities. Above all, the active markets with their broad base, which have increasingly controlled perceptions with the exuberant reliance of recent years on the tradability of all conceivable titles, suggest choosing the price in active markets from transactions between competent, independent business partners under normal business conditions as a benchmark for fair value. Unlike the intrinsic value, this price is easy to determine with the existence of transactions or even active markets. However, as not least of all the recent financial market crisis lets assume and the price of the VW shares at the end of October 2008 clearly showed, such prices reflect not only the values of the respective objects, but a range of other influences as well. These influences can be separated at best imprecisely. And each right to such a price adjustment is inevitably associated with great scope for discretion. International Financial Reporting Standards (IFRS) take into account possible distortions of market prices due to exaggerations and overreactions and basically give priority to prices from transactions, with the exception of prices from emergency sales where there is pressure to sell.[128]

Here it must not be overlooked that there are active markets for only a small part of the assets and liabilities of companies. These concern primarily financial instruments. For these too it is obvious that this often only applies in ‘fair-weather periods’. In the current crisis, at any rate, a large number of markets for financial instruments dried up. To calculate the fair values of these and other individual financial instruments and the mass of real or intangible assets, only downstream surrogates can be used. As such, the IFRS know the prices of the most recent business transactions with the same or an essentially identical commodity. If such prices do not exist, or it can be proved that they do not correspond with the fair value, the values estimated on the basis of market data with the help of proven assessment methods – normally used to handle the respective task – are to be used (‘mark to model’).[129]

2.3.2. The problem of prices in active markets as fair values

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[127] Cf. Ballwieser/Küting/Schildbach, 2004.
[128] Cf. IAS 39.AG 69 to AG 72.
[129] Cf. IAS 39.AG 74; Institut der Wirtschaftsprüfer (Institute of Auditors), 2008, p. 3.

Even the benchmark for the fair-value calculation and the highest-ranking surrogate for this value – the current price in the active market – do not provide a basis for a synthetic calculation of the assets of a company. There are two basic reasons for this.

Hidden behind the prices of active markets in reality, unlike in the ideal model, are not homogenous, but heterogeneous expectations. These are transformed into a price on the basis of the rule specified for calculating prices in the respective market, normally the principle of highest volume transacted, which is geared towards the highest possible sales. As the point where supply and demand meet, this price expresses, then, instead of the sought valuations only the valuations of the buyers and sellers at the margin. Since at least the non-financial assets in the companies are always used in accordance with the respective business model of the company and the individual capabilities of the managers and employees, for the buyers and sellers at the margin this price corresponds at best with the contribution that the asset makes to the value of the company. In all other cases this does not apply, so the values of other companies can also not be calculated synthetically by combining the fair values. The company's value is only ascertained if it has been calculated off the balance sheet by using a total valuation method, and the missing difference, the positive or negative original goodwill, is added as an additional item to the balance sheet with fair values. This procedure, however, is entirely independent of the initial valuation with fair values or any other values, and is therefore not a particular strength of the fair value. Measured by the size of the required addition, the individual value in use of the assets and liabilities to be valued would, on the contrary, be superior to the fair value, without having any serious disadvantages, as the overall value of the company has to be determined separately from the calculation of the individual valuations on the basis of subjective estimates with extensive scope for discretion.

As already indicated, the prices in active markets are not only calculated from the value of the future benefits expected from the traded object.[130] At least the extremely positive price movements, which regularly precede a crisis, and probably also a part of the negative price developments during the crisis, are due to psychological exaggerations. Research in the area of behavioural finance has revealed a plethora of systematic distortions that are seen time and again in the behaviour of market participants, and obstacles that prevent arbitrage processes from creating efficient price structures.[131] Investigations relating to share option programmes in the USA can provide clear evidence of

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[130] Cf. the problems in detail Schildbach, 2006.
[131] Cf. in particular Shleifer, 2000.

manipulation of relevant share prices.[132] In the end, the prices, which Enron (as the market-maker and as a party in approximately 80% of the transactions on the electronic market platform created by Enron) had a crucial part in determining, were the source of a large part of the profits reported before the collapse.[133] Although there is much evidence of distortion of market prices, not to mention prices from individual transactions, IFRS are basically holding onto prices especially in the active markets. 'With price distortions resulting from exaggerations and overreactions on the part of market participants a price adjustment is often out of the question, assuming that transactions take place at these prices' (translation of original quote).[134] The valuation does not always remain tied to distorted prices though. In the case of emergency sales where there is pressure to sell and when it can be proven 'that the last transaction price does not correspond with the fair value, this price is to be adjusted' (translation of original quote).[135] This seemingly narrow exemption clause breaks the tie to distorted prices. The condition that the price must not correspond with the fair value requires knowledge of the true value, irrespective of the observed market price. Due to this it is solely based on unspecified value judgements of managers and auditors and actually opens up a less clearly confined scope for using estimates instead of observed prices and the still-to-be-defined broad area of discretion when determining values with the help of the 'mark to model'.

2.3.3. The broad area of 'mark to model'

If no contemporary prices in active markets or from individual transactions with at least essentially identical commodities can be observed, or if the prices observed in this respect do not correspond with the fair value, the fair value has to be estimated. Significantly, the target figure for the estimate is defined as the transaction price 'that would have resulted between independent contract parties under normal business conditions'[136] (translation of original quote), although these prices may be distorted and the estimate should help precisely when the observed prices are not fair values. What distinguishes the fair value from a distorted price remains entirely open.

Also, when making the estimate, data from the market, and therefore as little company-specific data as possible, should be used to the greatest possible

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[132] The Wall Street Journal Europe, 18 December 2002, p. A8.
[133] Cf. Anonymous 2002.
[134] Institut der Wirtschaftsprüfer (Institute of Auditors), 2008, p. 4.
[135] Ibid., p. 4; cf. also IAS 39.AG 72.
[136] IAS 39.AG 75.

extent.[137] If a price materialises in the market, though, which is influenced by overreactions, systematic misjudgements by market participants, manipulation attempts and/or specific intervention by the market maker, the underlying parameters of the market for the valuation also reflect these distortions. It therefore remains entirely open how relying on these parameters should solve the problems. This is applicable more than ever where markets have dried up. Here transactions and prices no longer materialise because the value judgements of potential buyers are irreconcilably below those of potential sellers. The use of parameters which influence market developments in this case can only expose again the irreconcilable differences in the valuations of the market participants that are already known. It is not possible to derive from this the price that would be formed if these problems did not exist and the parties could agree. In the previously mentioned cases, if fair values are consequently derived on the basis of the 'mark to model', they have to be based on a much more general understanding of market parameters. In the absence of clear criteria for their calculation, there is already a broad and undefined area for personal discretion. The company-specific data, which is not allowed, presumably because of the fear of manipulation, is, at least in the view of financial officers, still conceivable. The parameters that would apply to form a price corresponding with the fair value in a market that has actually dried up can only be speculated, though.

Even if this scope for consciously influencing the fair value is not considered, huge areas of uncertainty remain for calculating the necessary parameters for assessment models (discounted cash-flow methods or option-price models).[138] There are no future payments expected by the market, due to an absence of homogeneous expectations. It is also only possible to tell after the value has become known what market expectations with regard to future payments are suitable, in terms of the relationships of the model for the selected parameters of the model. The parameters of risk-free interest, market price of the risk, company-specific beta risk and volatility of the share price, which of late is also a factor for considering the liquidity of the market,[139] cannot be defined clearly even as variables of the past, but are required as expected variables for the future. The variables in the past can only be measured imprecisely because many parameters, especially the risk-free interest and the beta risk, are purely theoretical constructs, which are derived approximately in various ways from variables that are actually observed. On top of this, the occurrences of the variables that are required for the measurement have been deviating greatly in the past and can be selected and processed very differently by different

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[137] Cf. ibid.; Institut der Wirtschaftsprüfer (Institute of Auditors), 2008, p. 4.
[138] Cf. IAS 39.AG 74.
[139] Cf. Institut der Wirtschaftsprüfer (Institute of Auditors), 2008, p. 4.

measurement methods that are all highly regarded. Even the parameters of the past can therefore only be determined within a significant range. The highly regarded study by Carleton and Lakonishok (from 1966 until 1980), for example, only determined the annual risk premium to be between 0.9% and 24.9%.[140] Unlike interest rates, which are still comparatively transparent in their effect on value, changes to variables for volatility, for example, have surprising consequences. For a ten-year call option (as was typical for Enron) for a commodity with a current price of 100, an exercise price of 200, and with an interest rate of 5%, a doubling of volatility from 5% to 10% results in an almost seven-fold increase in value.[141] Based on effective reports to the SEC, Ernst & Young highlight the ranges for assessing share-based management remuneration. By making changes in ‘several equally legitimate ways’, expenditure for these payments changed by up to 114% compared to the expenditure shown in this item in the report to the SEC, and by up to 116% compared to the annual profit.[142] Mulford aptly sums up the significance of this criticism of fair value: ‘Fair value is what you want the value to be. Pick a number.’[143]

2.3.4. The practicality and acceptance of fair value

Even at the IASB both its liking of fair value and the extent to which it believes it can ask the economy to use fair value is limited. Contrary to the shining vision of a synthetic asset statement based on a comprehensive understanding of the assets and valuation at fair value, in truth only limited changes have been made in the direction that had been promised. In many areas the annual financial statements according to IFRS are still bound to the principle of imparity with an upper limit for acquisition costs. With the balance sheet approach, expansions are essentially limited to the capitalisation of original development costs, on the one hand, and derivatives on the other. Valuation at fair value is only mandatory for financial instruments in trading assets and held for sale, for derivatives, and for biological assets. For monetary items in foreign currencies, these are only updated with regard to the change in the exchange rate.[144] There is a right to choose whether to value on the basis of fair value for the following: tangible and intangible assets where the revaluation does not affect profit or loss, investment property,

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[140] Carleton/Lakonishok, 1985, p. 41.
[141] Cf. Lüdenbach/Hoffmann, 2002, p. 1173.
[142] Cf. Ernst & Young, 2005, p. 5.
[143] *The Wall Street Journal Europe,* 8 November 2004, p. M8, with refrence to Charles W. Mulford.
[144] Cf. IAS 21.23 and 21.28.

shareholdings above 20% and those financial instruments where this is allowed under IAS 39.9 and 11A. With such a fragmentary fair value assessment, which is often also only optional, it is hardly possible to prepare a report on the assets, if the principle of imparity for valuing acquisition costs, which in fact is not very suitable for this purpose, is held onto. As they can be exercised differently by companies, the options also damage the information by further reducing both the ability to compare assets, which are already affected by the mixed acquisition costs and time assessment anyway, and profits.

Particularly from the viewpoint of SMEs and handicraft enterprises, but not only for them, the cost–benefit relationship of an accounting system also plays a role, if this is based on fair value.[145] As the additional benefit is, if anything, negative, it does not look good for this relationship. The costs for such an accounting system are much higher than those for the traditional process. With the principle of imparity for valuing acquisition costs, changes in value only have to be recorded if they are below the previous book value. The lower fair value also has to be calculated, it cannot simply be taken from a list. There are, though, specific rules concerning the basic approach, such as replacement value, residual value or capitalised earning power, which at least give the procedure a structure and direction.[146] For the valuation at fair value, on the other hand, all changes in value have to be registered, negative and positive. In the process, it has to be thoroughly reviewed which surrogate for the fair value has to be used in the specific case, and whether the variables that are determined in this way reflect prevailing market conditions between competent and independent market participants. For this purpose, sound knowledge of one's own business is not enough. Experts are required who have comprehensive knowledge of the conditions in the market, the assessment methods that are normally used for valuations in the market, and the current variables of the parameters necessary to value the respective object on the one hand, and the appropriate IFRS regulations on the other. Such consultants and evaluators do not come cheap, though. As the current financial crisis demonstrates, requirements resulting from the labyrinth of rules on fair value alone can make the solution so difficult for even the best experts, that a change back to the lower of cost or fair value in accordance with the German Commercial Code (HGB) should be possible.[147]

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[145] As a 'constraint' the 'balance between benefit and cost' even plays an important role within the Framework of IFRS (Framework para 44), without really being taken seriously.

[146] Cf. Hoyos/Schramm/M. Ring, 2006: § 253, note 287 ff.

[147] Cf. International Accounting Standards Board, 2008.

Almost even more serious are the dangerous, misguided incentives stemming from the fair value valuation and affecting the behaviour of managers, particularly if these receive profit-related remuneration or bonuses, and the strong procyclical effect of this valuation. Particularly, if not exclusively, the major corporations, but also the economically more significant SMEs are 'programmed incorrectly' in such a manner that the consequences for the efficiency of the economy and the economic system can no longer be foreseen.[148] With an ongoing time assessment (as is prescribed for trading securities and derivatives in accordance with IFRS[149] and – according to the government draft for the BilMoG – will also be introduced in the HGB,[150]) the profits from the changes in price for these financial instruments are affected. Managers who share in such profits will be motivated to balance productive and speculative investments against one another. Particularly in times of economic recovery, speculative investments promise high and easily earned profits. Derivates open up such prospects with minimal use of capital, but also at the cost of a very high risk. In order to achieve these profits, it is in particular not necessary to sell the respective financial instruments, for this would be linked to an increase in supply, pressure on prices and, above all, the danger of causing the feared reversal of opinion with signals of any possible doubt. On the contrary, in particular continued buying promises profits, for with rising prices the capital gain also rises. The managers who share directly in profit, or indirectly via share options, benefit directly from the increased capital gains. If the 'bubble' bursts, and the value of the financial instruments also falls with prices, managers who receive profit-related remuneration often do not participate in the losses. The misguided incentive, which the Americans call 'heads I win, tails you lose' (opportunity of profit for me, risk of loss for you), is heightened by the fair value valuation and has to be viewed as one of the central reasons for the current financial market crisis, even if it took effect in different circumstances there.

The procyclical effect on the overall economy is intensified by the central role of equity in particular for the business of banks, to a lesser extent, though, also for other companies that also tend to be more creditworthy on the basis of greater equity. With banks equity determines the volume of risk that they may take by issuing loans to companies, but also by making other financial investments. The prices, which tend to rise in times of economic recovery, quickly escalate beyond the fair value of equity and at the same time increased credit capacity increases the scope for action in the rest of the

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[148] Cf. Huerta de Soto, 2009.
[149] Cf. IAS 39.46.
[150] The final version of the wording of the law only provides for an unrestricted time assessment for credit institutes in accordance with § 340e para. 3 of the HGB.

economy. During the downswing, the opposite process of equity reduction and the associated obligation to reduce the volume of credit with the consequence of less scope for action in the rest of the economy start immediately. With the principle of imparity for valuing acquisition costs, on the other hand, the negative chain reaction is not triggered immediately, but only when the statutory reserves deposited during the upswing due to the upper limit for acquisition costs are consumed. As these reserves are distributed across many assets and liabilities, which are affected differently by the downswing, this change does not take place suddenly, but gradually. If the silent reserves are exhausted, though, the process of contraction in the economy is also fed by this kind of accounting. In addition, opinions are divided on whether the fair value valuation or the lower fair value records the changes in value more appropriately, understates or exaggerates the changes or more or less allows manipulation. No one has a patent for calculating the ‘correct’ values.

In recent months, the initial and in part even euphoric approval of fair value valuation has given way to growing scepticism and rejection. Now, doubters, originally almost hopelessly in the minority, are growing in number and in all areas of society that are concerned with the problem. With carefully worded statements, the central banks of Europe and Germany distanced themselves from fair value at the outset, primarily because a valuation based on fair value increases volatility and has a distinctively procyclical effect.[151] In the academic world the number of critical voices is growing both nationally and internationally.[152] Admittedly, the reasons are much more complex and are often argued very emphatically, especially as the critical voices come from the camp of economics and the camp of jurisprudence.

In the business world, objections are rarely worded so clearly as by the ‘Hundred Group’ of leading finance directors, which is influential in Great Britain, and which objects to the excessive costs, the complexity, the difficulty of explaining figures to investors on this basis, the uncertainty on its usefulness for the market and the excessive volatility of results when accounting on the basis of fair value.[153] There were fewer objections to fair value valuation by the banks in public, but they were obviously made all the more effectively to political decision-making bodies. Due to political pressure, the regulations on fair value valuation of financial instruments were almost simultaneously partially withdrawn in the USA, Europe and Japan. They are softened by easier access to estimated values, independent of the market

[151] Cf. for example the European Central Bank, 2004; Zeitler, 2003, p. 1530.
[152] Cf. for example Bieg/Bofinger/Küting/Kußmaul/Waschbusch/Weber, 2008.
[153] *The Financial Times* UK, 30 August 2005.

parameters, and by greater opportunities to reallocate financial instruments to categories that are not valued at fair value.[154]

The objections by auditors are reported in a rather reserved manner but are often well-founded with well substantiated arguments. Hans Wagener (PwC) touched on the core of the problem and perhaps also the timing of the reorientation to the proven accounting principles, when he stated: 'The principle of prudence of customary German accounting will find its way back into international accounting practice in five years at the latest, just with a new Anglo-Saxon term' (translation of original quote).[155] Ernst & Young goes deeply into the problems by looking into the question 'how fair is fair value?' Although the weaknesses of the 'mark to model' in particular are clearly elaborated, the conclusions remain half-baked: fair value should either only be used as a price in active markets or ought to be explained in detail.[156] Small and medium-sized entities in particular would be overburdened by the latter solution. The IDW's criticism of the attempts of the FASB and IASB to reform their basic theoretical concept, the 'Conceptional Framework for Financial Reporting', is surprisingly clear.[157] Although fair value is only mentioned peripherally, the criticism of the IDW, which fiercely attacks the disregard for auditability, the taking of 'financial reporting' away from 'accounting', the suppression of the reporting task by management, the treatment of the cost–benefit relationship merely as a secondary condition and the refusal to investigate any conceptional changes of direction and calls for 'a fundamental revision',[158] rips into the heart of this value, in particular because it warns against the danger of impractical standards and annual financial statements that are no longer auditable.[159]

PwC adds to the discussion with a study which evaluates modern Anglo Saxon accounting by leading experts in the areas of investment and financial analysis from the USA, Canada and Western Europe.[160] The fair value valuation is accepted by the experts surveyed at best for highly liquid financial instruments. The high costs of implementation are also viewed critically, as are the dangers of disguising profit, partially due to free scope with the valuation, partially by

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[154] On this 'race to the bottom' cf. *The Wall Street Journal Europe*, 2 October 2008, p. 23; 20 October 2008, p. 19; 10 November 2008, p. 31; 9 December 2008, p. 21; 3–5 April 2009, p. 17; also *Frankfurter Allgemeine Zeitung*, 15 October 2008, p. 12 and 25 October 2008, p. 19; and *Financial Times Deutschland*, 31 October 2008, p. 27; 3 April 2009, p. 17; 8 June 2009, p. 19.

[155] *Frankfurter Allgemeine Zeitung*, 23 February 2004, p. 16; here you can also find the revealing statement: 'If even finance directors can no longer underststand their annual financial statements, there is something wrong' (translation of original quote).

[156] Cf. Ernst & Young, 2005, p. 2 ff.

[157] Institut der Wirtschaftsprüfer (Institute of Auditors), 2007.

[158] Ibid., p. 7.

[159] Ibid., p. 8.

[160] PwC, 2007.

using the opportunity to derive profits from a fall in credit-rating by devaluing liabilities. 'Investors do not want the accountants valuing companies for them. That's what investors do.'[161] Expert users could not distance themselves more clearly from the concept of fair value static. The circle of sceptics is closed by Jochen Sanio, the President of BaFin. In his speech to greet the New Year on 14 January 2009, he too highlighted the procyclical effect of fair value valuation. In the absence of any willingness in this respect to take notice of the weaknesses of their proposals, there remains only political pressure to make the international standard-setters in the area of accounting review their concepts and make necessary changes.[162]

3. Accounting in accordance with IFRS or IFRS for SMEs in the light of the requirements of SMEs and handicraft enterprises

Proposition 2.2:

The alignment of the IFRS solely towards the information requirements of anonymous financiers in international capital markets contradicts in every respect the accounting requirements for SMEs and handicraft enterprises. Relying on informative results to control the enterprises and on different combinations of disclosure and secrecy, IFRS are no longer suitable for providing them with information. The for them much more important tasks of calculating profit distribution for owners and income taxes can, according to the view which is widespread in literature, in no way be met by IFRS. The views of equity of IAS 32 threaten their existence and show successes in business policy as losses. Independent empirical studies emphatically show that SMEs in Germany recognise the lack of advantages and the threat of the disadvantages of IFRS, as well as the almost always much higher costs, compared to the benefits of IFRS.

Reason:

3.1. Shortcomings of IFRS from the viewpoint of non-capital-market-oriented enterprises and their reasons

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[161] Ibid., p. 9.
[162] Cf. Sanio, 2009; *Frankfurter Allgemeine Zeitung*, 16 January 2009, p. 14.

IFRS concentrate, like their role model and convergence partner US-GAAP, on only one task of accounting. By limiting their perspective to capital-market-oriented companies, they consider the meeting of the information requirements of anonymous owners who provide the risk-bearing capital as representative of the requirements that annual financial statements must meet.[163] Although particularly in Anglo-Saxon countries the capital market is used by many companies, the regulation by the international and current prevailing international standards is geared in a one-sided manner towards major companies. This focus came about because in the USA only the around 13,000 nationally listed limited-liability companies[164] are subject to supervision by the SEC, and the SEC gave the task of developing accounting regulations for these companies to the FASB and its predecessors; its standards also become obligatory almost exclusively by way of the SEC. This is manifest in the composition of the bodies which create the standards. Both the FASB and the IASB are dominated by members who, before joining the Board, were professionally linked to major companies that are known all over the world or the Big Four auditors or their predecessors. Links to SMEs on the other hand, not to mention handicraft companies, and their specific problems remain almost insignificant. This applies even to the board which developed the IFRS for SMEs and thinks it can get by with one (by the way, German) representative for SME business.

Accounting is an instrument. As such, its characteristics, and the regulations which these characteristics should bring about, have to be geared to the tasks and requirements that the accounting has to meet. International Financial Reporting Standards only partly take heed of these fundamental relationships. They do distance themselves from the supposedly completely different requirements of the tax balance sheet, and the transition to IFRS in individual financial statements is often associated with the introduction of solvency tests;[165] the basic concept of ‘full IFRS’, however, despite being geared solely to capital-market information and all its essential elements, which is completely irrelevant for non-listed companies, is to be adopted for SMEs as it stands. Uniformity of regulations in both branches of IFRS and comparability of incomparable circumstances determine the proposals for the additional IFRS for SMEs. However, the questions concerning the tasks that the annual financial statements have to meet for non-capital-market-oriented companies, concerning the characteristics of accounting that are important for these

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[163] Cf. International Accounting Standards Board, 2009, Framework para 10.

[164] Cf. Braun, 2005, p. 138; apart from these few companies registered with the SEC there is practically no accounting information on comapnies available in the USA, as shown clearly by Siegel, 2007, p. 102 ff.

[165] Cf. in particular Rammert, 2008.

companies, the reasonable degree of splitting into different branches of accounting, and above all the relationship between costs and benefits of special IFRS for these companies, have not been considered at all. The fact that they are not geared to the accounting requirements of SMEs and handicraft enterprises is, along with the distinct weaknesses of the basic fair value concept, the main reason why IFRS are not suited at all to non-capital-market-oriented companies.

3.2. Requirements of SMEs and handicraft enterprises of accounting for information purposes

Companies, whose external accounting is not primarily used for the wide and fair information of the market, place other requirements on accounting for information purposes. If they, as is the case for handicraft enterprises for example, due to their small size can only concentrate on a basic calculation for information, this has to enable various degrees of insight. Deep insight for the company's own management, and where necessary also for important financiers, mark one extreme and limited insight for the public the other. As annual financial statements for small, comparatively homogeneous and therefore comparatively transparent companies allow more conclusions on the factors for success than they do for major companies, the possibility of different degrees of secrecy plays a much greater role, especially as this is not faced by any requirements for equal and fair treatment of all market participants. International Financial Reporting Standards (IFRS) do not meet these requirements. The legislator points this out clearly in the general part of the government's reasoning for the draft of a law to modernise accounting (BilMoG). The legislator addresses the risk 'that, due to the detailed degree of IFRS, data which is of interest to the competition has to be disclosed';[166] this 'however, can result in the existence of SMEs being threatened' (translation of original quote).[167]

While the owners and management of SMEs and handicraft enterprises are normally one and the same, the activity in their own company for the most part also provides the basis for the income of the owners and their families. Therefore, the degree of success of this activity becomes the focus of interest. This is not so much as to estimate the potential of future consumption, but rather to recognise the consequences of their policy to date and, where necessary, to receive indications of any necessary changes. As the focus is on

[166] Bundesrat printed document (344/08), p. 70.
[167] Ibid., p. 71.

the successful continuation of the business, and not on capital gain from a sale which, in view of the close tie with the management, would be much more difficult and costly, the new asset-orientation of IFRS from its general direction alone would only be suitable in exceptional cases: these are when SMEs are taken over by private equity investors with the goal of being able to sell them again within a clear time-frame at a profit after improving the business policy. The exception, in which the balance sheet concept of IFRS geared towards assets and asset growth corresponds with the business concept of a private equity investor, is rarely suited to typical SMEs and handicraft enterprises.

In addition, SMEs and handicraft enterprises have to have elementary accounting requirements, in order to be able to meet them with their resources. The accounting regulations should be as clear and simple as possible. If complex elements cannot be avoided, the knowledge should at least be spread in such a way that a small circle of highly paid experts does not have to be used to acquire it from them. Changes in regulations make adjustments necessary or result in a need for consultation. It is therefore particularly in the interest of SMEs to reduce such changes to the absolutely necessary ones. Ultimately, the accounting accommodates SMEs and handicraft enterprises when it does not expect them to deal with theoretically sophisticated ideals, such as an as accurate as possible report, and does not demand its implementation with ‘professional judgement’. The ultimately responsible entrepreneurs themselves have hardly the time and expertise to meet such requirements, but are at risk of being held accountable for misjudgements. Operational specifications of rules-oriented accounting regulations accommodate them much more easily. International Financial Reporting Standards, as principle-oriented, complex and dynamic accounting standards that are geared to prevailing theory and therefore review by major consultants and auditors, and that on top of this are only familiar to a small minority of experts, are diametrically opposed to these requirements. The legislator clearly conceded this in the reason for the government draft for a law to modernise accounting law, when it declared: ‘In addition, SMEs cannot be expected to switch from the established, simple and low-cost commercial law accounting to IFRS for cost reasons alone’ (translation of original quote).[168]

3.3. The lack of suitability of IFRS as a basis for assessing income taxes

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[168] Ibid., p. 70.

Due to the essential demand for taxation of all citizens and companies according to their ability to pay, it is necessary to measure this ability to pay for companies in a suitable way. If we disregard relief for those who neither dutifully nor voluntarily keep books in line with commercial law regulations, the ability of tradespersons to pay is assessed by calculating the balance sheet profit in line with tax law. This applies to partnerships and limited liability companies at any rate. Therefore, the necessity of determining profit in line with tax law, which is basically given for SMEs and handicraft enterprises, when changing from HGB to IFRS moves alongside accounting for information. The additional cost for tax as well as IFRS accounting depends on the consistency of the requirements placed by tax law and IFRS on the figures required and the composition of their rules. Tax law and HGB have in the past been harmonised to a large extent. Beyond the authoritativeness of commercial law principles for tax balance sheets, which are used all over the world in important economic nations,[169] the relationship between the two was also characterised by a formal authoritativeness of decisions in the commercial balance sheet for the tax balance sheet and by rights to adopt purely tax values in the commercial balance sheet. Even if the recently addressed 'reverse authoritativeness principle' should fall with the act to modernise accounting law and the number of differing regulations in commercial and tax law has increased in the last ten years, a large area of commonalities remained, which made separate accounts unnecessary. With a change from HGB to IFRS the situation fundamentally changes. The requirements of IFRS and tax law on accounting are so fundamentally different, that a very costly, almost continuous double accounting is necessary. As each system generates fixed and variable costs, this duplication of accounting hits SMEs and handicraft enterprises particularly hard.

The IFRS make a clear distinction in the foreword to the Framework by not including the determining of tax bases in the large sphere of possible tasks in the accounting influenced by them, and only allow other accounting requirements, particularly those of the state, if they are used for information purposes in the accounts. The opposite possibility, of adopting IFRS to determine the tax base, puts the process of creating these standards up against insurmountable obstacles. International Financial Reporting Standards are created by a private panel of experts. Regulations for calculating tax bases, though, which interfere in an authoritarian manner in the rights of citizens, may not be determined by private persons. They require, rather, for reasons under constitutional law and due to the principle of legality of taxation, legitimation by democratic bodies, in particular parliaments, or by the responsible courts. The

[169] Cf. Sigloch, 2000, p. 163 ff.

idea of basing the tax balance sheet across the board on IFRS as the governing regulations would be completely out of the question. International Financial Reporting Standards are permanently being adjusted by the IASB for changing conditions. Specifying IFRS as the governing regulations before their precise content is determined would be a carte blanche for a private body to shape the central details of taxation as they see fit. If the responsibilities are turned upside down, so that ultimately parliaments and courts decide on the content of IFRS for receiving the necessary legitimation to be used to calculate tax bases, IFRS lose their central character as specialised standards. If IFRS are no longer created independently of political influence, solely with regard to the best objective solution, they lose the trust in their exclusively objective regulations. In view of the political fragmentation of the world and the many regional parliaments and courts, there would also be different IFRS in various forms with only regional relevance. The particular claim of providing worldwide standard accounting regulations, and therefore the characteristic which helped IFRS to break through on all continents would be lost.

Not only responsibilities for regulation are inconsistent with the requirements of tax law, but also the regulations in detail. Based on the principle of 'Tatbestandsmäßigkeit' (distinguishing between the elements of the offence), the tax bases have to be produced by specific, justifiable standards and cannot be left largely to the discretion of the company reporting the accounts, or even have the proviso that if there is a threat that the law on fair presentation is broken, all specific standards have to be left out. Approach and valuation regulations are not suitable for a tax balance sheet because the special treatment of agricultural business in IAS 41 and of broker traders in IAS 2.3 (b) is as inconsistent with the law of equal treatment as the option where the revaluation of tangible and intangible assets does not affect profit or loss in IAS 16 and 38. Completely unacceptable for a tax base are the numerous violations by IFRS of the principles of congruence. Profit and loss statements are congruent, if the sum of the period profit and losses across the whole life of a company correspond with the total payments surplus or deficit for this company. Violations of congruence mean, therefore, that profits are never taxed or taxed twice, which, from the viewpoint of the tax authorities or the taxpayer, in any case, though, from the viewpoint of tax justice, cannot be accepted. Profits in the amount of the fictitious expenses for real share options of managers in accordance with IFRS 2 remain untaxed and profits that have not been generated are taxed, when actuarial losses relating to retirement pension commitments made to employees, which have previously not been considered, are reported in equity and do not affect profit or loss in accordance with IAS 19.93 A to 19.93 D.

The above inconsistencies are emphatically confirmed by the draft of a law for determining taxable profit (StGEG) from the pen of the ‘Kommission Steuergesetzbuch’ (Tax Code Commission) under the umbrella of the Stiftung Marktwirtschaft’ (Foundation for the Market Economy) of 17 May 2006.[170] Although the draft, which uses IAS/IFRS as its starting point, should guarantee the greatest possible proximity to international developments in accounting, hardly any regulations from these standards are included in the provisions. The economic good remains instead of changing to an ‘asset’; intangible assets are only valued if they were acquired against payment or are destined for sale; the strict realisation principle is held onto; abandoning any fair value valuation, likewise comprehensive imparity, is also held onto; when purchasing replacements hidden reserves may be transferred, while actuarial profits and losses may only be recorded on a deferred basis within limits; ultimately, there are no violations of congruence and of maintenance of nominal capital.[171]

The separate calculation of the tax base, which is required when the commercial accounting is based on IFRS, not only produces a second independent tax balance sheet, but also makes it particularly time-consuming and expensive to prepare the commercial balance sheet. So long as the commercial and tax balance sheets, according to commercial law before the modernisation, are still largely consistent, the income-tax expenses transferred from the tax balance sheet to the commercial balance sheet only require slight modification with deferred taxes. This requirement increases drastically if the commercial balance sheet is uncoupled from the tax balance sheet, for instance if it is based on IFRS instead of HGB. Küting and Zwirner investigated the practical importance of deferred taxes in the consolidated financial statements of listed German companies in 2001 or 2000/2001, when the exemption clause of the then § 292a HGB tolerated consolidated financial statements in accordance with IFRS and US-GAAP as an alternative to those in accordance with HGB. Only companies that had rendered accounts in accordance with IFRS or US-GAAP, but not in accordance with HGB, appear in the three tables, which show the 10 companies with the greatest ratios for deferred tax assets to equity, deferred tax assets on losses brought forward to equity, or deferred tax revenue to consolidated annual profit.[172] The ratios that were stated peaked at almost 29 times and 16 times equity respectively and five times the consolidated annual profit. The task of calculating deferred taxes of this size and importance places great demands on the companies producing the accounts. Particularly SMEs and handicraft enterprises are overburdened by this task and require external support.

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[170] Kommission Steuergesetzbuch (Fiscal Code Commission), 2006, pp. 2, 4 f.
[171] Cf. ibid., pp. 4, 7, 8 f., 11, 13.
[172] Cf. Küting/Zwirner, 2003, pp. 308, 309, 311.

3.4. Consequences of the inability of IFRS to calculate payouts to the owners

In a market economy personal liability or equity not being paid out at random to the owners provides the necessary counterbalance to the right of the owners to determine the company's policy. The opportunities that are to be expected if the business performance is positive have to be opposed by the risk of being financially responsible for losses in value, if the business policy fails. The current discussion on the too low equity base of many banks and the problems of state rescue programmes in view of the future policy of the banks clearly shows the importance of this relationship.

The task of where applicable making owners take a share in the risks that have occurred by limiting the payouts to which they are allowed is currently performed in Europe largely by capital maintenance restrictions for the balance sheet. Only profits generated on the basis of fundamental imparity-based, prudent accounting and valuation may be paid out to owners without negative consequences for their personal liability. Capital maintenance and prudent profit calculation are no longer undisputed. With IFRS the role of calculating payouts takes a back seat, if it is considered at all seriously.[173] The secondary role of calculating payouts within the scope of IFRS and the apparent inability of these standards, which are being more widely used all over the world, to perform such tasks, have fuelled the fundamental doubts in capital maintenance. Critics consider the traditional capital maintenance to be unsuitable for protecting creditors, a detrimental hindrance to the free allocation of equity, and a stumbling block for the worldwide spreading of IFRS. Remarkably, however, they do not advocate replacing the previous method for calculating payouts, using balance sheets according to HGB, with one based on IFRS balance sheets, but propagate information with IFRS and solvency tests to protect creditors.[174] Insight into the lack of suitability of IFRS for calculating payouts corresponds both with the great shortcomings of these standards for calculating verifiable and performance-based tax bases and with a telling verdict by the legal expert Ekkenga. In his view 'IFRS financial statements are not only less than optimally equipped for the task of calculating payouts, they are totally unsuitable' (translation of original quote).[175] As the unfortunately only partial confession of weaknesses of IFRS accounting is associated with the claim of being able to protect creditors more efficiently with information and solvency tests, these reform ideas also have to be reviewed

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[173] Cf. International Accounting Standards Board, 2009, Framework preface letter (f).
[174] Cf. Rammert, 2008, p. 430 f.
[175] Ekkenga, 2006, p. 395.

from the viewpoint of the SMEs and handicraft enterprises and compared with the previous supposedly inferior protection of creditors.

Information protects creditors insofar as it makes them aware of the supposedly increased risks relating to the planned policy of the recipients of their credit. On this basis, creditors can then decide whether they grant credit and what risk premium they have to demand. To the extent provided for in the contract – and complete foresight of all eventualities is only possible in a theoretical world – creditors can, where applicable, also adjust their credit conditions and collateralisation to the improved information. The best information, though, does not protect them from owners or managers acting in their interest being able to use a lack of payout restrictions in order to always reduce the financial commitment of the owners, whenever this promises to benefit the owners. Such benefits for the owners are not only always at the expense of the creditors, but can completely devalue their position. 'Consequently, without payout restrictions there would be no borrowed finance' (translation of original quote).[176] This clear rejection of creditor protection based solely on information is now, for all the remaining differences concerning the details, undisputed in the academic world. From the viewpoint of the SMEs and handicraft enterprises it is established that a change from HGB to IFRS is not possible without an additional statement to limit payouts to the owners. The IFRS financial statements have to be supplemented either by an additional balance, which is frozen for payouts along the lines of the HGB, or by solvency tests. The accounting costs would rise yet again due to the requirement for an additional statement to limit the payouts to the owners.

The question concerning the characteristics of solvency tests compared to capital maintenance in the balance sheet is asked not only in relation to the possible change from HGB to IFRS. In Europe an independent discussion has started on reforms that may possibly be required if creditor protection is legally regulated. The EU Commission, which has obtained several reports on this issue, is reviewing a change to solvency tests and in this respect has put the second EC directive, which to date has been relevant for capital maintenance, up for discussion. Should this directive be reformed this year as planned, solvency tests can in future gain in practical importance, irrespective of the scope of IFRS for SMEs and handicraft enterprises.

Solvency test tie in with the payout restrictions in American law, where they admittedly were able to gain so little trust from creditors, that comprehensive individual credit agreements (covenants) were much more usual there than here. Payouts are forbidden by law in the USA when they result in insolvency

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[176] Ewert, 1986, p. 66.

or over-indebtedness. The solvency tests currently being discussed combine these two approaches with two regular hurdles – in each case a finance plan and in part supplementary accounting ratios with regard to capital maintenance.[177]

Ongoing financial planning is therefore an essential element of limiting payouts with solvency tests. Within the scope of the financial plans that are to be prepared for two years into the future, the payouts that are then contemplated are to be reviewed as to whether they threaten to make the company insolvent in the period under review. The payout is prohibited if such a threat is faced. What at first sight appears to be a plausible procedure loses its appeal when it is considered that it is based on planning, and mortals cannot see into the future. The far-reaching consequences therefore tie in with a plan which can only be prepared with the greatest uncertainty and courageous discretion. With regard to the necessity of having to justify the chosen assumptions and forecast procedures in the case of an emergency in court, expectations would play less of a role in the planning than the possibility of having to justify them at a later date. A preparatory document of convincing arguments for forecasts and assumptions and the search for experts who, in the event of disputes are prepared to confirm the figures used by the company as appropriate, become, according to the experiences of such payout restrictions in the USA, the focus of attention.[178] In the process, the companies are threatened with disaster, regardless of whether their estimates are optimistic or pessimistic. If the liquidity is valued ‘generously’, there is the threat of the obvious charge of consciously favouring shareholders over creditors. Overcaution, on the other hand, is not disadvantageous only for the owners, by limiting the payout to them; above all, it sends signals of lower liquidity to the capital market. If, as a result, there are no payouts to the owners, the impression of tight liquidity or even the threat of illiquidity could be given, which may further tarnish trust and in extreme cases result in insolvency. It is difficult to judge with hindsight, particularly in the light of the latest development, whether the forecasts included in the financial plan may have occurred due to unfavourable environmental developments or due to deliberately distorted assumptions and expectations. While manipulations of forecasts in favour of excessive payouts though have to be sanctioned, the honest unlucky individual faces far greater risks than the lucky window-dresser, in particular if the latter has taken precautions with broad documentation and precautionary agreements with willing experts. These dangers are very real. It is a popular view that solvency tests need to be supplemented by a solvency declaration,[179] in which the

[177] Cf. Institut der Wirtschaftsprüfer (Institute of Auditors), 2006.
[178] Cf. Kuhner/Sabiwalsky, 2006, p. 512 ff.
[179] Cf. Institut der Wirtschaftsprüfer (Institute of Auditors), 2006, p. 6.

management stands behind its financial plan and practically assumes liability for its content. While the managing owners of SMEs cannot receive any payouts without the risk of later liability, at best, those creditors are protected whose entitlement will be due in the next couple of years and are therefore included in the financial plan.

In order to prevent payouts which, when taking into account the longer-term liabilities as well, would cause over-indebtedness, the financial plans strengthened by liability need to be supplemented by a statement to secure a minimum level of equity. Often, as for example in the proposals by the IDW for redesigning capital maintenance and for calculating payouts of the 11 September 2006, a 'financial status', with a comparison broken down by liquidity or by maturity of financial resources and liabilities, is required to check the plausibility of the financial planning.[180] While the statement to secure the minimum level of equity is therefore not cut, further cost-driving supplementary statements are added. If they are required in the individual case to enable a credit agreement, they may be entered into contractually. As a legal requirement for all companies, though, they overshoot the objective by far.

Compared to solvency tests, classical capital maintenance only has advantages. It is simple and produces largely reliable payout entitlements, even if they only provide the creditors, like all of their competitors, with imperfect protection. The objections previously presented in the literature of the supposedly dark sides of prudence can be refuted. In the contractual credit agreements in the USA, restrictions similar to capital maintenance are voluntarily agreed not only with a structure close to our previous payout limit, but also with modifications to the approach and valuation regulations, for which applies: 'All the variations from GAAP are consistent with conservatism.'[181] In the process, solvency tests cannot do without capital maintenance anyway. And the capital maintenance hardly allows payouts in the event of threatened insolvency under current law. In this case, valuation has to switch to liquidation values, which for the most part drastically reduces equity. All signs are therefore against the usefulness of changes to the current method for calculating payouts on the basis of prudent balance sheets, whether this is in relation to the change to IFRS or in comparison with the fashionable solvency tests.

3.5. The from the viewpoint of SMEs and the overall economy questionable views of IFRS on equity

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[180] Ibid., p. 5.
[181] Watts/Zimmerman, 1986, p. 214.

The existence of SMEs and handicraft companies is threatened by the highly strange ideas of IFRS to part from equity and borrowed capital and to value the assets of shareholders in the balance sheet, if these are viewed in line with the absurd ideas of the IASB as borrowed capital. Although the IASB acknowledges the problems itself in updates of June 2004 and July 2004 by admitting 'apparently anomalous accounting',[182] its numerous attempts to find a solution have so far been unsuccessful. The problematic ideas about what features characterise equity are responsible for this.

In consistence with our traditional ideas, equity is also characterised within the scope of IFRS by its fundamentally subordinate residual claim for creditors and by its in principle indefinite tie to the company. The role of liability is viewed completely differently, though; it is not considered at all, for example, when a partner, after leaving an oHG (general partnership) or KG (limited partnership) is liable in accordance with §§ 159 para. 1 and 161 para. 2 of the HGB for a further 5 years for the company's debts. The most important difference, though, is that IFRS view claims of individual shareholders or minority shareholders to payments from their company as completely inconsistent with the status of equity (IAS 32.17 and 32.18 [b]), while granting the majority of shareholders and the company management used by this shareholder majority complete freedom with the payment of dividends, repayment of capital and buyback of equity shares. The capital of a partner who can terminate his share but then has to be liable for a further 5 years to shareholders, has to be reported as borrowed capital in the balance sheet, irrespective of the probability of such a termination. The reporting of capital as equity does not acknowledge that the majority of partners either decide themselves or get their company's management to decide to make payouts up to amounts which threaten illiquidity, without assuming any liability towards creditors, although this can set them back to a residual claim. With its understanding of equity, the IASB meets the interests of private equity companies, which, in 2005 (according to a report in the FAZ newspaper, dated 12 April 2006, p. 25) were allowed to withdraw 77% of the equity they employed within 20 months (64% in 29 months the previous year) without losing the preferred status of equity. German partnerships, on the other hand, lose their equity completely on the basis of this understanding, although liability in the event of redundancy continues, and German cooperatives lose at least the business assets and redundancy reserve as part of the equity. The suggestion in the literature that the problem can be easily resolved with a general change to the legal form of the public limited company,[183] in view of the threatened disclosure obligations, from the

[182] International Accounting Standards Board, June 2004, p. 4 and July 2004, p. 2.
[183] Cf. Rückle, 2008.

point of view of the SMEs and in particular the handicraft enterprises appears, to put it mildly, to be adventurous.

The loss of equity due to the dictate, in the event of claims for payments by individual holders of such capital of having to report this capital as borrowed capital, describes only one part of the problem. Almost even more threatening are the ideas of the IASB for valuing such ‘borrowed capital’. In accordance with SFAS 150.22 from the USA the IASB has prescribed in an update of July 2004 a valuation with the ‘net asset value owed to the shareholders’, i.e. the capitalised earning power, which is adjusted annually in the income statement for the changes in value which have since occurred.[184] The consequences of this can only be described as disastrous for the reporting of profit. If the owners of this ‘borrowed capital’, who, as shareholders of an oHG (general partnership) for example continue to be obligated to the management, succeed with a clever business policy in increasing the value of the company, then, according to IFRS, a loss in the amount of the increase in value has to be reported. In the balance sheet according to IFRS the value of the borrowed capital has, namely, increased in this case and an increase in liabilities results in losses. Conversely, the company has to report a profit if the management has to accept a decrease in the company value due to a poor policy or an adverse environmental development, for under IFRS the value of the liabilities falls in this case, which results in a profit.[185] The confusing reporting of capital, whose value is oriented towards the value of the company, as borrowed capital and of changes in the value of such capital with ‘incorrect’ signs in the profit and loss statement can be qualified by highlighting and describing the capital in accordance with IAS 32.18 (b) as ‘inventory value per share’ and the effect on profit as ‘change in the inventory value per share’; however, only the profound connoisseur of the matter may see through this confusion.

The economic danger of such accounting is threatened by the misunderstandings which it causes. For example, a partnership that attaches to a request for a loan a balance sheet, in which not only equity, but massive over-indebtedness is reported because the company promises to provide high future profits, threatens to be judged badly. On the other hand, a less promising partnership appears to be more creditworthy because it has amassed fewer debts. Limited liability companies make a better impression because they at least have equity. If the banks do not succeed in correcting this ‘apparently anomalous accounting’ and get an unadulterated view, the

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[184] Cf. International Accounting Standards Board, July 2004, p. 2 f.

[185] Precisely this effect caused the worldwide deplored profits, in particular of banks, which were due to the devaluation of their own debts; for example in the amount of USD 2.7 billion in the first quarter of 2009 at Citigroup (*Financial Times Deutschland*, 8 June 2009, p. 19).

accounting in accordance with IFRS contributes decisively to the misallocation of credit capital, to the detriment of productive companies and the overall economy. At the same time, it not uncommonly encourages irresponsible practices of private equity companies which, by massively repatriating equity, can evade the negative consequences of their policy.

On 14 February 2008 the requirements that the IFRS places on the reporting of equity, if this capital is 'callable' and furnished with a return option, were softened, but they further narrow the scope considerably. Only instruments of the most subordinate class, which allow claims to the full residual assets (with which the in practice widespread compensation clauses cannot be reconciled) and which do not trigger any other contractual obligations concerning payments by the company, are recognised as equity. Differences in capital also continue to be sanctioned in this way, as does the continuing liability because it does not play a role.

3.6. The surprisingly profound knowledge of IFRS among SMEs

The change to accounting along Anglo-Saxon lines was triggered in Germany on 5 October 1993, when Daimler-Benz listed its shares on the NYSE during the takeover of Chrysler, in order to use them in exchange for Chrysler shares. In doing so, Daimler-Benz was the first German company to accept the requirements of SEC, including accounting in accordance with US-GAAP. So many major companies in Europe followed this example, that US-GAAP's process could only be stopped by Europe siding with IFRS, which at least promised to maintain a remnant of European tradition. The merger between Daimler and Chrysler failed with huge losses. A large number of the European global players who list their shares on the NYSE regret their decision to do so; the consequential costs are for them much higher than the benefits. Many are trying to withdraw from the American stock exchange. The accounting revolution triggered by Daimler-Benz in 1993 was, therefore, at least partly based on incomplete information.

Based on all available relevant research on the knowledge of SMEs of the characteristics of IFRS, there is a comparatively profound knowledge from which appropriate conclusions can be drawn. This should be proved based on selected results of two surveys of German SMEs: the 2005 survey by DIHK and PwC on International Financial Reporting Standards (IFRS) in SMEs (Study 1)[186] and the 2007 survey (Study 2) by the BDI, DIHK, DRSC and the faculty of Financial Accounting and Auditing of the University of Regensburg

[186] DIHK and PwC, 2005.

on the draft of an international standard for the accounting of Small and Medium-sized Entities (ED-IFRS for SMEs).[187]

The first study shows, based on 600 companies which took part in the survey,[188] that 58% of the respondents have looked into IFRS, 18% of these companies, and therefore around 10% of the respondents, are planning to change over to or prepare additional financial statements in accordance with IFRS, and 8% have already changed over. Conversely, 36% had no contact with IFRS and 79% also do not see any specific need for such a changeover or addition.[189] The second study, based on 410 questionnaires analysed from 4,000 sent out,[190] confirms the picture in the respect that, here, 68% signal no need or only a small need and 12% a high or very high need.[191] In summary, 16% are considering using IFRS for SMEs, while 70% reject them, of which 83% on the other hand prefer HGB and 10% the 'full IFRS'.[192]

After the practical-based and academic literature has propagated time and again in recent years the supposed benefits of harmonised international accounting on the basis of purely objective standards – by way of example Part D of Study 1 once again summarises these arguments without any proof of their justification[193] – the sober, and in the view of the author sound, judgement of SMEs is surprising. The percentages put the supposed benefits of accounting in accordance with IFRS tellingly into perspective when one is made aware that for x% of the companies which see the respective benefit, precisely 100 - x% doubt the existence of this benefit. Precisely this doubt, though, deserves respect, even if it conflicts with an almost overwhelming trend and actively conflicts with literature and the interests of consultants. Companies can only inform themselves with the largely predominantly positive-to-exuberant literature and meetings with consultants, who, if there is any doubt, will advise in favour the IFRS because a lucrative transaction beckons.

In **Study 1** the following possible advantages are expected:

by 47%: better reporting of the net assets, financial position and results of operations

by 30%: borrowed capital easier to procure

[187] Haller/Eierle/Beiersdorf, December 2007.
[188] DIHK and PwC, 2005, p. 32.
[189] Ibid., p. 27.
[190] Haller/Eierle/Beiersdorf, 2007, p. 2 f.
[191] Ibid., p.13.
[192] Ibid., p. 51.
[193] Cf. DIHK and PwC, 2005, pp. 18–26.

by 19%: positive rating effects

by 12%: easier access to national and international capital markets

by 5%: easier access to alternative financing (e.g. mezzanine capital,

by 14%: advantages in international competition

by 8%: improved presentation for customer acquisition

by 6%: help when looking for foreign partners

by 13%: advantages when selling the company

by 22%: easier internal and external reporting[194]

In the same study the following disadvantages are expected:

by 79%: substantial changeover and consequential costs

by 48%: high complexity (and frequent changes)

by 18%: transparency of external reporting too high

by 11%: other reasons – particularly double accounting[195]

The second study does not directly enquire about disadvantages and advantages of IFRS, but seizes on important specifics of IFRS and asks the companies to assess the benefits and costs supposedly associated with adopting the respective specific. Possible ratings were mainly 'lower', 'the same', 'higher' and 'assessment not possible'; or 'none to low', 'average', 'high to very high' and 'assessment not possible'. If, for simplification purposes, only the respective shares of the ratings 'higher' or 'high to very high' for the expected benefits for external addressees and for internal information and control purposes on the one hand, and for the expected costs on the other are compared, this produces an enlightening picture, where, in the view of companies, the percentage increases in costs are almost without exception greater than the increases in benefits. The exceptions are identified in bold print. The following table evaluates all of the partial results of the study, which include data on benefits and costs.[196]

IFRS specific and the figure no. in **Study 2**	Benefits higher in %		Costs higher in %
	external	internal	

[194] Ibid., p. 28 f.
[195] Ibid., p. 30 f. with appropriate short comments by the companies.
[196] Haller/Eierle/Beiersdorf, 2007, pp. 25–45.

Re-evaluation of tangible assets when market prices exist (29)	52	54	48
Ditto for estimates of a market price (30)	23	20	58
Re-evaluation of intangible assets (32)	36	31	64
Capitalisation of development costs (35)	41	36	58
Depreciation by component instead of standard scheduled depreciation (39)	19	27	74
Special treatment of 'tangible assets held for sale' (40)	52	33	56
Obligation to report deferred taxes in the balance sheet (41)	30	27	54
Ditto, but assessment by persons with a good to very good knowledge of IFRS (45)	49	49	63
Profit realised in accordance with improvement in performance (46)	51	53	68
Pension reserves with performance-oriented pension schemes (47)	35	29	51
Ditto, but assessment by persons with a good to very good knowledge of IFRS (48)	43	41	62
Obligation to use total cost approach (51)	32	30	40
Evaluation process for raw materials and supplies limited (52)	19	13	14
Obligation to discount provisions (53)	25	18	53

Overall, both studies confirm in unison the great reservations of SMEs concerning both the 'full IFRS' and the IFRS for SMEs, which were already apparent for IAS from a study by Gießen-Friedberg University of Applied Sciences in cooperation with the Central Hesse Chamber of Commerce and Industry (FAZ newspaper, 13 January 2003, p. 19).

4. IFRS for SMEs – a contribution towards solving the problems of SMEs and handicraft enterprises?

Proposition 2.3:

IFRS for SMEs were created because 'full IFRS' are not suitable for SMEs and handicraft enterprises. This shortcoming can in no way be resolved, however,

only by reducing the rules to a few core statements while fully maintaining the concept of 'full IFRS'. In this manner, IFRS are not fully adapted to the different needs of the SMEs. The true scope for the regulations only appears to be reduced, for only the 'full IFRS' make the content and spirit of the concept, which is only outlined for SMEs, in the IFRS understandable; 'mandatory fallback' arises from the decision to hold on to the very specific concept of 'full IFRS'. The improvements promised by the IASB are mostly non-existent or disadvantage the SMEs: they are refused options, disadvantageous reports become mandatory or rules with shortcomings are specified. Because the notes in financial statements provide a much deeper insight for SMEs, they will, if anything, be more heavily – rather than less – burdened by the only moderate reduction in 'disclosures'.

Reason:

4.1. Prospects of relief from IASB with IFRS for SMEs

The draft IFRS for SMEs addressed above, which formed the basis of the second empirical investigation in part 3.6 of this document, has now been succeeded by the final standard 'IFRS for SMEs', which was passed in June and published in July 2009.[197] The new standard should establish accounting which is tailored to the special needs of SMEs. In the view of the IASB, this was already the case in the draft of February 2007 for several reasons:

- It comprised only 254, instead of now 2,749 pages (IFRS 2009 without Glossary of Terms and Index).
- It summarised in one standard and in a systematic order the guidelines which were otherwise scattered across several standards.
- It was limited to the in the view of the IASB relevant aspects and procedures for SMEs.
- Finally, the draft was already formulated in line with the will of its creators in such a way that mandatory fallback on 'full IFRS' is not necessary.[198]

The final standard appears to the IASB to be further improved:

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[197] International Accounting Standards Board (2009a).

[198] According to Pacter, 2007, p. 330. Paul Pacter was responsible for leading the project IFRS for SMEs at the IASB.

- In their view the standard has been developed into a ‘stand-alone document’, not least because the references to ‘full IFRS’ were eliminated.
- It was in many cases reduced to ‘simple’ representations; forms, options and basis for recourse to individual ‘full IFRS’, which were viewed as costly, were removed – the latter admittedly only with the exception of IAS 39.
- Issues such as asset sales and discontinued operations were eliminated, reporting requirements reduced, and the burdens arising from the necessity to update the standard alleviated.

Whether the new standard meets the different requirements of the SMEs and handicraft enterprises, compared to capital-market-oriented companies, will have to be reviewed as carefully in the following, as the substance and background of the improvements, which were published together with the draft of the standard in a Fact Sheet when the final version was published.

4.2. Alignment of IFRS for SMEs towards the old concept, which is unsuitable for SMEs and handicraft enterprises

Although the IASB knew the complexity of ‘full IFRS’ and their lack of suitability for SMEs – otherwise it would not have created special IFRS for SMEs – it has not been able to decide on an independent, different approach for this new standard. Section 2 picks up without question the proposition of the primary task, to inform a wide circle of users on a general and not on a needs-specific basis. This viewpoint, which is understandable for capital-market-oriented companies, is in no way suitable for SMEs and handicraft enterprises. It is not only this incorrect principle which is adopted, but also all of the significant consequences derived from this for the principles and basic rules of accounting. The desire for uniformity in the fundamental characteristics and for comparability of the accounts produced was, according to the project manager of IFRS for SMEs, decisive for this change of course.[199] He summarises the result himself: ‘It is not justifiable to talk of a “separate set of rules or framework for SMEs”’ (translation of original quote).[200] With the assertion of the ‘stand-alone document’[201] by the IASB in the Fact Sheet of 9 July 2009,

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[199] Cf. ibid., p. 328 f.
[200] Ibid., p. 329.
[201] International Accounting Standard Board, 2009b, p. 4.

the Board therefore contradicts the view of the manager responsible for the project. In the following section additional arguments are mentioned which support the view of the project manager.

The fact that the basic concept of IFRS does not apply to SMEs has already been proved in detail. SMEs and handicraft enterprises do not have anonymous financiers in financial markets who require standardised information with annual financial statements. In this respect, the comment by the project manager, according to which IFRS for SMEs free the way for borrowing capital in international and national markets,[202] is evidence of a certain ignorance of the financing problems of SMEs and handicraft enterprises – at least in Germany and in the current situation. They know their financiers and need tailored information for each important stakeholder. Also, the focus of possible tasks for annual financial statements for SMEs and handicraft enterprises is not on capital market information, but on assessing the profit that can be paid out and taxable profit. Often they even have to meet their obligations to provide information by submitting the tax balance sheet.

The adoption of the basic concept of ‘full IFRS’ in the IFRS for SMEs is particularly unsuitable primarily due to another reason. It aligns the annual financial statements according to IFRS entirely without compromise solely with the information function, which is irrelevant for SMEs. Therefore, huge resources have to be placed in an accounting system that is completely unsuitable for SMEs and handicraft enterprises, and further resources in separate balances, which are frozen for payouts, tax balance sheets and, due to the lack of suitability of IFRS for control purposes, cost accounting. IFRS for SMEs, though, as did their role models, place insurmountable obstacles in the way of the ‘multifunctional balance sheets’, which are desirable in the view of SMEs and handicraft enterprises and which were used in Germany in the form of the ‘Einheitsbilanz’ (standard balance sheet). The use of private bodies to create rules and numerous violations of the requirement to report profit neither incompletely nor in some parts twice mean that the resulting financial statements cannot be used for payout and tax-assessment purposes.

As will be shown in the following, the detailed modifications made to IFRS for SMEs vis-à-vis ‘full IFRS’ can also hardly be justified by the aim of adapting to the special needs of SMEs and handicraft enterprises. Other motives explain the events much more convincingly.

4.3. Consolidation of the regulations a disadvantage for SMEs

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[202] International Accounting Standard Board, 2009c, p. 3.

The Anglo-Saxon accounting standards establish independent rules and principles, which deliberately break from the previous widespread, but viewed as outdated, traditions. Their creators see themselves as determined reformers who, if need be, temporarily make compromises in the interest of wider acceptance. Supported by modern financing theory, which admittedly has largely lost its old lustre in the recent scandals and crises, they want to help an accounting system that improves market efficiency to become established. The complete realignment of the approach for annual financial statements from reporting profit to reporting assets, based on a broadened understanding of assets and ongoing real-time valuation, is evidence of the willingness to follow the theories viewed by the IASB to be correct, even if old taboos have to be radically broken.

The in part revolutionary reform concepts of the IASB have to be implemented by a large number of financial officers, consultants and auditors in annual financial statements which conform with the rules. For this purpose the new and continually improved principles and rules need to be conveyed in both an understandable and comprehensive manner. This is the case not least of all because, with the revolution, the previous rules, principles and traditions are considered to be largely unusable, and the accounting world, therefore, has to be completely re-established. Comprehensive standards with principles in bold print and explanations in normal print, with application guidances, a basis for conclusions, appendices and illustrative examples alone are not enough, as the comments, international accounting journals and textbooks prove. Only on this basis can the concept of all IFRS be understood, implemented, audited and vitalised. If this were possible without the comprehensive reporting of ‘full IFRS’, these could be consolidated in a few pages like the IFRS for SMEs. The ‘full IFRS’ were consequently only composed in detail because the IASB rightly considered this to be necessary. Without recourse to these comprehensive presentations and explanations of the specific IFRS accounting concept, the IFRS for SMEs cannot be implemented. Therefore, the removal of the references to ‘full IFRS’, which were still found in many sections of the draft for this standard, only changes the appearance, though not the close relationship with the matter and therefore the necessity to fall back on all of the rules of ‘full IFRS’, in order to be able to prepare accounts in accordance with IFRS for SMEs. In the ‘derivation table’ at the end of the standard these relationships are confirmed again. IFRS for SMEs are described as an ‘extract’ from the IASB Framework and the ‘full IFRS’, and the primary sources relevant for understanding are assigned to each section of the new standard.

The impression intended by the consolidation of the rules from 2,749 to now 230 pages, that short rules are simple rules, is completely misleading. Not consolidation, but only radical simplification and in particular the forgoing of the revolutionary changes, which are questionable anyway, would make short IFRS for SMEs easier to implement. As long as the IASB believes, though, that it cannot do without its many revolutionary changes, it has to describe and explain its ideas in sufficient detail. Companies voluntarily buy comprehensive commentaries in order to implement accounting rules without expensive consultation. Reporting which is understandable and systematically clears up

as many issues of doubt as possible, but limits obligatory, difficult assessments, would better serve SMEs and handicraft enterprises in particular, than a 'concentration of rules' based on the model of IFRS for SMEs.[203]

Similarly, the supposed advantage of collecting reforms for IFRS for SMEs in accordance with preface 17 for three years and then introducing them bundled together into the standard is mere window-dressing. The additional burden on accounting depends first and foremost on the coverage and scope of the changes. Particularly for smaller companies, the bundling has fewer advantages than disadvantages. It saves permanently searching, but hampers equal distribution of the workload over time – and that is important for SMEs and handicraft enterprises. In truth, the announcement of reforms every three years hides the threat of a regular increase in workload.

4.4. Disadvantages for SMEs disguised as simplifications

The IASB Fact Sheet issued when the standard IFRS for SMEs was published lists under the simplifications the banning of individual reporting options covered by 'full IFRS' with the remark that the IFRS for SMEs allow instead 'a more simplified method'.[204] Elsewhere the Board admittedly reveals its knowledge of the value of options for accounting policy, in particular when alternatives are created, which help to present the position of the company advantageously. The Board, namely, highlights the right to report directly in equity actuarial gains and losses relating to retirement pension commitments by bypassing the profit and loss statement as an important improvement to the final standard versus the draft,[205] which is undoubtedly correct. The new right does away with the previous necessity to immediately report the full actuarial gains and losses in the profit and loss statement, and therefore does not merely create scope for accounting policy, but also the opportunity to allow the company's profit to appear more advantageous. If, therefore, the scope for accounting policy is eliminated or potentially advantageous reports are replaced with potentially disadvantageous reports with IFRS for SMEs vis-à-vis 'full IFRS', this does not hide a simplification, but a discrimination against SMEs and handicraft enterprises. Many supposed simplifications of IFRS for SMEs possess this unattractive quality.

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[203] It is precisely in this sense that Winkeljohann/Morich (2009, p. 1634) also ask the question 'whether instead of separate IFRS for SME – the implementation of a full IFRS with greatly reduced disclosures for the appendix would be a better answer to the needs of the addressees of SMEs' (translation of original quote).

[204] International Accounting Standards Board, 2009b, p. 3.

[205] Ibid., p. 6.

- Even if actuarial gains and losses, in accordance with the final standard, may be recorded directly in the profit and loss statement, or directly in equity in a way that does not affect profit or loss, the third option of recording them with a time delay in accordance with IAS 19.92 and 19.93 is not afforded, which, in a similar way to depreciation, would allow the burden to be spread over time.
- Without recourse to IAS 39, Sections 11 and 12 know only the valuation of financial instruments at fair value affecting profit or loss and the valuation at amortised cost; the category of financial instruments held for sale with their valuation at fair value not affecting profit or loss, which is very advantageous in the current financial crisis for example, remains closed (IAS 39.55[b]).
- In terms of Section 15.9 joint ventures may – unlike in accordance with IAS 31.30 – not be reported with the help of proportional consolidation.
- Sections 17.15 and 18.18 only allow valuation at amortised cost for tangible and intangible assets. A revaluation at fair value may be advantageous in particular for tangible assets, particularly as this does not affect profit or loss (IAS 16.31 and 16.39; IAS 38.75 and 38.85).
- In Section 16 the valuation of investment property is largely narrowed to the valuation directly affecting the operating result, while IAS 40.30 allows an explicit option to also value at amortised cost. Section 16.7 seemingly limits the valuation at fair value to property which is used for purposes outside the company's real objective which can be reliably valued at fair value, the reference to Section 11.27–11.32 though not only clarifies valuation methods that reliably determine the fair value, but also specifies assumptions whereby fair values can normally be determined ongoing for assets acquired by third parties. The assertion by IASB in the Fact Sheet, that an option tailored to the circumstances is granted here,[206] is therefore ultimately not in line with the facts.
- Section 19.23(a) specifies in contrast to the impairment only of IAS 38.107 a scheduled depreciation of the derivative goodwill over 10 years. This debatable treatment of goodwill has to be described as far-reaching discrimination against the SMEs, as the forgoing of scheduled depreciation was the hard-fought-for consideration that the major limited liability companies achieved for their agreement to abolish capital consolidation methods not affecting profit or loss – the real cause of the problems.

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[206] Ibid., pp. 3, 5.

- Section 18.14 prohibits the capitalisation of development costs; in fact, it stipulates that they are recorded immediately in profit or loss. IAS 38.57 on the other hand requires that development costs are capitalised as soon as the six conditions listed there are all met. The difference in the rules is at the latest discriminatory when the requirement of IAS 38.57 to disclose is recognised as a factual option.[207]
- Unlike IAS 23.8, which regulates the capitalisation of interest on borrowed capital proportionately attributable to the procurement and manufacture of assets, Section 25.2 prohibits precisely this procedure. It requires that all interest on borrowed capital is recorded immediately in profit or loss.

From the viewpoint of the interests of SMEs and handicraft enterprises the removal of the 'cross-references' to individual IAS is also considered to be rather negative. This removal, which obviously aims to wipe out as many indications of 'mandatory fallback' as possible, takes away from the SMEs and handicraft enterprises the possibility of adapting IFRS more greatly to their particular needs by specifically combining regulations, which in future is only possible with financial instruments with the option of IAS 39.

4.5. Discrepancies between the standard IFRS for SMEs and the associated Fact Sheet

The extreme consolidation of the regulations has allowed inconsistencies to emerge which also make it more difficult to behave in a way that conforms to the rules. On top of this further propositions listed in the Fact Sheet of the IASB dated 9 July 2009 do not correspond with the facts, and the two problems are partly linked.

- When the Fact Sheet praises the revision of IFRS for SMEs with the special regulations on assets held for sale, this does not really reflect the situation for which inconsistencies in the standard may be responsible. Vis-à-vis the draft the old Section 36 'Discontinued Operations and Assets Held for Sale' was taken out. In fact, however, detailed regulations on these problem areas have survived in other parts of the final standard. The mandatory disclosures within the balance sheet have been eliminated, but not in the profit and loss statement nor in the notes. In the profit and loss statement two

[207] Cf. Lüdenbach/Hoffmann, 2008, § 13.29.

components of success attributable to this problem (Section 5.5 [e], [i] and [ii]) still have to be reported. The details from this area have to be reported on separately for instance in accordance with Sections 4.14, 14.14, 19.26 (c) and 32.11. Without a clarification of the issue in the standard itself, these obligations can only be met by a now factual mandatory fallback on 'full IFRS'.

- With IFRS for SMEs, 'various options' [208] for the treatment of government grants in accordance with IAS 20 should be cut, by either recording all grants strictly parallel to meeting the specific conditions or, if there are no conditions, immediately in profit or loss (Section 24.4). In Section 24.5 the valuation of donated assets is prescribed at fair value. Both requirements are only compatible if the required matching is made possible with a deferred income item. However, in terms of the matching concept, precisely such deferred income items in terms of the matching concept are not possible in accordance with Section 2.45. The requirements of IFRS for SMEs for the treatment of government grants therefore contradict the 'concepts and pervasive principles' of the same standard.
- The references in the 'Fact Sheet' to the restricted significance of the fair value valuation in IFRS for SMEs are almost embarrassing.[209] The IASB cannot convincingly sell the repressing of fair value as an advantage if it at the same time despite the justified criticism stubbornly holds on to this highly problematic value, because without it its questionable concept of asset-oriented accounting would collapse. On top of this, this restricted significance, apart from the prohibition of revaluation, does not exist. Biological assets have to be valued even more decidedly in accordance with section 34.4 at fair value than in 'full IFRS', for the comparable IAS 41.12 itself refers to the exception as a consequence of a lack of opportunities to reliably determine fair values. In addition almost all financial instruments in accordance with section 11 of the IFRS for SMEs are not valued at amortised cost. If shares in limited liability companies are traded in markets or can be reliably valued on another basis, they also have to be valued at fair value as a recently introduced, though only vaguely defined in terms of content, category of receivables, the 'financing transactions' (Section 11.14 [a]).

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[208] International Accounting Standards Board, 2009b, p. 3.
[209] Cf. ibid., pp. 3, 4.

4.6. 'Substantially fewer disclosures'?

The realignment of annual financial statements by the current leading Anglo-Saxon standard-setter is accompanied by a drastic expansion of the reporting requirements in 'disclosures' or 'notes'. The number of these disclosure requirements is now incalculable, the mere presentation of them fills books, and their implementation by companies has made their annual reports explode in size. Against this background even 'substantially fewer disclosures'[210] still cover a wide area of possible scope for disclosures. They are at any rate worlds away from the scope of disclosure requirements in accordance with the HGB, because sole traders and commercial partnerships do not compile an appendix, and for small, and even medium-sized or large limited liability companies the disclosure requirements of the HGB are limited in comparison with the 'full IFRS' of the IFRS for SMEs; in particular, small limited liability companies are granted relief by §§ 288 para. 1 and 326 of the HGB (no disclosures on related parties and on profit and loss statement items for example).

Relief in the scope of disclosure requirements must also not be equated with limits in the granting of insight to third parties into the business of the company which has a duty of disclosure. The smaller and therefore necessarily also more homogeneous a company is, the more precisely conclusions can be made from the disclosures on the actual circumstances in the company. It is precisely because of this reason that the legislator of BilMoG referred in the justification for the government draft to an existential threat for SMEs; this is explained in more detail in chapter 3.2. Particularly from the viewpoint of SMEs and handicraft enterprises, therefore, even thinned-out disclosure requirements will often reveal much more than more extensive requirements for larger companies.

- If disclosures are not summarised under the special Section 8 Notes to the Financial Statements, the disclosure requirements are based on specifications concerning notes or disclosures in the individual sections of IFRS for SMEs, and such specifications are found in all sections apart from sections 1, 2 and 22.
- The disclosure requirements are in many cases wide ranging and markedly detailed. This applies in particular to:
  - Sec. 10 Accounting Policies, Estimates and Errors (10.13, 10.18 and 10.23),

[210] Ibid., p. 3.

- Sec. 11 and 12 Financial Instruments (11.39–48 and 12.26–29),
- Sec. 16 Investment Property (16.10 and 16.11),
- Sec. 20 Leases (20.13, 20.16, 20.23, 20.30 and 20.35),
- Sec. 21 Provisions and Contingencies (21.14–17),
- Sec. 28 Employee Benefits (28.39–44),
- Sec. 29 Income Tax (29.30–32),
- Sec. 33 Related Party Disclosures (the whole section deals with disclosure requirements) and
- Sec. 34 Specialised Activities (Agriculture 34.7 and 34.10).

– Various disclosure requirements concern very sensitive and – particularly for the protection of the business models of SMEs and handicraft enterprises – important, or – from the viewpoint of the privacy of the partners – potentially awkward facts. Unlike the HGB in § 286, the IFRS do not have any exceptions from reporting obligations to protect higher interests. Sensitive issues are addressed in particular in Section 16 *Investment Property*, Section 18 *Intangible Assets other than Goodwill with the disclosure of expenditure on research and development*, Section 29 *Income Taxes* and Section 33 *Related Party Disclosures*. SMEs and handicraft enterprises, and also legislators who flirt with IFRS for SMEs, are, therefore, well advised to analyse the disclosure requirements precisely before they rush into the adventure of accounting in accordance with IFRS.[211]

5. Conclusion

Accounting in accordance with IFRS is completely unsuitable for SMEs and handicraft enterprises. First of all, serious conceptual weaknesses are responsible for this, which fundamentally call into question the suitability of IFRS even beyond the circle of SMEs and handicraft enterprises. The aim of reporting assets in the balance sheet cannot even be closely achieved in our imperfect world, and certainly not synthetically. Both the unavoidable scope for discretion and manipulation (in approach as well as valuation) and the inability to take into account the individual business models are as much a consequence as the loss of a meaningful performance variable. While the new asset concept is only partially followed and in many areas rules according to

[211] Remarkably, Winkeljohann/Morich also come to this conclusion (2009, p. 1634).

the old ideal are mixed with a prudent profit calculation, the IASB also basically acknowledges the limits of its approach. Not least of all the experience with the financial crisis has made clear the shortcomings of the concept and allowed critical voices to swell.

It is also the case for SMEs and handicraft enterprises that the sole alignment of IFRS to capital market information creates an accounting system which does not meet the needs of these companies, and can even damage them with disclosures that go too far. The accounts that are really required, though, would also have to be prepared due to the uncompromising nature of IFRS at additional cost, even though accounting in accordance with IFRS itself imposes higher costs. What is downright dangerous for partnerships are the views of equity, which are ideally geared to the interests of the private equity sector. On closer analysis of the IFRS for SMEs, the standards that are supposedly tailored to the needs of SMEs and handicraft enterprises turn out to be an incomprehensible consolidated summary that cannot be implemented without profound knowledge of ‘full IFRS’. Improvements highlighted by the IASB often do not exist or they are a disadvantage to SMEs; valuable options are denied, disadvantageous reports become mandatory and rules with a few inconsistencies are created.

Fortunately, surveys show that SMEs know or feel many weaknesses of IFRS. Therefore, anyone who wants to protect SMEs and handicraft enterprises from the dangers of accounting in accordance with IFRS fortunately does not have to break down any resistance here; he will probably find a lot of understanding and approval.

Part III

Legal framework for accounting regulations detrimental for non-capital-market-oriented SMEs and handicraft enterprises

Joachim Kormann

Outline

1. **The legal reservation for accounting regulations according to national constitutional law and primary community law of the EU**

2. **Suitability and reasonableness as basic requirements for the legal creative power of accounting standards**

3. **IAS/IFRS and IFRS for SMEs measured against occupational freedom in accordance with art. 12 para. 1 of the German Constitution (GG)**

4. **IAS/IFRS and IFRS for SMEs measured against the principle of equality in accordance with art. 3 para. 1 of the German Constitution (GG)**

5. **IAS/IFRS or IFRS for SMEs for non-capital-market-oriented SMEs in accordance with current secondary community law?**

6. **Future community law: IAS/IFRS or IFRS for SMEs for non-capital-market-oriented SMEs measured against primary community law**

7. **Urgency of deregulation and simplification of accounting regulations for SMEs in terms of legal policy**

1. The legal reservation for accounting regulations according to national constitutional law and primary community law of the EU

Proposition 3.1:

International accounting standards need to be implemented by the

- *national legislator in German law or by the supranational*
- *standard-setter in directly applicable, mandatory EU community law.*

Reason:

1.1. International accounting standards intend to determine bindingly with which specific content or based on which specific procedures companies have to prepare their accounts. They therefore make binding specifications, which require direct or indirect enforceability (making subject to disadvantages for non-compliance) and are subsequently applied. Such enforceability could theoretically come from a voluntary, also implied, agreement of all parties, particularly of the companies concerned; for example, from joining a certification group or similar. This is immediately ruled out here: the standards are *generally* binding and apply to all; the acceptance of occupational activity cannot be misunderstood as a declaration of joining.

Therefore, there only remains the obligation by and enforceability based on a sanction by an authority which is higher than the company concerned. A non-governmental, privately organised and composed institution, as is the case with ‘standards’ boards like the IASB, is neither authorised to do this, nor could it be authorised to do this without further ado by a supreme authority.[212] To exercise the sovereign power to create a law, it is necessary to define the parties that are obliged to prepare accounts, to impose obligations upon them, to regulate them closely and to take or only threaten appropriate steps for their non-compliance. Such a power can basically only be of a governmental nature or of a nature derived from the government. Only the government, legitimised by the people of the state,[213] can make and implement such specifications.

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[212] Cf. Kormann/Klein, ‘(De-)Regulierung für die Rechnungslegung mittelständischer Unternehmen’ ([De]regulation for the accounting of SMEs), Part 1 Section III. B. 4. and Part 2 Section I. A. 2 with further references.

[213] Cf. Art. 20 para. 2 p. 1 of the German Constitution (GG) ‘All state authority is derived from the people’ (translation of the original text).

This is completely irrespective of whether the content-wise consequences of accounting regulations (with regard to the tax balance sheet) can directly occur for the state, here fiscal sector or whether (with regard to the commercial balance sheet) they might occur primarily in relation to likewise private legal entities (co-partners, creditors, customers, other companies, financiers etc.). It is not the motive of the regulation that is relevant, but the effect of accounting regulations and standards. If these should obligate and be authoritative and enforceable, this requires the use of the *state* 'monopoly of power' over its citizens.[214]

1.2 Furthermore it remains the right, according to German constitutional law in view of the associated effect on the basic rights of the parties concerned (art. 12 part. 1, art. 3 para. 1, in certain circumstances also art. 14 para. 1 of the German Constitution [GG]), within the scope of the separation of powers of the legislative, of the parliament therefore as the formal legislator to specify, i.e. order, the application and sanctioning of such standards, or – for example with the admissible transfer of its powers – to expressly delegate this if necessary wholly or in part. The regulating of accounting at all, its content, scope, procedure etc. for companies, limits its autonomous freedom (of scope and forbearance), interferes with its basic rights and therefore requires special formal[215] justification. Parliaments, which are chosen by the people in free, equal, secret and direct elections, are, as the organ of the legislative, responsible for such acts. Responsible and legitimised in the German federal state (art. 20 para. 1 of the German constitution), in this respect, is the federal level, i.e. the Bundestag (German Parliament), based on the competences specified in art. 74 no. 11 of the German constitution (commercial balance sheet) and art. 105 para. 2 in conjunction with 106 para. 3 clause 1, 108 para. 5 clause 2 of the German constitution (tax balance sheet), which the German federation has used here in particular with the relevant regulations of §§ 238 ff. of the German Commercial Code (HGB) and §§ 140 ff. of the German Tax Code (AO) and the German Income Tax Law (EStG).

1.3 A delegation of legislative authorities to the executive would only be allowed within the scope of art. 80 of the German Constitution to a certain extent. Decree regulations arising from this could substantiate details of accounting obligations within the scope of guidelines specified and to be

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[214] In this respect, neither the principle of equal treatment of the commercial balance sheet and the tax balance sheet in accordance with § 5 para. 1 German Income Tax Law (EStG) is a criterion of whether the mandatory provision of accounting regulations is reserved for the state.

[215] And also special material justification: see Sections 3. and 4.

specified by the legislator itself. In the process, the *numerus clausus* of the delegators (German federal government, federal ministers, German state governments), in accordance with art. 80 para. 1 clause 1 of the German Constitution, is to be observed.

It is simply legally not possible to delegate to a private international board, such as the IAS Board. Regulations originating from it require, in order to become valid for parties that are obliged to prepare accounts, to be adopted by the state in law. This, in turn, can only happen with such private 'standards' being clearly received in the will of the legislator by adopting the content on an individual basis. A global referral for the mandatory validity of the whole standard even only for a certain time seems to be hardly reconcilable with the state rule of law principle (materiality principle) and constitutional guarantees. Even a dynamic referral with a general adoption of 'respective' standards of a private body would amount to a transfer of legislative authorities and would therefore not be allowed as a breach of principal constitutional standards.

1.4 Basically, with accounting standards of international origin too, as is the case with IFRS etc., legal authorisation by the German legislator is required. Any agreements under international law need to be adopted in German law by a formal treaty in accordance with art. 59 para. 1 clause 1 of the German Constitution (GG), in order to become legally effective for the companies concerned as parties that are obliged to prepare accounts. Such a reception by treaty is to be measured against the same requirements as any other law; a global adoption of international standards by referral could not bring about the occurrence of binding effect for the parties that have to prepare accounts.

1.5 By virtue of the integration of Germany in the European Union and due to the latter's characteristic as a supranational organisation with its own law-making authority, the legislative organs of the Community, in line with or in place of, the national legislator are, of course, basically able to take direct action against the citizens of the member states; here, for example, to establish and closely regulate accounting obligations for companies. This occurs primarily by decree, in accordance with art. 249 para. 1 and 2 EC, needs special authority with primary community law and requires observance of the procedural regulations of art. 250–252 EC and the content-wise compatibility with higher primary community law (e.g. fundamental rights, fundamental freedoms and the principle of proportionality). Such decrees in the area of reception of supranational accounting standards are the IAS

decree and the endorsement decrees for individual standards based on it.[216] With this instrument, the legislative organs of the supranational Community can issue binding dictates and prohibitions with immediate effect for the individual citizens or companies, without implementation in national law by the member states being necessary.

This is to be distinguished from the process of (merely) issuing directives which basically obligate the member states only to ensure that they are duly implemented in national law (two-tier law-making procedure in accordance with art. 249 para. 3 EC). This too is practiced on a wide scale in the area of accounting by commercial enterprises; for instance, with the fourth and seventh EC directives to coordinate the company law of 1978 and 1983, including their national reception by the German BiRiLiG of 1985. Here, the laws do not come into effect until the legislative act by the national legislator is completed.

2. Suitability and reasonableness as basic requirements for the legal creative power of accounting standards

Proposition 3.2:

The rules of IAS/IFRS and IFRS for SMEs are not suitable as a legally binding basis for the accounting of non-capital-market-oriented SMEs and are not reasonable for them.

Reason:

2.1. The basic requirement for the provision of accounting obligations by the EU or the national legislator are, by virtue of higher law (primary community law/national constitutional law),[217] primarily, the suitability of the regulations for the goals pursued by the legislator and their reasonableness for the companies concerned. Here, there are fundamental differences between companies, depending on whether they are capital-market oriented or not.

For capital-market-oriented companies, whose securities are therefore registered in at least one EU member state for trading on a regulated market (cf. art. 4 IAS regulation of the EU), or where this has been applied for (cf. §

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[216] For greater detail see Kormann/Klein, l.c. Part 1 Section II. B.
[217] In detail in the following Sections 3., 4. and 6.

264 of the HGB n.v.), there are, naturally, special requirements for accounting. This concerns in particular the increased information requirement for investors, which, in view of the internationality of the capital markets (and the activity of such companies), increases and calls for comparability, and ultimately system uniformity, of the information and in particular financial statements.

Accounting by non-capital-market-oriented SMEs, on the other hand, pursues several goals, which may differ between the commercial and tax balance sheets, but in German Commercial Code (HGB)/ German Tax Code (AO) accounting stand on strong ground, have found many resolutions and compromises and in themselves represent a complete system. Compared to the information function, which is thoroughly valid here too (cf. for example § 264 para. 2 of the HGB), which, however, is not specifically for the purposes of the capital investor, but also for the entrepreneur's own information[218] and other persons related with the company, other goals come to the fore. These are, for instance, general protection of creditors, calculating payouts, company maintenance with capital maintenanc, [219] and, last but not least, tax assessment based on the authoritativeness principle in accordance with § 5 para. 1 clause 1 of the German Income Tax Law (EStG).

2.2 IFRS, like the IFRS for SMEs, which have now been published, differ so seriously in their basic objective that hardly any area of mutual compatibility remains. They have set themselves premises and principles that are essentially unusable for non-capital-market-oriented SMEs. This divergence in goals naturally and necessarily makes its way into the individual content of many standards. Seen overall the necessary compatibility cannot be established; they even contradict each other in parts. Based on the assumed international activity of the company concerned, both in its general business activities and in procuring capital, the goal of information for international investors gains such prevalence, the interests of these investors are weighted so highly, that very little – *too* little – of the other accounting functions remains. In particular, the interests of those investors who are to be protected by the other goals of accounting, including the entrepreneur himself and the tax authorities, take a back seat.

To mention only some of the particularly serious aspects and examples relating to full IFRS:[220]

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[218] Including in association with operational cost accounting.

[219] Cf. Baumbach / Hopt, Rdnrn. 10 ff. before §§ 238 ff. of the HGB with further references; Kirsch, 2008, 71/72.

[220] On this and many others, fundamental and in detail, see Schildbach, in this volume, Part II, *passim*.

- the widely demanded valuation at fair value is not suitable for the maintenance of SME assets and SME stability, unusable for calculating payouts and is overall a dangerous risk to the company's assets and creditor protection,
- these regulations are simply unsuitable as a basis for income tax assessment, which ultimately makes double accounting necessary,
- the extensive and intensive, from the viewpoint of investors perhaps desirable, information is at best of peripheral value for the necessary entrepreneurial decisions in a SME; this important accounting function particularly for owner-managed SMEs is despite great expense essentially neglected,
- the IFRS views, definitions and evaluations of equity for non-capital-market-oriented, owner-managed SMEs are completely out of the question.

The final IFRS for SMEs that have now been presented try, on the surface, to make a few simplifications and rather formal adaptations to the needs of SMEs. They too are bound to the previous concept, however, and are therefore unusable for non-capital-market-oriented SMEs.[221] In part expressly, in part contrary to its basic statement in Sections 1 and 2, the content of IFRS for SMEs does *not* cater for the specific information needs of users which have to be to the fore with non-capital-market-oriented companies: payouts, tax assessment, general protection of creditors, help for operational cost and organisational decision-making. Instead, in the interest of uniformity and comparability of IFRS and IFRS for SMEs, a framework concept is retained or adopted, which is ultimately only suitable for anonymous financiers; i.e. for it to be usable the company has to be capital-market-oriented. The actual alignment and factual content of an accounting system are crucial. The assertion alone that it is not (primarily) oriented to the capital market remains irrelevant if it is not put into practice, and it is precisely this that is missing for IFRS for SMEs.

2.3 In addition to this, the application of the IFRS standard is based on its scope and complexity as unreasonable for SMEs in terms of financial, personnel and organisational cost as it is due to the disclosure of company data for third parties. The latter all too greatly affects the legitimate business secrets of SMEs.

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[221] For further details see Schildbach, l.c. Proposition 2.3 and Section 4.2.

The scope of the regulations alone (IFRS: ca. 2,500 pages, IFRS for SMEs 230 pages) speaks for itself. In addition, despite the formal supposed prevention of 'mandatory fallback' for understanding and application of IFRS for SMEs, a fallback to full IFRS is in practice inevitable.[222] Without external professional help such requirements cannot be met by SMEs. It is not possible to even convey the understanding of the many complex standards in an SME that cannot afford its own staff of controllers, auditors etc. Considerable expenditure, organisational costs and personnel costs are incurred, which are proportionately much greater for SMEs than for major companies; costs that are not made up for by a benefit for the company or by any major benefit at all for third parties. If there is no capital market orientation, the sphere of interest of 'investors' is unreal and illusionary – these do not exist, they cannot exist. The balancing of interests, which is always required in issues of reasonableness, is like being faced by a set of scales where only one scale has a weight on it, accordingly it can only move in this direction, i.e. in favour of the SMEs.

Beyond the complete lack of benefits for companies and third parties and beyond the much higher costs for the company, a further particular problem for SMEs is to be considered: greater publicity always means a much higher competitor risk for SMEs. Data from the accounts of an SME reveal, if they are prepared in accordance with accounting standards such as IFRS, very much more than might be the case for major companies. The worry that entrepreneurial decisions that have been made or are intended, or existing technical, economic or financial situations of the SME can then be deduced, that this will be exploited unfairly by third parties in competition or in another way, and that therefore ultimately even the success and existence of the company might be threatened, is widespread, and not to be dismissed. To risk this without any recognisable value in return or any possible benefit would be absurd; to have to do it upon demand would be unreasonable.

At the same time, between full IFRS and IFRS for SMEs benefiting the parties who have to prepare accounts there are no differences so significant that another assessment would appear to be appropriate or justifiable. In this respect too, the detailed view of Schildbach[223] can be referred to. From the remarks made here it is very clear that the sensible application of IFRS for SMEs would virtually require the intimate knowledge of full IFRS. To talk of 'simplification' here would be to mock this term.

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[222] For more detail see Schildbach, l.c., Section 4.3.
[223] In this volume, l.c., Sections 4.2 and 4.3.

2.4 The German legislator probably also sees it like this: at any rate, in the official justification by the German government of the draft of the now effective BilMoG,[224] which favours another way, that of maintaining and modernising the HGB accounting, it literally set itself the goal of 'further developing the proven HGB accounting law into a lasting and in relation to international accounting standards equal but more cost-effective and simpler alternative' (translation of original quote).[225] With regard to IFRS including the draft of IFRS for SMEs it was also stated that 'in view of its complexity and density of regulations it is not suitable to sufficiently meet the needs of SMEs for informative accounting, which, however, are limited to the degree required' (translation of original quote). As a result, the decision was taken[226] 'due to cost reasons not to expect [companies] to switch from the established, simple and cost-effective commercial accounting to IFRS […]. Therefore, the switch to IFRS not only brings no additional benefit, but there is, in fact, even the danger that, due to the level of detail of IFRS, data which is of interest to the competition has to be disclosed. This may be necessary for capital-market-oriented companies and acceptable for diversified and internationally active major, non-capital-market-oriented companies; however, it can result in the existence of SMEs being threatened' (translation of original quote). This view, even if it is not directly that of the legislator (Bundestag/Bundesrat), but that of the initiator of the law (the German government), is not a factor in the validity of the law but it shows, even with the legislative bodies of the Bundestag and Bundesrat following this proposed route – clearly the described authoritative tendencies and fortunately clearly confirms the critical view represented here. It also remains valid in its basic statement for the final IFRS for SMEs of July 2009, which have now been published.

The European Parliament, an important legislative organ should the issue of admissibility and usefulness of an installation of IFRS for SMEs or similar international standards into European community law via the IAS regulation arise, commented in a similarly clear manner. In the resolution for the so-called 'Radwan initiative', [227] the EP raised not only considerable objections concerning the legitimacy, and in part the way in which the private standard-setting boards work, but also very fundamental doubts concerning the meaningfulness of the drafts being discussed at the time, and also doubts

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[224] 'Bilanzrechtsmodernisierungsgesetz' (act to modernise accounting law) – BilMoG, 28 May 2009 BGBl. I p. 1102.
[225] Bundestag printed document 16/10067 of 30 July 2008 – Introduction, Section A.
[226] l.c., Justification A. General Part, Section II. 2, p. 33 right-hand column.
[227] Resolution of the European Parliament of 24 April 2008 concerning the international accounting standards (IFRS) and the lead of the International Accounting Standards Board (IASB) (2006/2248[INI]).

concerning the process of their further development. Amongst other things the widespread view among SMEs is referred to, that IFRS for SMEs are much too complicated and often are referred to the full IFRS.[228] The EP itself expressly represents the 'view that the disclosure obligations are too extensive and the necessary effort required for this compared to the duty to provide information is disproportionate in view of the resulting benefits' (translation of original quote).[229] It sees an 'extensive need for a simplification of measures in the areas of accounting and auditing for SMEs'[230] (translation of original quote) and points out that the political mandate of the IASB and the community implementation process do *not* refer to the preparation or implementation of IFRS for SMEs for non-capital-market-oriented companies.[231] Finally, the EP also[232] demands a precise analysis of user needs, to which the accounting requirements for SMEs should be adapted. It clearly criticises the lack of consideration that the addressees of the then draft proposal of IFRS for SMEs were not 'anonymous investors', but 'essentially general partners, creditors, business partners and employees' (translation of original quote).[233] In so doing, it pointed directly at the sore point of such (express or factual) capital-market-related standards, which only serve to provide information to international investors of capital; however, all of the other at least as important for non-capital-market-oriented SMEs *only* functions to be met by an accounting system are basically missing.

3. IAS/IFRS and IFRS for SMEs measured against occupational freedom in accordance with art. 12 para. 1 of the German Constitution (GG)

Proposition 3.3:

The mandatory provision of IAS/IFRS or IFRS for SMEs by the German legislator would therefore not be consistent with Art. 12 para. 1 of the German Constitution (GG).

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[228] Cf. no. 36 clause 1 of the resolution. At least the IASB is trying to formally take into account the objections of the EP in no. 36 clauses 1 and 2 of the resolution in the final version of the IFRS for SMEs, which has now been published – admittedly without changing the basic concept and practically without any serious change to the situation.

[229] No. 36 clause 2 of the resolution.

[230] No. 48 of the resolution.

[231] No. 38 of the resolution.

[232] Cf. no. 42 of the resolution.

[233] As in no. 46 of the resolution.

Reason:

3.1 The binding imposition of accounting by government dictate is an interference in the occupational freedom of art. 12 para. 1 of the German Constitution (GG). Also to be called upon, and to be evaluated with necessary consideration, are in individual cases the fundamental right to property in accordance with art. 14 para. 1 of the German Constitution (GG) and the fundamental right to 'informational self-determination' developed by the German Federal Constitutional Court of art. 2 para. 1 of the German Constitution (GG),[234] the latter e.g. vis-à-vis legal disclosure requirements of owner-managed SMEs in particular. In the definition between property and occupational freedom based on the 'rule of thumb' of the German Federal Constitutional Court, art. 14 protects the acquiree, art. 12 the acquisition. [235] The focus of the interference with accounting obligations therefore lies here in the scope of protection of art. 12 of the German Constitution (GG).The nature of the occupational activity is mandatorily regulated closely, the freedom to operate is affected.[236] By virtue of national sovereignty, the entrepreneur has to collect and compile data from his company, which is defined in nature, depth and frequency in more detail by this, and generally make it accessible to the state, certain groups of interested third parties and in part also to the public. If he does not do this, or if he does this incorrectly, i.e. incompletely or inaccurately, then he is threatened with enforcement, disadvantages and/or other sanctions, again determined by the national government. Whether the national accounting arrangement (as with the tax balance sheet) serves the tax authorities or (as with the commercial balance sheet) has in mind as well as public interests also or even primarily the interests of third parties, does not play a role, as mentioned: the nature of the government action, not the purpose, determines the qualification of the interference in fundamental rights. This interference is mandatory here, under some circumstances even reinforced, and directly regulates the occupational

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[234] Established case law, since BVerfGE 65, 1/41 f. Cf. also margin no. 6 to art. 2 of the GG.
[235] BVerfGE 30, 292/333; similarly BVerfGE 84, 133/157; 85, 360/385; 102 26/40.
[236] Cf. for further detail Kormann/Klein, l.c., Introduction to Part 2.

activity of the parties that are obliged to prepare accounts, whether they are sole traders, partnerships or limited liability companies.[237]

3.2. The purpose of the regulation is certainly important for the – necessary – *justification* of the legislative action. The case law of the German Federal Constitutional Court requires, should interferences in the exercising of occupation be legal, besides foundation or basis on (formal) law, the existence of sufficient reasons of general interest, for whose pursuance and achievement the measures concerned are – according to the principle of proportionality – suitable, necessary and, when considering the party concerned, reasonable.[238]

3.3 There would be a lack of all of these premises, if the German legislator wanted to impose on SMEs that are not capital-market-oriented the use of IFRS, of IFRS for SMEs or similar standards or principles ultimately based on capital-market orientation. To prescribe this to them *mandatorily* would be a breach of the constitution and reason for an objection by the German Federal Constitutional Court, e.g. based on a judicial review or constitutional complaint.

The use, and therefore the possible legal order of IFRS and IFRS for SMEs for non-capital-market-oriented SMEs, proves to be, as Proposition 3.2 argues, neither sensible ('suitable') nor necessary even. On the contrary, the associated cost of the imposition is for them grossly disproportionate to any conceivable benefit for them or for a third party. It would also result in a burdensome and, due to the absence of capital market orientation, totally inappropriate disclosure of competition-sensitive data to competitors. All of this makes it necessary to provide regulations for the SMEs that meet the requirements of constitutional law; regulations other than those provided by the IFRS or IFRS for SMEs, which are primarily oriented towards internationality, capital market requirements and major requirements, and are one-sided for disclosure requirements and investor interests. Measured against the specifications of art. 12 para. 1 of the German Constitution (GG), these standards can in no way exist. They are simply unusable for non-capital-market-oriented SMEs.

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[237] Cf. concerning in this respect the given capacity for fundamental rights also of 'Personengesellschaften' (partnerships) and 'Kapitalgesellschaften' (limited liability companies) art. 19 para. 3 of the GG and margin no. 15 to art. 19 of the GG, margin no. 9 to art. 12 of the GG with further references, and Maunz/Dürig/Schulz, margin no. 106 to art. 12 of the GG.

[238] So-called step theory; established case law of the German Federal Constitutional Court since BVerfGE 7, 377/402.

The main motive, to protect international investors and, particularly with IFRS, to open up and to maintain the functionality of international capital markets, does not apply to non-capital-market-oriented SMEs at all. There is, therefore, no public interest at all for their inclusion in such regulations; in this respect, there are insufficient reasons of general interest.

For secondary goals, which are also pursued, the use of such international standards for SMEs is also neither suitable nor necessary. The existing, more balanced system of HGB accounting and the income tax regulations based on it appear to be much more preferable and much more appropriate for the possible and admissible purposes of the governmental arrangement of accounting.

Finally, the necessary weighing up of the general benefits and specific burdens for the party who has to prepare the accounts reveals that there are much more of the latter than reasonableness would allow such a regulation, despite all of the assessment scope and decision prerogatives granted to the legislator here. With the companies not being capital-market-oriented, there are no measurable advantages here either for them or for third parties. The burdens due to costs, workload and organisational problems are unusually high, and the inappropriate depth of the disclosure requirements can also have a significant negative impact specifically on SMEs, and their competitiveness – in extreme cases their existence – can even be threatened.

What the legislator is at liberty to do is to establish instead of basically *another* appropriate method of accounting, to *also,* i.e. only *optionally,* establish such methods for non-capital-market-oriented SMEs. If this is only done alternatively and not obligatorily, e.g. in § 315 para. 3 of the HGB, based on the method shown in art. 5 letter b) of the IAS regulation,[239] it is probably admissible under constitutional law; if there is no legal or only a factual obligation, there is no interference in fundamental rights. The charge against a legislator of making a mistake in legal *policy* would remain if the legislator makes for its own purposes obviously unusable methods available to legal entities even on only an optional basis.

4. IAS/IFRS and IFRS for SMEs measured against the principle of equality in accordance with art. 3 para. 1 of the German Constitution (GG)

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[239] Whether in a declaratory or constitutive manner, remains to be seen here.

Proposition 3.4:

The mandatory provision of IAS/IFRS or IFRS for SMEs by the German legislator would also be in breach of Art. 3 para. 1 of the German Constitution (GG).

Reason:

4.1 Art. 3 para. 1 of the German Constitution (GG) prohibits 'the arbitrary unequal treatment of what is basically equal' and 'the arbitrary equal treatment of what is basically unequal'. It is generally not easy to determine where exactly in this second case the boundary with a breach of art. 3 para. 1 of the German Constitution (GG) lies; therefore, when there would be an 'arbitrary' equal treatment of different circumstances.[240] The legislator is entitled to form types, groups and classes of grades, limits and divergences of regulations. It must not and cannot produce 'maximum justice', but has to interpret the most varied individual cases in abstract legal rules and must therefore take into account uncertainties at the edges and perhaps make not immediately understandable rulings in a specific individual case. This comprises the legislative creation of types as a basis for drawing boundaries and establishes a particularly wide scope for the legislative, which appears to be usable in totally different and very widely diverging ways. The legislator can in particular choose which of several features of the circumstances, the parties concerned, third parties, content or legislation it uses to draw the boundary.

4.2 This freedom is admittedly not unlimited. Each regulation has to be supported by the obvious intention of producing appropriate solutions. The original formulation of the German Federal Constitutional Court (only) accepted a breach of art. 3 para. 1 of the German Constitution (GG) if the legislative decision were 'plainly arbitrary', if 'a reasonable reason relating to the nature of the matter [could not] be found'. [241] However, in practice, the new ruling of the court limits – where fundamental rights are affected as is the case here – the reasons which can be considered, by laying down the standard for the principle of proportionality; for example, when unequal treatment and a justifiable reason are not in proportion with one another. [242] Conversely, it

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[240] Since BVerfGE 4, 144/155 established case law. cf. margin no. 3 to art. 3 of the GG with further references.

[241] Cf. margin no. 14 to art. 3 of the GG.

[242] BVerfGE 82, 126/146.

stipulates a different regulation if the actual inequalities considered are so significant, that this is necessary.[243] Here again it has to be reviewed and decided from the viewpoint of proportionality when such a significance is to be established. This puts the interest which justifies the intervention, the suitability and necessity and the burdens on the party concerned up for discussion.

4.3 In the above case the following applies:

The main purpose of using IFRS – and effectively of IFRS for SMEs as well – is the opening up and the protection of investors in international capital markets. Precisely this goal, however, does not exist for non-capital-market-oriented SMEs. These are not even listed on stock exchanges.

There is necessarily, therefore, a 'basically unequal' starting point, which also requires an unequal, i.e. different treatment by the legislator. There is no reasonable reason for the equal treatment of non-capital-market-oriented SMEs. To stretch accounting regulations, which serve the information purposes of the investors of capital and the comparability of internationally active major companies using international capital markets, and aim to achieve efficient international capital markets, to non-capital-market-oriented SMEs would disregard significant inequalities, be inappropriate considering the goal of the regulations, lack any reasonable reason relating to the matter and be just plainly arbitrary.

The 'mere' use of IFRS for SMEs for non-capital-market-oriented SMEs would not be consistent with art. 3 para. 1 of the German Constitution (GG). These standards fundamentally pursue the same, here unsuitable, material concept; a need for international comparability with regard to the capital markets is fundamentally no requirement here, however. IFRS for SMEs are actually not so different vis-à-vis the full IFRS in terms of greater benefits and/or smaller burdens, neither in essential content nor in terms of the difficulty of their application, cost, time and risk for the SME users, than their application for non-capital-market-oriented SMEs could at all justify.

5. IAS/IFRS or IFRS for SMEs for non-capital-market-oriented SMEs in accordance with current secondary community law?

Proposition 3.5:

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[243] BVerfGE 86, 81/87.

Applicable community law neither obligates

- *non-capital-market-oriented SMEs directly to apply*
- *nor member states to implement IAS/IFRS or IFRS for SMEs.*

Reason:

5.1. The directly relevant community law, the IAS regulation, addresses *capital-market-oriented* companies and clearly obligates in art. 4 (only) these companies listed on an EU stock exchange to prepare their financial statements in accordance with the endorsed IFRS standards.

5.2. As art. 5 letter a) specifically provides for the annual financial statements of these companies in terms of art. 4, art. 5 letter b) of the IAS regulation provides an *opportunity* for the member states to expand their personal scope of the IFRS standards: member states can ‘allow or prescribe that […] companies, which are not companies such as those in terms of art. 4, prepare the consolidated and/or their annual financial statements’ in accordance with the standards. To what extent this regulation, as it also includes non-capital-market-oriented companies, is without further ado consistent with EU primary law and how it is to be interpreted more closely in relation to the member states remains to be seen here.[244] In any case this potential ‘expansion’ in the possible scope of the IFRS standards is left for the member states to decide. The member states can also decide whether they mandatorily ‘prescribe’ or voluntarily ‘allow’ the use of the IFRS standards to the parties who have to prepare accounts in their territory. The Community, therefore, neither takes direct action itself against the parties who have to prepare accounts, as is the case with capital-market-oriented companies with art. 4 of the IAS regulation, nor does it stipulate that the member states have to implement them in their territories.

There is also nothing else in the relevant EC accounting directives;[245] these may obligate the member states to adopt specific individual standards and will certainly do so time and again with regard to content, even if in a modified form; however, not as an obligation to globally apply IFRS, but, where applicable, as an individual Community regulation with binding character for its

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[244] Cf. though the short remarks in Section 6.1. in connection with Proposition 3.6.
[245] For example the fourth, seventh or eighth directive on the coordination of company law.

member states to implement. In this respect, these are parallel, congruent or similar regulations of the Community itself if needed for individual IFRS Standards, not implementation, adoption or application of such standards by reference.

5.3. An endorsement of the IFRS for SMEs, which has now been passed by the IASB, would at any rate also not be allowed on the basis of the applicable IAS regulation. Systematic and teleological arguments prohibit this:[246] non-capital-market-oriented SMEs are fundamentally not the object and purpose of the IAS regulation. This addresses, in terms of content and purpose, the efficiency of the capital markets, therefore ultimately the free movement of capital; not, however, the standardisation of accounting for all SMEs in the Community.

This limit on major capital-market-oriented companies in this respect is stressed incidentally by the European Parliament in the often mentioned resolution.[247] No. 38 of this resolution states: the European Parliament "underlines that no political mandate has been conferred on the IASB to develop an IFRS for SMEs; notes that the endorsement procedure applies only to international accounting standards and interpretations for publicly traded companies; notes further that the endorsement procedure may not be used for the recognition of the IFRS for SMEs.' The Commission also assumes, incidentally, that it would also not be possible to adopt IFRS for SMEs on the basis of the current IAS regulation, but that this would need to be amended or a new legal instrument would be necessary.[248]

6. Future community law: IAS/IFRS or IFRS for SMEs for non-capital-market-oriented SMEs measured against primary community law

Proposition 3.6:

Appropriate mandatory community law would be inconsistent with primary community law (the principle of proportionality, the principle of democracy, entrepreneurial freedom and the principle of equality).

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[246] Cf. for further details Kormann/Klein l.c. , Part 1, Section II.B.4.
[247] The so-called Radwan initiative.
[248] Cf. Kormann/Klein l.c., Part 1, Section II.B.4. at the end (with directory).

Reason:

6.1. An amendment, expansion or addition to the current IAS regulation, or the creation of a new secondary community regulation next to it, would also not make it possible to constitutively sanction the use of IAS/IFRS or IFRS for SMEs for non-capital-market-oriented companies, therefore enforcing or enabling their implementation in terms of Propositions 3.1 and 3.5. If community law intended to directly obligate non-capital-market-oriented EU companies to prepare accounts in accordance with IAS/IFRS, IFRS for SMEs or capital-market-oriented standards of a comparable nature, it would be opposed by the higher primary community law. The same applies for a dictate or constitutive [249] authorisation of the member states to prescribe such standards to their companies. Likewise, the following three constellations are covered:

- Community law cannot directly obligate non-capital-market-oriented SMEs (for example by an EU regulation) to generally apply the standards.
- Community law cannot obligate member states to generally implement the standards for such non-capital-market-oriented SMEs (for example with EU directives).
- Community law cannot constitutively authorise member states to implement standards for non-capital-market-oriented SMEs, if their constitution is opposed to this.

Such regulations would e.g. by an amendment to the IAS regulation, by creating a comparable parallel legal basis for IFRS for SMEs or in the form of EU directives, if they were geared like the IAS regulation to protecting investors and the efficiency of community capital markets, not be permissible and declared null and void by the ECJ upon plea for annulment in accordance

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[249] In the sense of an authorisation which overrides a, for example conflicting, national constitutional provision. With art. 5 letter b) of the IAS regulation 'The member states can […] prescribe' it is therefore to be interpreted in conformance with primary law that the regulation only has a declatory effect in this respect, but does not, for example, constitutively override a conflicting national constitutional provision, which also appears to be hardly consistent with the granting an option with the principle of subsidiarity. Concerning the eligibility of interpretation in conformance with primary law in general Cf. Streinz, margin no. 17 to art. 249 of the ECT with further references from the case law of the ECJ.

with art. 230, 231 EC or based on a submission in the preliminary ruling procedure in accordance with art. 234 EC.

6.2. Secondary community law has to be measured against primary community law. The measure is all of the sources of primary community law, therefore as well as the foundation treaties with all of their amendments and additions, in particular the general (unwritten) legal principles developed by the ECJ, which have as their source the consistent basic definition of an offence in the legal systems of the member states. The ECJ derives the validity of fundamental rights – which bind all of the Community's bodies, and of general legal principles from the community treaties – from common constitutional traditions of the member states and from guarantees under international law, in particular the European Commission of Human Rights. This includes here in particular the fundamental right to entrepreneurial freedom (cf. art. 16 of the CFR) and the principle of equality (cf. art.[250] 20 of the CFR),[251] to which both natural and legal persons are entitled,[252] constitutional content and procedure guarantees, the principle of proportionality[253] and, in the absence of an EC 'Staatsvolk' (leading national group) an admittedly modified principle of democracy, in particular the constitutional legal proviso for interferences in fundamental rights. The Charter of Fundamental Rights of the EU provides indications of this: to date, it has not been legally binding, but it also compiles in wide areas stipulations made by the ECJ concerning, in its view, valid 'unwritten general legal principles' of the Community and common constitutional traditions of the member states. It may therefore widely serve as a 'look forward' to expected future decisions by the ECJ.[254]

6.3. If fundamental community rights are interfered with, this formally requires legitimation under community law in accordance with the legal proviso[255] of

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[250] Fundamentally ECJ court decision 4/73, *Nold/Kommission* coll. 1974, 481 margin no. 12, 13; also ECJ court decision C-177/90 *Kühn/Landwirtschaftskammer Weser-Ems*, coll.1992, I.– 35 margin no. 6; ECJ court decision 230/78, *SPA Eridonia Zuccherifici/Italian state*, coll. 1979, 2794 margin no. 20 and 31; cf. also Steinz margin no. 1, 4 to art. 16 of the CFR.

[251] Since ECJD 1978, 204 court decision 125/77, *Isoglukose*, established case law.

[252] Cf. for entrepreneurial freedom Streinz margin no. 7 to art. 16 of the CFR with further references and general margin no. 12 to Art. 51 of the CFR; for the principle of equality this, at any rate, appears to be obvious. In fact, the characteristic of a natural or legal person can be a suitable differentiator in the principle of equality, which is valid for both.

[253] E.g. ECJD 1979, 677 H – court decision 122/78 and ECJD 1980, 1979 H, verb. court decision 41/121 and 796/79; 796/79; cf. also Streinz margin no. 5 to art. 20 of the CFR.

[254] Cf. also Streinz margin no. 4 ff. preliminary remarks to the CFR.

[255] Cf. Kormann/Klein, l.c., Part 1, Section III.B.1. page 47 ff. with further references.

special justification due to reasons of general interest (barriers to fundamental rights)[256] and may not be disproportionate to the pursued goal.

With regard to the barriers the ECJ states:[257] ‘that the exercising of these rights […] may be restricted, provided that the restrictions in fact correspond to objectives of general interest pursued by the Community and that they do not constitute, with regard to the objectives pursued, a disproportionate and intolerable interference which infringes upon the very substance of the rights guaranteed.’

The necessity of the formal legitimation[258] of the restriction of a fundamental right by legislatively authorised bodies has as its source the principle of the state rule of law and the principle of democracy. Even if the latter, in the absence of a ‘Staatsvolk’ (leading national group) supporting the EU, is only applied in a modified way, it is still indisputable that at any rate a general proviso applies for interferences in fundamental rights.[259]

6.4. This legitimation lacks, in terms of content and formally in every respect, if the EU wanted to extend the IFRS for SMEs directly to non-capital-market-oriented companies by expanding the IAS regulation in a comparable procedure to the endorsement, for example, or force the member states to implement them with directives. A significant aspect here is always the objective of strengthening the protection of investors and the community capital markets on the one hand, and the lack of capital-market-orientation of the SMEs concerned on the other. It is not possible to build a bridge between these two extremes.

Reasons of general interest for the restriction to entrepreneurial freedom under the viewpoint of capital-market orientation, which are necessary for this, cannot be found. The capital markets are only affected if companies become listed on a stock exchange. Only then does the pursued goal of investor protection also apply for a large number of providers of equity, which recommends the standardisation of financial statements with a meticulous standard set of regulations anyway. Only a profound difference between listed and other companies can also preserve the principle of equality here and satisfy the dictate of proportionality. These IFRS for SMEs are not able to do

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[256] Cf. also art. 52 para. 1 of the CFR.

[257] Court decision C 292/97, *Karlsson u.a.*, coll. 2000 I 2737 margin no. 45.

[258] Cf. also Streinz, margin no. 23 to art. 6 TEU; also art. 52 para. 1 of the CFR: ‘… has to be legally provided.’

[259] Cf. for example ECJ of 21 September 1989 in the verb. court decision 46/87 and 237/88, *Hoechst*, margin no. 19; in detail here Kormann/Klein, l.c., p. 43 ff., p. 56 ff., on the question of legitimation for accounting regulations in accordance with the endorsement procedure.

this at any rate: as demonstrated above, they are neither suitable nor reasonable for SMEs which are *not* listed on a stock exchange. The same would have to apply to all standards geared to the efficiency and trust of the capital markets, as they have the wrong objectives. If the basic lack of benefits of a regulation were not in reasonable proportion to its burden, which here at any rate is considerable, then the regulation would not meet its primary legal requirements.

There are also deep concerns relating to the principle of democracy – for all the provisos vis-à-vis an unrestricted litigability of the principle anchored in art. 6 para. 1 of the EU[260] and for all the modifications offered due to the lack of a 'Staatsvolk' (leading national group) vis-à-vis a nation-state understanding of democracy. The endorsement process, the activation of the private IASB as the basic standard-setter, is ultimately only consistent with the legal proviso for fundamental rights, as the ECJ[261] also recognises, when the EU bodies are in a predicament:[262] the goals pursued with the IAS regulation, in particular the realisation of the free movement of capital by strengthening the European capital markets, only allow the Community legislator the choice between recognising US-GAAP or adopting IAS/IFRS. As there is only a chance of influencing the content of the standards with the latter, the Community has therefore tried to optimise unional democratic legitimation and in so doing realised, where possible, the principle of democracy. It maintains the possibility (and duty!) of also holding onto this influence in future.[263] Precisely this predicament, which, so to speak, recognises the 'choice of the lesser of two evils' as the basis for legitimation, in no way exists, though, for non-capital-market-oriented companies; the free movement of capital and the strengthening of the capital markets of the Community are not affected at all. Therefore, the necessary formal legitimation for the interference of fundamental rights does not exist. A standardisation of accounting for non-capital-market-oriented companies as well can, due to *other* considerations and general interests, be perfectly permissible, though not with the goals and general content of the IAS/IFRS or IFRS for SMEs or comparable systems that are massively geared to the interests and needs of providers of equity to listed companies.

7. Urgency of deregulation and simplification of accounting regulations for SMEs in terms of legal policy

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[260] Cf. Kormann/Klein, l.c., Part 1, Section III B and Section III B. 2.
[261] Jugdment of the Court of 21 September 1989 in the verb. court decision 46/87 and 2227/88, l.c.
[262] Cf. in detail Kormann/Klein, l.c., Part 1, Section III. B. 4. b) (3).
[263] Cf. Kormann/Klein l.c. and further references.

Proposition 3.7:

Efforts at international, community or national level to increasingly implement international systems with comparable goals to IAS/IFRS (mandatory or optional) for non-capital-market-oriented SMEs are also mistaken in relation to legal policy. Rather, the deregulation and simplification of applicable accounting regulations remains urgent for SMEs.

Reason:

7.1. If one follows the propositions 3.1 to 3.6, then it is revealed that the scope for the 'legislator' in accounting matters is *legally* much more restricted by higher provisions than has probably been previously discussed. Much, which was previously regretted as perhaps being inappropriate, but unfortunately was judged to be inevitable, has proved, upon closer examination, to be illegal. The catalyst for this step from inopportunity to illegitimacy is essentially the unusability of IAS/IFRS, IFRS for SMEs and comparable capital-market-oriented systems for non-capital-market-oriented SMEs and the inappropriateness of the obligation to use such standards. This applies, as demonstrated, both to the German national legislator, by virtue of higher constitutional law, and to the law-maker of Community secondary law, by virtue of higher primary law.

There remains, however, further scope for the legitimate legislation of accounting regulations for non-capital-market-oriented SMEs as well. The legislative bodies at Community and national level have very wide scope here for valuation and forecasting and decision-making prerogatives. Using such scope appropriately and making balanced decisions remains an important ongoing challenge for legal *policy*. Finally, there should be at least a few brief general remarks on how this can be realised.

7.2. This concerns, on the one hand, opportunities for member states of the EU to implement IFRS[264] and the like also for non-capital-market-oriented SMEs on a mandatory or optional basis:[265] nevertheless, to allow a system of standards which is basically unsuitable, as is the case here, for the purposes of parties who have to prepare accounts and in so doing freeing the parties concerned from using systems which are (more) suitable for them, may be

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[264] 'Endorsed' as required in art. 5 of the IAS regulation, or not 'endorsed'.
[265] In the wording of art. 5 of the IAS regulation: 'allowed or prescribed'.

legal. However, from a legal policy point of view such a process does not appear to be sensible.[266] It is even less so if there is an obligation to use the unsuitable system, if this should not be a problem legally, based on the constitution of the member state concerned.[267]

Overall, it is recommended that not only the national legislators of the member states thoroughly consider to what extent they adopt possibly unsuitable systems, but also that the Community bodies consider whether art. 5 letter b) of the IAS regulation should be amended: the regulation, with regard to the statement of applicability of IFRS by the member states, may only be declaratory;[268] nevertheless, it does create a certain pressure, at least a temptation, to ‘solve’ accounting problems here with a global referral to IFRS; the concept may be simple, but objectively it is less convincing. The more IFRS is used, even if only on an optional basis, in areas for which they were not intended and are totally unsuited, the greater the pressure for their general mandatory implementation. This may appear to be useful for the reputation of IFRS, and therefore their assertion over US-GAAP, however, it would not be long before the lack of suitability for such areas as the non-capital-market-oriented SMEs here is proved.

7.3. Another way is correct, namely that of deregulating, simplifying and concentrating accounting regulations for SMEs to what is really essential. This is not the place for specific detailed proposals on which of the numerous regulations could be nullified or even how they could be amended. A few principles and aspects should, however, be briefly addressed, whereby it is known that the devil is in the details, that simplification, especially of regulations, is mostly an extremely difficult matter and that for every potential individual proposal numerous good reasons can be used that are against it. Among others, the following theoretical starting points could promote simplifications and relief, without causing serious losses in efficiency:

- *Less is (mostly) more*: the fewer individual regulations claiming validity, the more likely they are to be observed and the more obligations are complied with – a point of view which makes many a cumbersome harmonisation regulation expendable. The legislator should be wary of trying to make ‘perfect’ regulations; it will then only produce mostly perfectionist regulations.

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[266] In this respect the resolution of the European Parliament of the 24 April 2008 in no. 37 is also critical.
[267] At any rate not in Germany.
[268] Constitutively, possibly concerning a restriction to ‘endorsed’ standards.

- *Simpler is (mostly) more efficient*: someone who does not understand a standard cannot apply it properly; someone who does not understand it properly, will not want to do so. When an SME requires external help for accounting, not only its workload increases with resources being tied up for non-productive activities, but its willingness to take the regulations seriously dwindles and internal resistance grows.
- *Differentiation is necessary:* an accounting regulation, from the point of view of the pursued goal and the workload created, should pay great attention to which companies it obligates to do what. This concerns in particular their size and legal form. The legislator of the HGB pursues this goal in line with its basic concept in the area of formal requirements. With its step concept the HGB proves itself to be far superior to the Procrustean bed of IFRS, IFRS for SMEs or similar 'comprehensive' systems. This concept should be maintained and developed where suitable. Many an accounting regulation should, upon closer inspection, prove to be completely unnecessary or modifiable for many groups of companies.
- *The purpose of the regulation determines its scope:* this requires particularly for accounting regulations for non-capital-market-oriented SMEs precise attention to the quite specific goals. Only where they do not serve to strengthen the capital market and protect investors, but are really important for the general protection of creditors, calculating payouts, capital maintenance or tax assessment, are they justified. Here, differentiation, precise deliberation and proper consideration are required, which do not always appear to be given sufficiently. European harmonisation efforts in the area of accounting also have to ask beforehand to what extent there is a specific Community interest in harmonisation anyway.
- *The legislator's wish becomes the user's worry:* many a thoroughly desirable value results when implemented in consequences which its creators had neither considered nor approved. Both the freedom to develop and the initiative of SMEs are high values and a cause for productive state investment; paralysis damages everyone. The occasional formulaic denial of costs in the introduction of a draft law is rarely appropriate. Many a hotly disputed landmark decision made within the scope of the BilMoG legislative procedure (for example the abolition of the reversed decisiveness or the rejection of the exemption of small partnerships from the bookkeeping and accounting obligation) could once again provide cause for discussion here.
- *The legislator should understand its own work:* particularly in an area as complicated as the accounting of companies this requires a reminder. Of course not every individual member of the Bundestag or person otherwise involved in legislative bodies is able to do that – aids (e.g. hearings) and ancillary organs (e.g. commission or ministry officials) are necessary. However, this help should come from their

> own organisation, with state laws in the state sector, with standards being set for the Community in bodies of the Community or the member states. A lack of understanding should not result in the passing on of responsibility by means of external allocation, nor in the ‘privatisation’ of the sovereign legislative duty. Rather, it should prompt particular caution, constraint, self-restraint and finally deregulation. Particularly this point of view should be carefully heeded for the retention, redesigning or even expansion of the endorsement procedure. At least the internal distance of the legislative bodies to the private ‘standard-setters’ should increase, e.g. by not viewing the dismissal of a standard created by the IASB with the rejection of an endorsement as a spectacular exceptional case.

7.4. Without falling into inappropriate optimism, it can on the whole probably be assumed that the necessity of simplification and deregulation in the area of accounting regulations for SMEs is recognised and there is also basic willingness to act here. This applies equally to the national legislator in Germany and to the relevant standard-setters in the European Community.

The process of the most recent German legislative procedure, which was completed when the BilMoG came into effect, is very clearly a serious effort to reduce the burden on the parties concerned and to make simplifications. This started with the official justification for the law by the German Government, was continued with the discussion in the legislative bodies, the Bundestag and Bundesrat including their committees, and was also not without consequences in the wording of the law.

At Community level, the European Parliament, by reason of the ‘Radwan initiative’, fortunately clearly admitted in nos. 36, 42, 47 and 48 of its resolution of the 24 April 2008 the need for relief for SMEs with the simplification of accounting regulations. The Commission also takes this line when it links its proposal to exempt the ‘smallest companies’ from the scope of EU accounting law of February 2009 with an extensive consultation of interested circles to revise the fourth and seventh directive of the Council to coordinate the company law.

It is to be hoped that this consultation at Community level resulted in numerous and substantial deregulation and simplification proposals and that the will to implement is not merely lip service for the press, but is maintained, reinforced in the discussion, proves to be enforceable in the Council and will soon bear fruit at Community and national level. The basic conditions for this have rarely been so good as now.

Part IV

Economic problems of applying IFRS to SMEs and handicraft enterprises

Klaus Dittmar Haase

Outline

I. General understanding of accounting

II. Fundamental accounting differences between IFRS, HGB and tax law

1. Case law versus code law as fundamental differences for legislation
2. Private-sector organisation of law setting as a legitimation issue and source of inefficiency
3. Standard accounting standards with no differentiation for size and legal form of the company as a breach of the dictate of proportionality

III. Accounting goals compared

1. Heterogeneity of information requirements of users of balance sheets
2. Limiting of payouts for the purpose of capital maintenance
3. Reporting of the correct comprehensive income
4. Reporting of capital-value-oriented earnings

Appendix

I. General understanding of accounting

Proposition 4.1:

The financial crisis of 2008 has made the shortcomings in the concept of IFRS transparent. The easing of 'fair value assessment' reduced accounting-related risks in the financial markets, however, at the same time it created serious, new kinds of uncertainties for the medium- and longer-term outlook of balance sheets, which might accelerate the turning away from IFRS.

Reason:

As is well known, IASB and the European Union buried in a 'cloak-and-dagger operation'[269] the fair value valuation for financial instruments in 'inactive markets' and replaced it with the previously rejected valuation in accordance with the lower of cost or fair value of the HGB. This is tantamount to a palace revolution, triggered by wishes of the companies concerned and by the realisation that without this U-turn, the IFRS would have an exacerbating effect on the crisis. This U-turn provokes a multitude of questions on the design of IFRS, which had previously not been considered due to the lack of brisance in economic development. In addition, after such an emergency act, questions on the medium- and long-term development of IFRS should arise; e.g.

- whether asymmetrical IFRS accounting can improve the information value of IFRS balance sheets in the case of rising and falling fair values,
- whether the emergency action should be lifted again when market prices rise (until the next decline),
- how the IFRS philosophy of a preferential and mandatory valuation at 'market prices' is to be assessed in a world with large waves of speculation from the viewpoint of economic policy and
- whether they can be of use in terms of information efficiency to investors of capital as readers of balance sheets.

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[269] Schildbach, Thomas: 'Was bringt die Lockerung der IFRS für Finanzinstrumente?' (What does the relaxation of IFRS do for financial instruments?), in: DStR 49/2008, p. 2381.

As the IFRS rules lack a consistent system, the suspension at short notice of fair value valuation for financial instruments was possible without conceptual problems, as is another future U-turn.

II. Fundamental accounting differences between IFRS, HGB and tax law

1. Case law versus code law as fundamental differences for legislation

Proposition 4.2:

The diverging legal systems (case law versus code law) rule out a compromise, also in respect of internationally binding accounting principles. As a result there is the risk that the in many areas unsystematic and contradictory accounting practice according to IAS/IFRS (with the even less systematic US-GAAP in the background) will become the sole standard for capital-market-oriented enterprises and also binding for commerclal and tax balance sheets for medium-sized enterprises in continental Europe.

Reason:

(1) With IAS/IFRS, completely different accounting practices come up against the continental European accounting culture and account for far-reaching and deep dissent in virtually all accounting issues, which also is hardly solvable for the accounting of SMEs; the discussion also extends to the tax balance sheet, therefore, there are also constitutional principles which considerably limit the scope for accounting legislation.[270]

(2) Significantly, the development of IAS/IFRS is also affected by a similar conflict between general standards and standards for individual cases:

- On 29 June 1973 the *International Accounting Standards Committee* (IASC) was founded as a private-sector organisation based in London

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[270] Cf. Part III.

to develop accounting standards that would be accepted worldwide.[271] Accounting methods that were not widespread and unusable were to be abolished and accounting options only allowed on a very restrictive basis.[272]

- Since 1989 various attempts at a conceptual basis have been started in association with the *International Organization of Securities Commissions* (IOSCO). In the interest of international capital markets accounting options were to be limited and therefore comparability of financial statements improved. The result was the Framework for the Preparation and Presentation of Financial Statements of the IASB. In terms of content there was, however, a stronger orientation to the individual-case-oriented US-GAAP.[273] In 2001 a further orientation towards the USA's standard took place with the restructuring of the IASC to IASCF based in Delaware (USA). The IOSCO, therefore, still found fault with the insufficient and in part absent clarification of certain accounting issues.[274]

(3) The European Union confirmed a similar situation with regard to accounting law because the EC accounting directives contained a number of national implementation and accounting options which interfered with the comparability of balance sheets, especially for investors active in international capital markets. With the choice of an alternative form of accounting, the European Union therefore decided to take into account the fact that the IAS/IFRS since the recommendation of the IOSCO and the restructuring of the IASC were considered to be 'the' regulations in the area of international accounting; it therefore supported the IASB.[275] On 19 July 2002 the EU regulation of the European Council for the application of IAS/IFRS for accounting in capital-market-oriented companies came into force. In turn, this regulation provided for its implementation at national level a number of degrees of freedom with regard to the scope of IAS/IFRS.

In Germany the implementation in the 'Bilanzrechtsreformgesetz' (BilReG, Act to Reform Accounting Law) was very 'measured', with civil and tax law implications for German accounting law (capital maintenance obligations, insolvency law, determining taxable profit). Therefore, § 315a of the HGB n.v. only obligates parent companies whose securities are traded on an organised

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[271] Cf. Pellens, Bernhard/Fülbier, Rolf Uwe/Gassen, Joachim (International Accounting, 2004), p. 73.
[272] Cf. Kleekämper, Heinz (Activities, 1995), p 110; cf. also Achleitner, Ann-Kristin/Behr, Giorgio (International Accounting Standards, 2003), p. 44.
[273] Cf. Kußmaul, Heinz (Fundamentals, 2000), p. 348.
[274] Cf. Pellens, Bernhard/Fülbier, Rolf Uwe/Gassen, Joachim (International Accounting, 2004), p. 75 f.
[275] Cf. Baetge, Jörg/Zülch, Henning (Accounting Principles, 2004), p. 85, margin no. 167.

capital market or whose registration for trading on an organised market had been applied for by the reporting date to prepare their consolidated financial statements in accordance with IAS/IFRS. In accordance with § 325 para. 2a of the HGB, an individual financial statement prepared in accordance with IAS/IFRS only has an exempting effect with regard to disclosure; company and tax law obligations are unaffected by this. In Germany, the individual financial statement in accordance with HGB still forms the basis for reporting.

(4) Despite this restrictive decision of the German legislator the danger remains that the impact of IAS/IFRS on individual financial statements will actually grow, due to the supposed superiority of internationally comparable IAS/IFRS financial statements from the viewpoint of investors of capital, and to the lowering of financial statement costs from the viewpoint of those preparing financial statements. This may result in pressure from other market participants (banks, customers etc.) on SMEs, which creates precedents.

2. Private-sector organisation of law setting as a legitimation issue and source of inefficiency

Proposition 4.3:

The privatisation of the development and setting of legal standards, which is widespread in the Anglo-Saxon legal system, means that accountable enterprises can play an important part in the development of accounting standards. Therefore, a legislation that is independent from vested interests and geared to the common good is threatened by democratically legitimate parliaments; at the same time, the efficiency of standards for accounting and profit calculation, which should serve the interest of users of balance sheets and the general public, is diminished.[276]

For the purposes of taxing profit, regulations for calculating profit that are oriented to IFRS are therefore rejected.

Reason:

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[276] Cf. also Schildbach, Thomas: 'Grundlegende Ziele der Rechnungslegung und ihre Bedeutung für KMU und Handwerksbetriebe, These 2.1' (Fundamental goals of accounting and their significance for SMEs and handicraft enterprises, Proposition 2.1).

The IAS/IFRS regulations differ fundamentally in their origin from the development of commercial law accounting and the commercial law principles of proper accounting: neither the USA's US-GAAP nor the IAS/IFRS possess formal legal force in the Anglo-Saxon area. The private-law character of IFRS accounting is also clear in the structure of the IASB, the actual standard-setter, and in the standard-setting process (due process). The selection of Board members is especially geared to technical suitability; among the in total 13 members of the IASB there are at least five auditors, at least three experienced preparers of financial statements, at least three addressees of financial statements and at least one academic. By grouping these Board members by balance sheet addressees on the one hand and preparers of balance sheets on the other, it is shown that the second group clearly dominates. Accordingly, standards for individual accounting issues are developed that are pragmatically also determined by the interests of the participating preparers of balance sheets. Although the IASB stresses its independence, doubts remain whether the loyalties of the Board members allow neutral solutions in important individual cases. If the information value of balance sheet data for balance sheet addressees falls, the efficiency of accounting standards for the economy as a whole diminishes.

Terminologically, the IAS/IFRS, as is the case with the USA's US-GAAP, are inductive technical standards, while the commercial law principles of proper accounting are to be understood as deductive legal standards.

The content of the IAS/IFRS standards lacks sufficient parliamentary legal legitimation.[277]

Due to the dominance of companies represented on the Board that have disclosure obligations and their auditors, there is a one-sided alignment of accounting standards to the requirements and needs of these major companies; this was also shown in the discussion on 'IFRS for SMEs'.

3. Standard accounting standards with no differentiation for size and legal form of the company as a breach of the dictate of proportionality

Proposition 4.4:

Accounting standards that are independent of size and (largely) independent of legal form conflict with the requirements of proportionality and equality as

[277] Cf. here in detail among others Tipke/Lang: 'Steuerrecht' (Tax Law), 18 A., p. 102 f.

they abstract from how the accountable enterprises are affected differently; the IFRS for SMEs are also in breach of this principle, because their rationality and understanding are often only developed by studying the extensive 'full IAS/IFRS',[278] and the IFRS for SMEs also conflict with the established German regulations for determining the taxable profit of smaller enterprises, such as the determining of profit and the net income method.

Accounting regulations for SMEs and handicraft enterprises should be systematically geared to the peculiarities of smaller enterprises in the sense of a 'bottom-up approach' and contain appropriate additional regulations for larger enterprises.

Reason:

In German accounting law many differentiations based on size categories and legal forms are normal, allocating a density of regulations based on the principle of proportionality (prohibition of excess[279]). In the 'Steuerbilanzrecht' (tax accounting law), § 4 para. 3 of the German Income Tax Law (EStG) and § 141 of the German Tax Code (AO) in particular are proof of the objectively needed differentiation.

While the IFRS for SMEs reduce the number of their standards, the regulations are often only understood by falling back on the extensive 'full IFRS'. In a survey the following requirements and criticisms of the draft of the IFRS for SMEs were revealed:[280]

> At the current time (July 2007) the essential results (of the survey) with regard to the development of IFRS for SMEs can be summarised as follows:
>
> Stand-alone document, therefore no mandatory fallback on IFRS if a matter is not regulated in the SME-IFRS.

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[278] Nothing has changed due to the removal of a number of references to the full IFRS, which were still included in the draft of the IFRS for SMEs. Cf. also Kormann, Joachim: 'Der Rechtsrahmen für Rechnungslegungsvorschriften zu Lasten von nicht kapitalmarktorientierten KMU und Handwerksbetrieben, insbesondere These 4.4' (The legal framework for accounting regulations at the expense of non-capital-market-oriented SMEs and handicraft enterprises, in particular Proposition 4.4).

[279] Cf. Tipke/Lang, l.c., p. 121 ff.

[280] Cf. http://www.ifrs-portal.com/Mittelstand/IFRS_fuer_KMU/IFRS_fuer_KMU_01.htm (as of December 2008).

> References to full IFRS with the options anchored in SME-IFRS and with issues not addressed.
>
> Thematic structure of SME-IFRS with in total 38 sections (382 pages including the ‘basis for conclusions’ and ‘implementation guidance’).
>
> In the view of the IASB, the users should include non-public accountable companies that publish annual financial statements for external addressees. It is left to the national legislators to determine the users (e.g. based on quantitative criteria).
>
> Retention of the options included in the full IFRS (exception: reporting of actuarial gains and losses in the accounting of performance-related pension plans) and anchoring of additional options.
>
> Compared to full IFRS insufficient relief with regard to accounting and valuation and with regard to disclosures. (Translation of original quote)

The EU Commission also expressed criticism in 2007: ‘After an initial analysis the Commission considers the current work of the IASB on the accounting of SMEs […] to be insufficient to really make life easier for European SMEs. The Commission has, instead, determined various other measures that could bring noticeable relief to the SMEs’ (translation of original quote).[281]

The Commission adds to this criticism as follows: ‘With accounting and auditing of financial statements, the attention should primarily be on lowering administration costs for SMEs, which are particularly burdened here, while the simplification measures should benefit all companies in the area of company law’ (translation of original quote).[282]

Finally, it has to be ensured that the methods for determining the taxable profit of SMEs are still compatible with the commercial law accounting standards. The final version has changed nothing here.

III. Accounting goals compared

1. Heterogeneity of information requirements of users of balance sheets

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[281] Cf. Commission of the European Communities (2007).
[282] Cf. Commission of the European Communities (2007).

Proposition 4.5:

Accounting in accordance with IFRS primarily serves the information requirements of anonymous financiers (shareholders and bondholders) on the future earnings of the enterprise borrowing the capital. Commercial and tax balance sheets, on the other hand, inform about the results of completed periods in the sense of reporting objective period-end dates. A standard balance sheet, which SMEs can currently prepare in the form of a tax balance sheet, would be made much more difficult based on the IFRS for SMEs.[283]

Reason:

(1) The IFRS are accompanied by the 'Framework', which should explain the fundamental premises for the individual IFRS.

No. 9 of the Framework explains:[284]

> The users of financial statements include present and potential investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies and the public. They use financial statements in order to satisfy some of their different needs for information. These needs include the following:
>
> (a) Investors. The providers of risk capital and their advisers are concerned with the risk inherent in, and return provided by, their investments. They need information to help them determine whether they should buy, hold or sell. Shareholders are also interested in information which enables them to assess the ability of the entity to pay dividends.
>
> (b) Employees. Employees and their representative groups are interested in information about the stability and profitability of their employers. They are also interested in information that enables them to assess the ability of the entity to provide remuneration, retirement benefits and employment opportunities.

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[283] Cf. also Federal Ministry of Justice: 'Wesentliche Änderungen des Bilanzrechtsmodernisierungsgesetzes im Überblick' (Essential changes to the act to modernise accounting law at a glance), March 2009, p. 2: The BilMoG 'ermöglicht insbesondere den mittelständischen Unternehmen, weiterhin nur ein Rechenwerk – die sog. Einheitsbilanz – aufzustellen, das Grundlage für alle genannten Zwecke ist' (makes it possible in particular for SMEs to continue to prepare only one set of figures, the so-called 'Einheitsbilanz' [standard balance sheet], which is the basis for all of the purposes stated).

[284] International Accounting Standards Board (IASB): IFRS 2009, London 2009, p. 78 f.

(c) Lenders. Lenders are interested in information that enables them to determine whether their loans, and the interest attaching to them, will be paid when due.

(d) Suppliers and other trade creditors. Suppliers and other creditors are interested in information that enables them to determine whether amounts owing to them will be paid when due. Trade creditors are likely to be interested in an entity over a shorter period than lenders, unless they are dependent upon the continuation of the entity as a major customer.

(e) Customers. Customers have an interest in information about the continuance of an entity, especially when they have a long-term involvement with, or are dependent on, the entity.

(f) Governments and their agencies. Governments and their agencies are interested in the allocation of resources and, therefore, the activities of entities. They also require information in order to regulate the activities of entities, determine taxation policies and as the basis for national income and similar statistics.

(g) Public. Entities affect members of the public in a variety of ways. For example, entities may make a substantial contribution to the local economy in many ways, including the number of people they employ and their patronage of local suppliers. Financial statements may assist the public by providing information about the trends and recent developments in the prosperity of the entity and the range of its activities.

While all of the information needs of these users cannot be met by financial statements, there are needs which are common to all users. As investors are providers of risk capital to the entity, the provision of financial statements that meet their needs will also meet most of the needs of other users that financial statements can satisfy.

(2) Clearly, the investor-oriented IFRS accounting only concentrates on providers of equity (cf. above no. 9[a]), for whom information on the company's performance that is relevant for decision-making and is forward-looking should be provided *(Decision Usefulness);* these financiers should be placed in a position to be able 'to assess the ability of the company to pay out dividends'. The goal, in this respect, is to protect current and potential shareholders against wrong decisions with asset losses from their shareholding.

With SMEs, current and potential financiers are, however, regularly provided detailed internal information, so that balance sheet data comes second to protecting these providers of equity.

The German Government shares these concerns with a remarkably clear admission:[285]

> **Improvement of the informative value of HGB financial statements**
>
> The modernised HGB accounting law is also an answer to the International Financial Accounting Standards (IFRS), which are published by the International Accounting Standards Board (IASB). International Financial Reporting Standards (IFRS) are tailored to capital-market-oriented companies. They serve the information needs of finance analysts, professional investors and other capital markets participants.
>
> The vast majority of accountable German companies, however, do not even use the capital market. It cannot, therefore, be justified to obligate all of the accountable companies to use the cost-intensive and highly complex IFRS. The draft of a standard advised by the IASB 'IFRS for small and medium-sized enterprises' is not a good alternative for preparing informative annual financial statements. Those with practical experience have sharply criticised the draft of the IASB; they believe its application, in proportion to HGB accounting law, is still too complicated and costly.
>
> The 'Bilanzrechtsmodernisierungsgesetz' [act to modernise accounting law], therefore, chooses another approach. It expands the proven HGB accounting law into a set of regulations that is on a par with the international accounting standards, but much more cost-effective and in practice simpler to manage. It is in particular still the case that the HGB balance sheet is the basis for determining the taxable profit and calculating the payout. This makes it possible for SMEs in particular to continue to prepare only one set of figures, the so-called 'Einheitsbilanz' [standard balance sheet], which is the basis for all of the purposes stated. (Translation of original quote)

(3) Although in the above-mentioned Framework 'needs which are common for all addressees' are highlighted, this cannot hide the fact that the primary interests of creditors and employees are diametrically opposed to the dividend interests of providers of equity. As will be shown in more detail below, IFRS

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[285] Cf. Bundesministerium der Justiz (2009), p. 2.

accounting cannot meet the needs of capital maintenance, as in it the reporting of unrealised profits is pre-programmed. Rather, limits on profit reporting in accordance with the strict realisation principle are required, as well as additional limits on profit distribution in the interest of a provision for equity-based investment opportunities for management.

(4) IFRS accounting cannot satisfy these competing interests; detailed information can help creditors to be better able to assess unfavourable developments, however they hardly represent a worthy replacement for missing payout restrictions. This would also apply if the IFRS balance sheet were supplemented with additional regulations for capital maintenance (e.g. with payouts for profits which have not been realised being blocked, as these, together with the reporting of deferred taxes, would result in theoretically unsatisfactory results and a workload which would hardly be manageable; cf. Proposition 4.5 and its reason).

(5) The calculation of profit in accordance with IFRS also does not meet the constitutional requirements of an objective and therefore verifiable determination of taxable profit.[286] An effective instrument against the drifting apart of commercial and tax law regulations for calculating profit is also the principle of equal treatment of the commercial and tax accounting laws in accordance with § 5 para. 1 of the German Income Tax Law (EStG). The tax balance sheet designed in this way also ensures that the net income method in accordance with § 4 para. 3 of the German Income Tax Law (EStG) produces the same taxable comprehensive income when determining of taxable profit for smaller companies as for companies which prepare balance sheets.

2. Limiting of payouts for the purpose of capital maintenance

Proposition 4.6:

The accounting goal of a capital holding in the enterprise is achieved in commercial and tax law by limiting the reporting of profits to profits which arise in accordance with the strict realisation principle from transactions that have been completed. These profits form the assessment basis for dividends, bonuses and taxes. This elementary goal is missing completely in the IFRS.[287]

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[286] Cf. also Kormann, Joachim, l.c., Proposition 3.4.
[287] Also Schildbach, Thomas, l.c., Proposition 2.2, item 3.4.

As is also proven in Proposition 4.7, the determining of profit under IFRS suffers from a tendency to report an inflated profit, which is of particular importance and regularly neglected in the literature; this effect contributes to the depletion of enterprises which prepare balance sheets in accordance with IFRS.

The regulations of the IFRS therefore constantly require an additional HGB balance sheet to counter the risk of the assets being depleted by dividends being distributed, bonuses awarded and tax being paid for profits that have not been realised.

For non-capital-market enterprises the HGB balance sheet completely meets requirements and at the same time provides more appropriate information.

Reason:

(1) The capital maintenance concept for the commercial balance sheet aims to report a profit that can be taken out of the enterprise without threatening equity with payouts, profit-related bonuses and similar payments that are too high to third parties (§§ 253 para. 1, 268 para. 8 of the HGB, § 256 para. 5 of the German Stock Corporation Act [AktG]). As it has proved itself, the IFRS were also adjusted accordingly in the financial crisis.

The capital maintenance concept for the commercial balance sheet is based on the strict realisation principle, which only allows a profit to be reported when a profitable transaction has been legally or at least economically realised. As a result, pure asset growth via acquisition and production costs is not reported as profit (§ 253 para. 1 clause 1 of the HGB).

The tax balance sheet also follows the strict realisation principle via the principle of equal treatment of the commercial balance sheet and the tax balance sheet (§ 5 para. 1 of the German Income Tax Law [EStG]).

As an exception § 248 para. 2 of the HGB has provided since 2009 for certain internally produced intangible assets[288] a capitalisation option, as evidenced by the reasons given for the law for the purpose of alignment with IFRS; in these cases too, however, the payout block in § 268 para. 8 of the HBG ensures that the corresponding increases in profit are covered by disposable

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[288] Not capitalisable are internally produced brands, print titles, publishing rights, customer lists and comparable intangible assets (§ 248 para. 2 p. 2 of the HGB).

reserves (corrected by profit carryforwards from the previous year and by the balance between deferred tax liabilities and assets).[289]

In the tax balance sheet such intangible assets are still not allowed (§ 5 para. 2 of the EStG).

(2) SME organisations also argue for the retention of this capital maintenance concept in the balance sheet, for example the 'Arbeitsgemeinschaft mittelständischer Wirtschaftsorganisationen in Bayern' (Consortium of SME Business Organisations in Bavaria):[290]

> We support the approach of the Commission to strengthen the principle of subsidiarity by reducing EU regulations in areas concerning domestic matters. In this respect we consider it to be beneficial if the individual member states can flexibly adapt their regulations quickly at any time to changing circumstances. However, the essential cornerstones in terms of an EU-wide minimum standard should be regulated to prevent competition between the member states with regard to the lowest requirements and therefore competition being distorted. This applies in particular with regard to the existing *capital maintenance concept* and the question for which companies this should apply. We strongly advocate the retention of the concept of capital maintenance in the balance sheet, which has been introduced in Germany. (Translation of original quote)

(3) As an alternative to the traditional HGB balance sheet an IFRS balance sheet could be discussed that is supplemented by the inclusion of further payout blocks to prevent unrealised profits related to increases in the value of assets via their acquisition and production costs being paid out. This would be consistent with the previous payout blocks of § 269 clause 2 of the HGB o.v. for start-up costs and § 274 para. 2 clause 3 of the HGB o.v. for deferred tax assets.

(4) However, the following argue against such an addition to the accounting regulations for the IFRS balance sheet:

- a number of individual items in the IFRS balance sheet would have to be compared with a corresponding HGB balance sheet; these

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[289] These payment blocks are admittedly not linked to a comprehensive protection of the company against excessive profit-related payments: first, even the payment block comes to nothing if there are free reserves from previous years that are, for example, paid out in the interest of financial investors acting for the short term; secondly there are no legal provisions against excessive profit-related bonus payments, interest payments and the like.

[290] Statement made by the 'Arbeitsgemeinschaft mittelständischer Wirtschaftsorganisationen in Bayern' (Consortium of SME Business Organisations in Bavaria) concerning the EC simplification directive, without prejudice.

differences would have to be carried forward over time for each individual item – an undertaking which would be comparable with the accounting of deferred taxes in the limited liability company balance sheet, which records the differences between the commercial and tax balance sheet

- the HBG balance sheet would therefore have to be carried forward parallel to the IFRS balance sheet. This contradicts the principle of efficiency in accounting. It therefore seems to be appropriate that IFRS accounting is not used.

(5) While the above-mentioned payout block of the current German Commercial Code (HGB) only addresses a few intangible assets in the commercial balance sheet and is therefore manageable in scope, the payout blocks discussed above could occur for other unrealised profits in the IFRS balance sheet for almost all assets. For unrealised profits as differences between the IFRS and HGB balance sheet result from all of the IFRS estimates above the highest values of the HGB balance sheet, for example for higher production cost estimates, longer expected useful life of assets, accrued and deferred items etc.

(6) It is also questionable whether reverse initial differences (lower IFRS values as HGB estimates) should or ought to be allowed as correction variables for the payout blocks; and what consequences would a negative value of the 'payout block' have?

(7) Finally, complicated interdependencies would emerge between

- the accounting of deferred taxes for differences between the tax and IFRS balance sheet and
- the payout blocks for differences between the IFRS balance sheet and the HGB balance sheet

which would completely show up the absurdity of the mechanism of payout blocks in an IFRS balance sheet.

(8) Certainly, the shortcomings of the current HGB capital maintenance concept should not be overlooked, as is clear by comparing the following two cases of deferred taxes: when an original intangible asset item in terms of § 248 para. 2 of the HGB is capitalised, deferred tax assets correctly reduce the profit that can be paid out in the HGB balance sheet in accordance with § 268 para. 8 of the HGB (even if only on the amount of the tax burden based on the capitalised amounts of around 30% for limited liability companies).

If a taxable, capitalisable item is allocated as an immediate expense in the commercial balance sheet, e.g. the disagio (§ 250 para. 3 of the HGB), the effective tax expense is compensated by a deferred tax asset as a result (§ 274 para. 2 clause 3 of the HGB),[291] the deferred tax asset item increases the profit that can be paid out in accordance with § 268 para. 8 of the HGB – a counterproductive consequence in the interest of capital maintenance.

In the first case, the capitalisation under commercial law of a value which has (not yet) been confirmed by the market of an internally-produced asset causes a partial payout block in the form of deferred tax liabilities.

In the second case, the non-capitalisation of the disagio violates the principle of determining profit on an accrual basis, because the profit under commercial law is reduced in the first few years of the term in excess of the liability, measured against the distribution of the interest expense on an accrual basis over the term of the liability in the tax balance sheet.

Despite such (correctable) individual shortcomings, the payout block of § 268 para. 8 of the HGB basically appears to be appropriate and essential; its extension to all of the differences between the IFRS and HGB items, however, would invite the risk of an unmanageable density of regulations.

3. Reporting of the correct comprehensive income

Proposition 4.7:

IFRS accounting contradicts established German commercial and tax law because it does not ensure that the comprehensive income of the enterprise is reported appropriately. Therefore, it does not comply with the constitution's requirement for taxation equality (art. 3 of the German Constitution [GG]) and is also in breach of § 4 para. 1 of the German Income Tax Law (EStG).[292]

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[291] The fundamental dilemma for the accounting of deferred taxes lies in this accounting being based on the premise that the calculation of profit in the commercial balance sheet is more informative than the determining of taxable profit, so that in the item 'tax on income and earnings' reported in the income statement under commercial law, not the actual tax expense for the year, but the sum (the balance) of the actual and the deferred tax expense has to be reported. As a result, the informative value of the tax expense item is diluted for external balance sheet analysis; in my opinion, the tax balance sheet profit is still much more informative than the commercial balance sheet profit.

[292] Concerning the details of accounting and calculating profit in accordance with IFRS for SMEs cf. in particular Beiersdorf, Kati/Eierle, Brigitte/Haller, Axel: 'International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs): "Überblick über den finalen Stand des IASB"' (An overview of the final version of the IASB), in: DB 2009, pp. 1549–1557, and Winkeljohann, Norbert/Morich, Sven: 'IFRS für den Mittelstand: Inhalte und Akzeptanzaussichten

Reason:

(1) Commercial law defines the period profit, and therefore also the total profit, with the individual legal accounting regulations and with the principles of proper accounting. In the tax balance sheet there is, accordingly, a sharp distinction between the changes in equity due to deposits and withdrawals on the one hand and the period earnings on the other. As § 4 para. 1 of the German Income Tax Law (EStG) states:

> **Profit concept in general**
>
> Profit is the difference between the business assets at the end of the financial year and the business assets at the end of the previous financial year, plus the value of withdrawals, less the value of deposits. Withdrawals are all assets (cash withdrawals, goods, products, profits and services), which the taxpayer has withdrawn from the company for himself, his household or for other non-company purposes during the course of the financial year. […] Deposits are all assets (cash deposits and other assets), which the taxpayer has supplied to the company during the course of the financial year […]. (Translation of original quote)

This separation between owner-related changes in equity and operational changes in equity has, in principle, also become accepted for determining profit under commercial law.

However, the determining of taxable profit applies stricter standards for the separation of both equity groups: for example, hidden deposits and hidden withdrawals, which are reported under commercial law via revenue items or expense items, are qualified so that they do not affect taxable profit.[293]

(2) IFRS accounting does not have such a relatively stringent separation of profit transactions from changes in equity. This results in a different comprehensive income for the company. These differences are caused by the other comprehensive income (OCI), which IFRS 2008 place in the following context:[294]

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des neuen Standards' (IFRS for SMEs: Content and acceptance prospects for the new standard), in: BB 2009, pp. 1630–1634.

[293] Hidden deposits are exceptionally reported in a way that does not affect taxable profit when they are made with deposits for services; the reason lies in the hidden service deposits not being able to be capitalised in the recipient's balance sheet.

[294] International Financial Reporting Standards (IFRS) 2008, published by Wiley-VCH, 2nd edition, Weinheim 2008, p. 32.

98 Changes in the equity of a company between two balance sheet dates reflect the inflow or outflow of its net assets during the period. With the exception of changes which result from transactions with shareholders acting in their capacity as shareholders (e.g. capital deposits, reacquisition of equity instruments and dividends of the company), and the directly associated transaction costs, the overall change in equity during the period concerned represents the overall revenue or expenditure including profits and losses which occur during the period concerned due to the activities of the company (irrespective of whether such revenue and expenditure items are reported in the income statement or directly in the statement of changes in equity).

99 All revenue and expenditure items recorded in a period are to be considered in accordance with this standard in the result, unless another standard or an interpretation stipulates a deviation. Other standards stipulate the recording of certain profits and losses (e.g. revaluation profits and losses, certain translation differences, profits and losses from the revaluation of assets held for sale and associated actual and deferred tax expenses) directly as changes in equity. As it is important for the assessment of the changes in the financial position of a company between two balance sheet dates to record all profits and losses, this standard requires the statement of changes in equity, which highlights all of the profits and losses of a company, including those which are recorded directly in equity. (Translation of original quote)

The IFRS for SMEs mention three items in 5.4 (b):

Three types of other comprehensive income are recognised as part of total comprehensive income, outside of profit or loss, when they arise:

(i) some gains and losses arising on translating the financial statements of a foreign operation (see Section 30 Foreign Currency Translation).

(ii) some actuarial gains and losses (see Section 28 Employee Benefits).

(iii) some changes in fair values of hedging instruments (see Section 12 Other Financial Instruments Issues).

These can be reported as follows (IAS 1.88 f.):

An entity shall recognise all items of income and expense in a period in profit or loss unless an IFRS requires or permits otherwise.

Some IFRSs specify circumstances when an entity recognises particular items outside profit or loss in the current period. IAS 8 specifies two such circumstances: the correction of errors and the effect of changes in accounting policies. Other IFRSs require or permit components of other comprehensive income that meet the Framework's definition of income or expense to be excluded from profit or loss (see paragraph 7).

(3) The OCI components may be components of success, however, they may only be booked in the period in which they occur, without affecting the income statement, directly via a revaluation reserve which is classed as equity.

In the following periods these values can either be released from the revaluation reserve and recognised as profit (recycling) or reposted directly to retained earnings. In the first case the profit is therefore reported in the income statement at the time these profits are realised. In the second case there is a continual violation of the principle of congruence: the sum of all non-owner-related deposits and withdrawals for the total period no longer corresponds with the sum of all of the period results[295] (*dirty surplus accounting*).

(4) Theoretically, the company's comprehensive income is calculated using the following *basic formula*, which records the difference between the total payments received E_t and the total payments made A_t in the life of the company, corrected by all deposits EZ_t (payments received and other monetary deposits) and withdrawals AZ_t between the company and its owners:

$$\text{Comprehensive income} = \Sigma_t (E_t - A_t - EZ_t + AZ_t)$$

This basic formula serves to separate the *operational* (and therefore affecting profit or loss) *payment surplus* from the *payment surplus between the company and its owners* (not affecting profit or loss).[296]

If it cannot be systematically ensured that these two groups of payment surpluses are strictly separated for all of the accrual-based accounting, then any form of calculation of appropriate profit for the individual periods is illusory as it can be manipulated. For this reason, German financial case law attaches particular importance to the comprehensive income identity of methods for

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[295] Cf. IFRS for SMEs, Paragraph 3.17:
Complete set of financial statements
3.17 A complete set of financial statements of an entity shall include all of the following:
(a) a statement of financial position as at the reporting date.
(b) either:
(i) a single statement of comprehensive income for the reporting period displaying all items of income and expense recognised during the period including those items recognised in determining profit or loss (which is a subtotal in the statement of comprehensive income) and items of other comprehensive income, or
(ii) a separate income statement and a separate statement of comprehensive income. If an entity chooses to present both an income statement and a statement of comprehensive income, the statement of comprehensive income begins with profit or loss and then displays the items of other comprehensive income.
(c) a statement of changes in equity for the reporting period.

[296] The deposits and withdrawals traditionally do not have interest added or discounted (perhaps in part to calculate the profit of individual periods). Revenues and expenses are also only necessary for profit deferral between the individual periods across the whole life of the company.

calculating profit (accounting, net income method) and therefore enforces complicated accounting principles for the net income method used for types of profit income to ensure performance-related taxation.

(5) A standard case for the different profit concept of IFRS accounting is the pension reserve. For the pension reserve, the expenditure and revenue expected at the start of the year are determined, which are included in this amount in the profit and loss statement for the current year. Any change to this revenue/expenditure can be recorded in accordance with IAS 19 / IFRS for SMEs 28.24 f. directly with a revaluation reserve;[297] these amounts, which are described as **actuarial gains and losses** do not appear in this respect in any period in the income statement. However, in such cases an off-balance-sheet statement is to be published, which also records the allocations to pension reserves for the current period that do not affect profit or loss; in doing so the IFRS profit to which the profit-related payments are linked (dividends, bonuses, interest etc.) is in no way adjusted.

(6) As a consequence of (5) the annual profit rises, whereby the impact of dirty accounting for the respective period can be seen in the statement of comprehensive income. On the other hand, the exaggerating of the period profit (and the profit reserves) reduces the revaluation reserve and therefore the remaining equity, and in the amount of the exaggerated profits accumulated in all of the previous years. The effect of the different, accumulated individual impacts on the OCI can only be seen to a very limited extent in the off-balance-sheet statement for the individual annual financial statement.[298]

> The frequent use of the new option by listed companies in 2005 (nine industrial companies that prepared balance sheets in accordance with

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[297] Paragraph 28.24:
An entity is required to recognise all actuarial gains and losses in the period in which they occur. An entity shall:
(a) recognise all actuarial gains and losses in profit or loss, or
(b) recognise all actuarial gains and losses in other comprehensive income
as an accounting policy election. The entity shall apply its chosen accounting policy consistently to all of its defined benefit plans and all of its actuarial gains and losses. Actuarial gains and losses recognised in other comprehensive income shall be presented in the statement of comprehensive income.

[298] Para 5.4 (b) names the following elements of the OCI:
Three types of other comprehensive income are recognised as part of total comprehensive income, outside of profit or loss, when they arise:
(i) some gains and losses arising on translating the financial statements of a foreign operation (see Section 30 Foreign Currency Translation).
(ii) some actuarial gains and losses (see Section 28 Employee Benefits).
(iii) some changes in fair values of hedging instruments (see Section 12 Other Financial Instruments Issues).

> IFRS in 2005 recognised actuarial losses directly in equity, including BMW, TUI, Bayer and Volkswagen), shows, though, that at least they attach more weight to improved earnings (including the important ratio of earnings per share) than to a lower equity ratio.[299] The greater emphasis remains on the direct reporting in equity in the 'Gesamtergebnisrechnung' (statement of income and accumulated earnings, in the appendix, German version). It is questionable, however, whether this presentation is actually noticed by the addressees of annual financial statements. All the same, the balance sheet shortfall has to be stated with the corridor method in the appendix, without any obviously noticeable effect on the assessment of the companies. (Translation of original quote)[300]

The philosophy of IFRS for pension reserves becomes clear in IFRS 19.95:

> In the long term, actuarial gains and losses may offset one another. Therefore, estimates of post-employment benefit obligations may be viewed as a range (or 'corridor') around the best estimate. An entity is permitted, but not required, to recognise actuarial gains and losses that fall within that range. This Standard requires an entity to recognise, as a minimum, a specified portion of the actuarial gains and losses that fall outside a 'corridor' of plus or minus 10% [...].
>
> The Standard also permits systematic methods of faster recognition, provided that those methods satisfy the conditions set out in paragraph 93. Such permitted methods include, for example, immediate recognition of all actuarial gains and losses, both within and outside the 'corridor'. Paragraph 155(b)(iii) explains the need to consider any unrecognised part of the transitional liability in accounting for subsequent actuarial gains.

(7) The effects of the violation of the congruence principle are shown and explained in more detail in Appendix 1 in a specific example by Theile[301] concerning the IFRS accounting of pension reserves.

(8) In accordance with IAS 19.93A–B with allocations to pension reserves which do not affect profit or loss specific details are required:

> If, as permitted by paragraph 93, an entity adopts a policy of recognising actuarial gains and losses in the period in which they occur, it may

---

299 In terms of the HGB balance sheet the reporting of excessive profit results in less remaining equity (however the equity ratio in accordance with IFRS rises due to the obligation to balance the pension reserve with the asset coverage).

300 Theile, Carsten, l.c., p. 132.

301 Cf. ibid., p. 122 ff.

> recognise them in other comprehensive income, in accordance with paragraphs 93B–93D, providing it does so for:
>
> a) all of its defined benefit plans; and
>
> b) all of its actuarial gains and losses.
>
> 93B Actuarial gains and losses recognised in other comprehensive income as permitted by paragraph 93A shall be presented in the statement of comprehensive income.
>
> In accordance with IFRS for SMEs 28.41(b), however, the following disclosure requirements apply:
>
> 'An entity shall disclose the following information about defined benefit plans […]:
>
> […]
>
> (b) the entity's accounting policy for recognising actuarial gains and losses (either in profit or loss or as an item of other comprehensive income) and the amount of actuarial gains and losses recognised during the period.

(9) In the example of Appendix 1 the difference in the annual profit in accordance with IFRS and in accordance with HGB reaches exactly the amount required for allocation to the pension reserve. This exaggerating of profit is a typical expression of 'window dressing'. The separate disclosures required in accordance with IAS 19.120 Ai cannot replace this distorted (total) reporting of profit with an external analysis of the accounting.

In the German HGB balance sheet such accounting would not be allowed. It is also to be assumed that such accounting would conflict with the interests of those preparing financial statements of appropriately low tax base because, due to the principle of equal treatment of the commercial balance sheet and the tax balance sheet (§ 5 para. 1 German Income Tax Law [EStG]) the excessive profits under commercial law would be subject to taxation.

(10) The violations of the congruence principle shown for pension reserves can also be proved for other balance sheet items. In this respect a serious conceptual shortcoming for IFRS can be seen here. Consequently, only one way out of this conflict of interests seems appropriate: for companies not using the anonymous capital market, IFRS balance sheets should not be used and HGB balance sheets should be used instead.

This opinion is also in line with the statement made by the 'Arbeitsgemeinschaft mittelständischer Wirtschaftsorganisationen in Bayern' (Consortium of SME Business Organisations in Bavaria) concerning the EC simplification directive: 'In order to prevent the smallest companies from where applicable virtually being forced to use IFRS (e.g. market power of customers etc.) it should be determined […] at EU level, that with voluntary accounting

the national accounting regulations have to be used' (translation of original quote).

4. Reporting of capital-value-oriented earnings

Proposition 4.8:

The goal of IFRS accounting emphasises in particular the advantages of decision and expected values, which are different to the traditional evaluation at historical acquisition and production costs. In so doing, though, IFRS accounting provides varied additional scope for evaluations with subjective and speculative elements, whose impact can be offset with actual performance in later periods in a way which does not affect profit or loss.

Reason:

(1) The impact of capital-value-oriented expected values is manifest in the approach of planned revenue and expenditure values in the income statement and in the choice of the appropriate interest rate to value these future earnings.

Theoretically, the expected internal post-tax return of the best not (yet) realised alternative investment for the company preparing the balance sheet lends itself as an appropriate level of interest. The lower (higher) this turns out, the higher (lower) is c.p. the capital value of the realised investments.

The choice of interest rate is of crucial importance for the fair value of the planned investments (cf. chart in Appendix 2); these interest rates show a wide spectrum and vary depending on the type of investment, their equity finance or borrowed finance, their risk etc. Even small changes in the interest rate can result in considerable changes in profit.

The forecast for future profit contributions is no less problematic. What profit contribution can be apportioned for example to a software solution designed in-house for a future advertising campaign?

In a planning calculation the timetable for realising the profit contribution is, after all, also uncertain.

In particular the treatment of realised and unrealised profits related to increases in fair value as the same conflicts with the information interests of external readers of balances sheets, if very restrictive conditions for the use of unrealised profits in the company are not met (cf. the explanations in appendix 2).

(2) It is questionable whether, in view of these uncertainties, the general information value of company-specific, capital-value-oriented figures can provide a better basis for decision-making for external financiers, employees, business customers etc. than the figures of traditional accounting; this applies all the more so if it is not necessary to adjust values expected and reported in previous years to values realised later in the income statement, and the expected profit determines the companies' profit-related payments.

Let us assume that at the start of the first year a profit contribution of 150 is expected, and that this should occur shortly before the end of the first year. If, in fact, the realisation of this profit contribution is delayed by 2 years, the actual profit achieved is only 100. As a result, in an IFRS balance sheet at the end of the first year (t=1) an increase in profit of 150 follows, although by this time it may already be clear that the time forecast was too optimistic. At least at the end of the third year (t=3) the reduction in the expected profit must be 'realised' with the actual profit, although not necessarily via the income statement, but also as a retirement of capital reserves that does not affect profit or loss.

(3) If the balance sheet should also perform for management the function of reporting to financiers on the actual profits of the capital used by management, it will be diluted with accounting oriented to IFRS regulations. Only someone using his own capital should use a planning and control calculation that is based on his own subjective targets and opportunities in terms of a capital-value-oriented calculation.

Appendix

1. Effects of the violation of the congruence principle

The effects of the violation of the congruence principle are shown and explained in more detail in this Appendix in a specific example by Theile[302] concerning the IFRS accounting of pension reserves:

Assumptions:

a.	Opening reserve (actual)	=	3,000
	Closing reserve (actual)	=	3,300
	Expected wages, interest expenses	=	320
	Other expected expenses	=	220
	Pension payments	=	240
b.	Opening asset coverage	=	1,000
	Closing asset coverage	=	900
	Expected interest income	=	100
	Expected expense	=	50
c.	Opening revaluation reserve	=	1,000
d.	Opening other assets	=	8,000

Changes in the pension reserve not affecting profit or loss:

Opening balance:	3,000
- Repayment	- 240
	2,760
+ Allocation up to closing balance:	+ 540
Closing balance:	3,300

[302] Cf. ibid., p. 122 ff.

HGB accounting produces an annual loss of 590, IFRS accounting produces a loss of only 50:

IFRS balance sheet with posting does not affect profit or loss:

Pension reserve

Repayment	240	Opening	3,000
Closing	3,300	Interest	120
		Wages	200
		Other expenses	220
	3,540		3,540

Revaluation reserve

Pension reserve	540	Opening	1,000
Closing 460			
	1.000		1.000

Profit and loss statement

Depreciation	100	Interest income	100
Coverage expense	50	Loss	50
	150		150

HGB balance sheet:

Pension reserve

Repayment	240	Opening	3,000
Closing 3,300		Interest	120
		Wages	200
		Other expenses	220
	3,540		3,540

Revaluation reserve

Closing	1,000	Opening	1,000
	1,000		1,000

Profit and loss statement

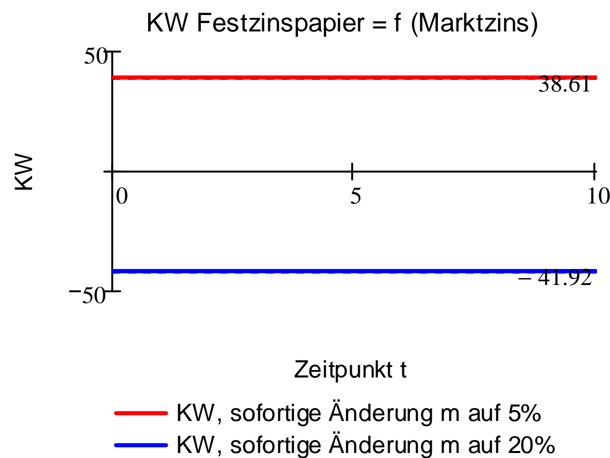
Reserve allocation	120	Interest income	100
Reserve allocation	200	Loss	590
Reserve allocation	220		
Depreciation	100		
Coverage expense	50		
	690		690

2. Effects of accounting with expected profits values based on capital value instead of actual profit values

A fixed-rate security with a current, market-driven interest rate (i) of 0.1 is acquired shortly before t = 0 at the price of 100 and has a term of 10 years. The company is speculating that the market interest rate will soon fall to 5%. It is assumed that shortly after t = 0 a permanent change in market returns (m) to 0.05 or to 0.2 will occur. Transaction costs are to be ignored.

The fair value (capitalised earning power [EW]) of the security then achieves with a fall in the market interest rate to 0.05 the value of +138.6 (profit: 38.6), to be reported in the first period in accordance with IFRS; accordingly, the capital value of the security reaches 38.6.

If e.g. the market interest rate rose to 20%, there would be a loss of 41.92.

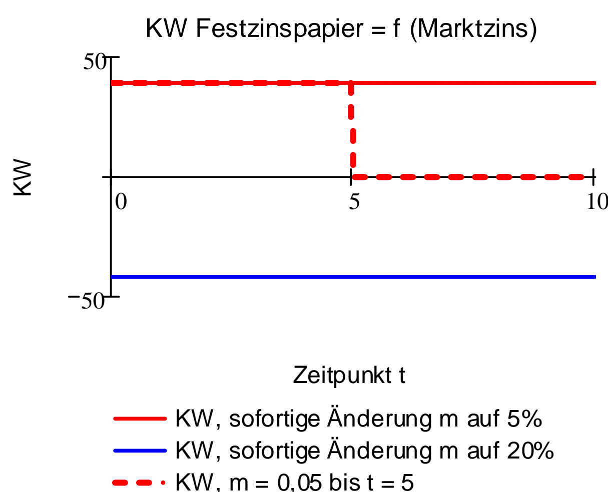


It becomes clear that the fair value is made from the total of acquisition costs and the capital value. The capital value is purely a future value: the present value of expected surplus returns.

The reporting of such a profit/loss by applying the fair value with acquisition costs faces conceptual criticism for two reasons:

1. Compared to an HGB-based profit calculation with actual profit values, when calculating profit with expected profit values a wide spectrum of justifiable expenditure and capitalised earning power values is available – here -41.92 or 38.6 – because the forecasting of further changes in market interest rates for the times t = 1, 2, 3 etc. is in practice often uncertain.
2. It also makes a difference whether the increase in fair value is realised by a sale in the first period or speculatively depends on the condition that the fall in the market interest rate, as expected, actually lasts until the end of the security's term; if necessary, this risk could be eliminated at a cost by a hedge.

3. This profit also depends on the current interest income being reinvested immediately and permanently elsewhere at the current market interest rate; e.g. if the market interest rate falls to 5%, the interest income can only be reinvested to 5%.
   - A reinvestment opportunity elsewhere with higher dividend yields (e.g. investments in property, plant and equipment) would considerably reduce the assumed speculative profit. For example, the profit for the first period of 38.6 would fall to 0 if the reinvestment return were 0.1.
   - Even if the market interest rate in t = 5 rose against expectations back up to 10%, the fair value would likewise fall again to 0.



In this respect, the fair value valuation is unfair to financiers requiring information, employees and the public if it reflects a speculative increase in returns which for the most part can hardly ever be repeated; for subsequent differences between expected and actual values, reporting that does not affect profit or loss should not be allowed.

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