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Minutes Round-table Discussions with Paul Pacter, Director of Standards for SMEs, IASB

**18/19 January 2007,
Düsseldorf / Frankfurt**

Time:

- 1) 18 January, 10am – 12am
- 2) 18 January, 3pm – 5pm
- 3) 19 January, 10am – 12am

Participants: Session 1)

Paul Pacter, IASB
Roland Franke, Deutscher Steuerberaterverband
Andreas Klein-Walbeck, Hansa Revision
Benno Lange, DHPG Dr. Harzem & Partner KG
Rolf Niewöhner, Schmitz-Werke GmbH & Co. KG
Silvia Prasse, BDI
Christoph Rust, GUS Group AG
Kay Schlüter, Handwerkskammer Arnsberg
Thomas Walther, WP/StB Meyer, Brockmeier, Becker & Partner, Minden

Liesel Knorr, DRSC e.V.
Kati Beiersdorf, DRSC e.V.

Participants: Session 2)

Paul Pacter, IASB
Hans-Hilmar Bühler, DGRV
Oliver Köster, Flick Gocke Schaumburg GmbH
Rolf Poppe, RST – Beratung
Dr. Thomas Senger, Warth & Klein Wirtschaftsprüfungsgesellschaft
Joachim Specht, S. Audit GmbH Wirtschaftsprüfungsgesellschaft

Kati Beiersdorf, DRSC e.V.

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Heinz-Joachim Neubürger (Vorsitzender), Dr. Helmut Perlet (Stellvertreter), Dr. Werner Brandt (Schatzmeister), Dr. Kurt Bock
Generalsekretärin: Liesel Knorr

Participants: Session 3)

Paul Pacter, IASB
Dirk Driesch, Susat & Partner OHG
Dominik Elgg, Deutsche Bundesbank
Markus Grund, BaFin
Tobias Lotz, GeGa Lotz GmbH
Birte Mörke, Deutscher Sparkassen- und Giroverband
Frank Reuther, Freudenberg & Co. KG
Dr. Thomas Ull, PwC
Martin Zabel, AC Christes & Partner
Thomas Zäncker, Commerzbank AG

Kati Beiersdorf, DRSC e.V.

The DRSC (Accounting Standard Committee of Germany) welcomed Paul Pacter and the participants. The basis of the discussion was the staff draft of the ED-IFRS for SMEs (and the implementation guidance) published in November 2006. The DRSC had prepared a paper in advance, which outlined some of the widely discussed issues.

Paul Pacter started out by introducing the background of the project and the development of the ED-IFRS for SMEs. He explained the reasoning on which the IASB based its decision. According to Paul Pacter there was one issue left to be discussed at the IASB Board meeting in January (deferred tax). However, he expected the final ED to be posted on the website on 1 February 2007. The printed version would be out in the middle of February.

Following Paul Pacter's introductory remarks, the participants each introduced themselves and laid out their particular interest in the ED-IFRS for SMEs, their first impressions about the ED, background information about the accounting environment in Germany or problems they faced with IFRS in general. The following main aspects were discussed during the three sessions (however, not every issue was discussed in every session):

SME environment in Germany and purpose of financial statements by German SMEs

In Germany SMEs do not primarily prepare financial statements for information purposes. Since IFRS and IFRS for SMEs are for information purposes only, there is some kind of general contradiction between the German accounting environment and the objective of IFRS. While most participants agreed that changes to the current situation are needed, they raised questions as to which requirements SMEs really need and what kind of information various groups of users need. Only then could be decided on which accounting changes should therefore be implemented.

Participants illustrated possible alternatives. One of them included extending the application of IFRS (e.g. to annual accounts) and hence fully orientate towards IFRS for SMEs as well. However, at this stage participants tend to favour modernising national GAAP as this would allow a more gradual change for SMEs. Legal requirements



could be more specifically adapted to national particularities (e.g. consideration of tax link). Hence, in Germany the IFRS for SMEs would be competing with the governmental project to modernize German GAAP (HGB).

Many participants explained that numerous SMEs prepare financial statements for tax purposes only. It would significantly increase the burden for those small companies (sometimes only a few employees in total) to prepare financial statements in accordance with tax requirements and HGB as well as the IFRS for SMEs. Thus participants predict low acceptance of the IFRS for SMEs in Germany and other parts of the EU.

Paul Pacter remarked that those kinds of companies are not companies that the IASB is developing this standard for. The IFRS for SMEs is intended for “general purpose financial statements”. Companies preparing financial statements only for tax purposes are not within the scope of the IFRS for SMEs.

A recently passed law now requires all limited liability companies to file their financial statements on a governmental website. This is perceived as a major problem as German companies are traditionally reluctant to provide company information as they find that sensitive with regard to competition. Problems especially arise for family-owned companies (e.g. with regard to related party disclosures). As mentioned before, IFRS on the other side are solely information oriented and require numerous disclosures. The disclosure requirements are still too onerous and not suitable for SMEs.

Some illustrated another problem in Germany: on the one side the financial reporting environment is changing quickly. However, on the other side corporate law and tax law have not yet been adapted to these changes. Therefore the situation for German SMEs appears to be quite critical.

Moreover, participants referred to the European discussion about reducing the bureaucratic burden on SMEs. Looking at the IFRS for SMEs it does not seem to be in line with such an initiative as it is still too burdensome for preparers of financial statements in accordance with IFRS for SMEs.

Nevertheless participants also described the advantages of a uniform accounting model in Germany or Europe respectively. A bank representative supported this view as it would be easier for banks to assess financial statements. To train staff on various accounting systems worldwide is inefficient for banks. He also made clear that transparency is most important for banks. However, so far German banks do not enforce application of IFRS. Participants generally agreed that German GAAP needs to be modernized in this respect (e.g. disclosures).

Participants explained that generally there is little knowledge of international accounting standards in SMEs, SMPs and banks respectively. Some fear that Germany might lack possibilities to actively take part in the process of designing the IFRS for SMEs.

Due Process at the IASB

Several representatives of SMEs (or larger family owned companies) and SMPs pointed out that regarding the due process there is room for improvement. So far



(non-managing) shareholders have not been included in the discussion. It was referred to the private company advisory committee of FASB and AICPA. Paul Pacter clarified that the private company advisory committee has only recently been formed, while the working group of the IASB has worked on the issue since three years. Moreover, FASB's advisory committee had come to the conclusion that - although there is need for disclosure simplifications - recognition or measurement requirements could stay unchanged. Paul Pacter added that he would be very happy to receive ideas on how to reach (individual) investors. He was preparing a summary of the ED-IFRS for SMEs and would appreciate this summary being distributed to as many investors as possible.

Participants added that companies have not been widely involved in the process. It was suggested that there should be more SMEs represented not only in the working group but the IASB itself or a specific advisory group. It was agreed that some SMEs would benefit from the change to IFRS as they might be highly internationally active; they could also benefit from aligning internal (management) accounting and external accounting. A participant pointed out that furthermore it would be beneficial for some SMEs to end tax oriented accounting. However, a vast majority of SMEs cannot cope with the current requirements. Their specific needs should be considered. This should include structural changes to the responsible institutions (SAC; IASB; etc.).

Scope

Participants:

Large parts of the discussion were dedicated to the scope issue. It was asked what exactly SMEs are supposed to be. In Germany some family owned companies could be very large, which overall results in a broad range of companies possibly being within the scope of the SME standard. As a result it was questioned, whether non-publicly accountability really is the best criteria. It is crucial that all speak about the same range of companies when discussing specific aspects of the ED-IFRS for SMEs.

Many stated that only a clarification of scope could result into clear requirements for the SME standard. For Germany many support a "three-tier-system" under which – generally speaking – large companies apply full IFRS, medium-sized companies apply German Commercial Code (HGB) or IFRS for SMEs and small companies would not have to prepare commercial financial statements but for tax purposes only (because they rarely have external users).

A bank association representative asked why small banks would be excluded from the scope of the IFRS for SMEs. There were some banks with only about 20 employees – there does not seem to be a convincing argument for them to prepare IFRS financial statements instead of applying IFRS for SMEs. In addition, banks are supervised by the Federal Financial Supervisory Authority (BaFin). In the view of this representative, the requirements stemming from public accountability are therefore met.

One participant expressed concerns with regard to the scope in general. Due to the width of possible SMEs there would be no workable/applicable criteria or factor for the cost-benefit-considerations the IASB wanted to base its decision about simplifica-

tions for SMEs on. The SME standard would be lacking “scalability” with regard to the cost-benefit-criteria.

Paul Pacter:

There was and is much discussion about the scope of the IFRS for SMEs. The IASB concluded that they should not have quantified size criteria. The IASB agreed on the non-publicly accountable definition, nevertheless reduced the criteria to “listed entities” and “fiduciary capacity”. The question had also been raised whether small listed entities should not be allowed to use the IFRS for SMEs as this would raise the quality of reporting for those small entities. This was especially raised by Latin American and Asian countries. Along the same line some argued that banks should not automatically be excluded from the scope of the IFRS for SMEs. However, so far the IASB has decided that these entities (any listed entity and banks) would not be eligible to apply IFRS for SMEs.

External User

Participants:

Some pointed out that the SME standard seems to be based on a misunderstanding about the external users of financial statements of SMEs. From some participants’ perspective banks cannot be counted as external users as they can get any information needed. A bank representative explained that this is not necessarily the case and they very often have to rely on whichever information they would get in the financial statements. Paul Pacter explained that this was also what he had heard from bankers earlier on. A bank representative added that not just content of financial statements was decisive for banks. Moreover, timeliness and reliability were crucial for banks. SMEs tend to prepare financial statements quite late. However, this was nothing to be solved in an ED-IFRS for SMEs.

It was added that SMEs do not have a problem with giving information to banks or non-managing shareholders. However, all information within the financial statements would need to be filed and therefore will be accessible to many others as well (competitors, customers etc.). Information tends to be more sensitive in SMEs as they have fewer products. As an example, a participant referred to a large listed group which has numerous products and a user of the financial statements could not conclude from that information which product is most profitable. However, SMEs would provide a different level of insight into their company by publishing similar financial statements.

With respect to external users one participant questioned whether the SME standard really incorporates different user needs. For example, requirements for business combinations in the SME standard contain the same recognition and measurement principles, which implies that users of SME financial statements are equally interested in purchase price allocation (evaluation of all intangibles) etc.

Paul Pacter:

It was explained that EUROSTAT was consulted. They laid out that in 12 EU-member states 40 to up to 85 % of the SMEs (including micros) had bank loans. Thus, banks seemed to be an important external user. More so since banks have

claimed to not always be in the position to require all information needed to evaluate a company.

Disclosures

Participants:

Current disclosure requirements within the ED-IFRS for SMEs are too detailed and give too detailed information and too deep an insight into a small or medium-sized company. This is problematic with regard to competitors and also customers. “Discontinued operations” were brought forward as an example. Others added that SMEs have major problems getting all information (e.g. from subsidiaries or associates).

While in general it is problematic for SMEs to not only inform their banks, but give information to competitors as well, related party disclosures were mentioned to be especially problematic. This is true especially for family owned companies. However, it was also pointed out that the EU had amended the fourth and seventh accounting directives by additional disclosure requirements for related parties.

Paul Pacter:

Paul Pacter encouraged all participants to go through the disclosure checklist and indicate in their comment letters the specific disclosures that are too burdensome for SMEs or which are “commercially harmful disclosures”. While he acknowledged that some disclosures are “competitively harmful” especially if family owned businesses are affected, he was wondering why the government decided to require these companies to have their financial statements registered on the governmental website. This seems to be an indication that government feels that there is public interest in this kind of information.

Stand alone SME standard / Options

Participants:

Many participants remarked the importance of a true stand alone SME standard. Therefore cross-references in the standard are problematic since changes in IFRS need to be considered in SMEs as well (this is true for single IFRS or specific options that the SME standard refers to). In this context it was also noted that the “volume” of the SME standard is not the only crucial criterion. According to the participants it would be more important to have a stand alone document.

With regard to the options it was mentioned by a company association that they should be eliminated since SMEs would otherwise be forced into reading full IFRS in order to evaluate the spectrum of options in full. If options were to be included in the SME standard they should either be part of an appendix or an appropriate SME version should be included instead of references to full IFRS. This would ensure that the SME standard was truly stand-alone. One bank representative supported deleting all options as for users of financial statements the comparability is most important. The fewer options the higher the comparability of financial statements.

Paul Pacter:

Compared to the beginning of this project some years ago the IASB is now much more aware of the need for a stand-alone standard. The IASB has tried to ensure that SMEs will be able to prepare financial statements by consulting the SME standard only (e.g. recent change with regard to the hierarchy, which does no longer require looking to full IFRS in case of a provision gap). In addition they provided illustrative model financial statements and further down the road will have some more educational guidance on the SME standard.

Regarding the options each country can choose to delete them or decide which of the available options to be included in the SME standard. Any SME standard without (or with fewer) options would still be in accordance with all the requirements of the IFRS for SMEs.

Maintenance of SME standard

Participants:

The stability of the IFRS for SMEs will be crucial. The standard should be far more stable than full IFRS. Participants would prefer amendments to the SME standard only every 3 – 4 years rather than the suggested “every other year”.

Paul Pacter:

Reported about FRSSSE and how this UK-standard also provides for updates every 2 years. Experience has shown that only after 4 years this standard has been updated again – there was no need to do so earlier. He hopes that this will be similar with the SME standard.

Equity / Liability

Participants:

Almost all participants explained that the main problem for SMEs arises from the equity/liability definition. Unfortunately this issue will not be sufficiently solved by the proposal laid out in ED-IAS 32 *financial instruments puttable at fair value*. It is difficult to communicate that a common legal form of SMEs (private limited partnerships, KG and cooperatives) would have present share capital as liabilities. Even though some feel this is more of a presentation issue, there are subsequent issues involved, e.g. need to treat dividends as interest expenses etc.

It was remarked that this is not however a “blanket-decision” as this issue is different depending on the individual contracts in the company. All participants feel that this will be a crucial issue to resolve for SMEs in Germany as otherwise there will be no motivation to apply neither full IFRS nor IFRS for SMEs.

One participant suggested adapting the framework so that different definitions for assets/liabilities and therefore equity would be possible.

Paul Pacter:

Paul Pacter confirmed that the IASB was very well aware of the issue. However, since this definition effects not only the SME standard it needs to be resolved more generally by including full IFRS. So far all that could be done was to include a footnote within the SME standard explaining that the IASB is discussing the issue. Furthermore, he acknowledged that the ED-IAS 32 does not sufficiently solve the problem. Nevertheless, this would need to be part of the overall project (including thoughts on framework), which is a joint project with the FASB and might therefore take some more time to resolve.

IASB would only address an issue within the SME project, if it is a special issue to SMEs. Even though SMEs are typically structured as the company forms affected, this is not an SME-specific issue.

With regard to changes to the framework, Paul Pacter explained that IASB strongly opposed the idea of having different definitions for assets and liabilities and equity in full IFRS and IFRS for SMEs. In fact, IASB members were quite concerned about any accounting changes (despite disclosure changes) as they might affect the current definitions in the framework.

Deferred taxes

Participants:

Many highlighted IAS 12 deferred taxes as one of the main problems when applying full IFRS. Participants were divided on the specific simplifications achievable in an SME standard. In Germany the temporary concept is perceived as being superior to the timing concept as SMEs have a tax balance sheet to derive the differences from. However, others acknowledged that the timing concept would be much easier to apply if no such tax balance sheets were available, which seems to be the case in many other countries.

In addition participants explained that deferred taxes were only to be understood if companies made extensive disclosures. This would enhance the burden for SMEs with regard to deferred taxes. Moreover, it becomes increasingly problematic the more jurisdictions a company needs to consider.

Participants commented on the number of years that deferred tax assets should be recognised for. Even though IAS 12 does not provide the basis to result in a cut off after a particular number of years it is obvious that it is harder to prove the existence of deferred tax assets if they are only to be recovered in the distant future. The participants agreed that in general measurement of deferred taxes is too difficult.

With regard to the burden of IFRS, one participant explained that companies usually buy tools to apply IAS 12 (which can range from 60.000 – 100.000 €). Next to the financial burden it is onerous for SMEs to create an artificial tax environment. It was doubted that deferred taxes are relevant information for the users. A rough estimate should be sufficient for SMEs. For example a 5 year planning is unrealistic for SMEs. It was also suggested that reconciliation of deferred tax should not be included in the notes.

Paul Pacter:

Even though the IASB has discussed deferred taxes in detail, the IASB rejected the suggested “flow through method”. Following this method companies would not have to accrue any deferred taxes. It was argued that a company does not have any assets or liabilities if it paid all taxes for the year. The counter argument proving that either assets or liabilities would exist and hence need to be recognised was that companies were allowed to e.g. accrue profits under the PoC-method and would consequently need to accrue deferred taxes as well.

IASB concluded that deferred taxes provide an important insight into the tax management of a company. In addition, liabilities should be shown on the balance sheet not off the balance sheet. A major requirement by banks was to have no off balance sheet liabilities.

An important simplification with regard to deferred taxes is a transition exemption according to which existing differences between tax basis and carrying amount of assets and liabilities do not need to be considered when applying IFRS for SMEs for the first time (unless readily determinable).

Overall, Paul Pacter remarked that he would welcome any specific simplification suggestions which keep the underlying principle (accruing deferred taxes).

Goodwill

Participants:

Many observed that a major issue for SMEs would be to subsequently measure the goodwill through an impairment test. Paul Pacter explained that the IASB views the indicator approach as an important simplification compared to annual impairment testing. People tend to mistake the amortisation approach. Amortisation would not mean: no impairment test at all. Companies would still have to evaluate whether the goodwill has been impaired. He did agree though, that impairment (and consequently impairment testing) was less likely if goodwill was amortised over a period of time. Participants explained that goodwill needed to generally be tested for impairment under HGB as well (although this would not often result in impairment, as this was prevented by annual amortisation).

Overall participants preferred the indicator approach over the annual impairment test. However, they believe that the amortisation model (including the revision of the carrying amount to ensure the lower of cost or market-concept) was the better model for SMEs. It was said that an impairment test requires valuation experts which implies a high financial burden for SMEs.

Paul Pacter:

Most people (comment letters or round-tables) have said to favour the amortisation model. However, the IASB had several reasons for rejecting the amortisation approach. First of all SMEs would still have to see if there were indicators for additional impairment. Second of all users of financial statements (analysts and banks) have said that amortisation had no informative value (in fact banks have said that the

goodwill does not have informative value at all). Nevertheless, this issue is very likely to be brought up again in many comment letters and the round-tables. Thus, the IASB will need to discuss this again.

Financial instruments

Participants:

Support was expressed for the short-cut method (hedge accounting) which the IASB has recently rejected. It seems as though there would not be real benefit in a simplified effectiveness test as companies either need to measure the effectiveness or they do not.

Paul Pacter:

The IASB argued that only few companies in the US (where the short-cut method is applied) can actually benefit from this model as it is very restrictive. The simplification achieved is that ineffectiveness does not need to be measured any time during the year but only at the end of the year. Thus SMEs do not need to go back in time and measure ineffectiveness.

Questioned about whether options are hedging instruments under this concept, Paul Pacter affirmed this. He explained that the earlier concept was much more restrictive. The current suggestion includes options as one of the main kind of hedging instruments in SMEs.

IFRS 5

With regard to IFRS 5 it was suggested to completely delete this section. Since SMEs are not very likely to have this kind of transaction the procedure should be simplified.

Paul Pacter confirmed that a disposal group can include inventories. This is not very clear from IFRS 5, but it is included in the example to IFRS for SMEs.

Experiences / Conversion issues

Some participants reported about their experiences (or the experience of their clients) with changes to full IFRS. Some concluded that companies should not change to IFRS if they did not have to. It would be too complicated and too costly. Asked about the specific complications they replied that deferred taxes (especially on loss carryforwards), classification of equity/liability and fair value measurement (e.g. investment property) were problematic. It was pointed out that there is no requirement to measure investment property at fair values under IFRS. Hence, companies were likely to assess the benefits (fair values in the balance sheet) higher than the costs (measurement of fair values).



Others reported that the company was very satisfied with the change over to full IFRS because they did not want tax driven HGB financial statements. On implementation, two major issues arose however: deferred taxes and disclosures.

An SME-representative explained that his company wanted to change to IFRS because US-American customers (mainly) and banks wanted to see IFRS financial statements. However, due to the company's legal form they would face the equity/liability issue, because of which they postponed the changeover.

Other Issues

- Agreement that IFRS for SMEs should be principles based. So far no particular issues with regard to guidance or missing examples arose.
- Asked about his expectations on how many countries will use IFRS for SMEs Paul Pacter explained that he of course cannot say for sure. However, countries that already implemented full IFRS for all entities will look at this standard. He added that he does not see the US demanding this SME standard as in the USA there is no need for SMEs to prepare financial statements at all. In his opinion it really is a "public interest issue" and a political issue. National (or European) jurisdictions will have to decide about the application of the IFRS for SMEs.
- Despite all possible problems, it was acknowledged that there are many merits in having IFRS as a common world-wide accounting basis (e.g. comparability, acceptance, efficiency of a uniform accounting system)
- Translation of the ED-IFRS for SMEs is an important step forward; suggestion that IASB considers accepting comment letters in other languages (Paul Pacter explained that English is the language agreed on in the constitution).