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REVIEW OF PRACTICAL IMPLEMENTATION ISSUES OF INTERNATIONAL FINANCIAL REPORTING STANDARDS

Case study in Germany

Executive Summary

In concluding its twenty-second session, the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) agreed to conduct further reviews of the practical implementation challenges of International Financial Reporting Standards (IFRS) as well as ways to meet these challenges. It was also agreed that the further review could be conducted by preparing country case studies with a view to developing guidance on good practices in IFRS implementation. Accordingly, five country case studies covering Brazil, Germany, India, Jamaica and Kenya were prepared**.**

This report presents findings of the case study conducted in Germany. As early as 1994, some German companies started to prepare consolidated financial reports in accordance with International Accounting Standards. This case study presents the structure of Generally Accepted Accounting Standards in Germany, the integration of internationally accepted accounting standards, institutional infrastructure, capacity-building and technical implementation issues.

The main objectives of this case study are to draw lessons learned from the experience of Germany in implementing IFRS and to discuss the findings with member States, with a view to facilitating sharing of experience among countries that are either implementing IFRS or that intend to do so in the coming years.

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I. Introduction*

1. Germany has a long tradition of accounting regulation, which has always been within the responsibility of the legislator.[1] Many changes have taken place in recent years in the accounting environment as a result of European regulations and numerous national laws, as a result of changes in capital markets. Predominant triggers were the increasing importance of capital markets to provide financing and the internationalisation of investors. Consequently, new demands on accounting, especially with regard to timely and decision-useful investor information, arose.

2. The question at stake is however, how traditional German GAAP will adapt to, or coexist with, international accounting philosophies (systems), whose influence is constantly increasing. In addition to accounting regulation, new enforcement regulations were developed to enhance both investor protection and market efficiency. Financial scandals such as Enron, Worldcom or Parmalat have brought to the fore the need for revised enforcement regulations worldwide. Furthermore, a European requirement for all listed companies to prepare their consolidated financial statements in accordance with International Financial Reporting Standards (IFRS)[2] demands an effective enforcement.

3. This study illustrates the process of implementing IFRS in Germany. It begins by explaining the structure of traditional German GAAP in order to point out the fundamental conflicts accompanying the implementation of IFRS (section II). Due to market forces German GAAP opened up and internationally accepted accounting standards were integrated in the German legal system. Exactly how the capacity was built and what institutional structures were needed to integrate and efficiently allow for the application of such a fundamentally different accounting system is described in section III. In section IV, specific transition issues and the predominant technical issue with regard to the IFRS are demonstrated. The study finishes summarizing the results and presenting an outlook on future developments.

II. The German financial reporting system and the need for Internationally Accepted Accounting Standards

The German accounting system

The main features of the German Commercial Code

4. German General Accepted Accounting Principles (German GAAP) are principle-based accounting standards. They consist of underlying principles (the so-called principles of proper bookkeeping, GoB) which are both codified and non-codified. The source for codified GoB and the majority of further accounting standards is the German Commercial Code (Handelsgesetzbuch, HGB). Legal requirements often lack detailed

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* This document was prepared and edited by the UNCTAD secretariat with substantive inputs from Kati Beierdorf and Kristina Schwedler, Accounting Standards Committee of Germany (ASCG).

[1] The first uniform accounting law (General German Commercial Code, AGHGB), which was adopted as early as 1861, requires all entities – independent of legal form or size – to prepare financial statements.

[2] For the purpose of this paper IFRS also comprise International Accounting Standards (IAS) and related Interpretations (SIC and IFRIC interpretations).

descriptions for specific accounting issues, e.g. guidance on leasing accounting. Therefore, additional literature and court decisions interpreting accounting issues are an essential part of the accounting system. Thereby the German GAAP evolved over time and adjusted gradually to the changes in the accounting environment.

5. Each accounting system needs to define its objectives and to develop accounting standards accordingly. For example, financial statements according to German GAAP are not only prepared to provide information for investors.[3] They also function as the basis to determine distributable profits which serve to protect creditors of the company. The creditor protection is the predominant objective in Germany. As a result, German GAAP focus on capital maintenance, because creditors are mainly interested in the capital remaining in the company to build up and strengthen the capacity to repay debt when due.

6. However, only the separate financial statements[4] (of individual legal entities) serve as the basis to determine distributable profits. Furthermore, separate financial statements serve as a basis for tax accounting. The initial idea of implementing the so-called conformity principle[5] was to simplify accounting. Companies were to prepare only one single balance sheet serving commercial and tax purposes. However, tax accounting did not only use commercial accounting regulations. Over time additional tax regulations were adopted. In order to continue to prepare one single balance sheet, some tax accounting standards are accepted under HGB. For instance, article 254 of the HGB states that additional depreciations are acceptable in order to carry items of fixed or current assets at the lower value that results from the application of accelerated tax depreciation. In addition, accounting options under HGB are carried out in accordance with the tax requirements. Therefore, the tax regulation influences financial statements under HGB. Contrary to the various objectives of separate financial statements (such as profit distribution, basis for tax accounting, and information for general users) consolidated financial statements are prepared solely for information purposes.

7. Since capital maintenance is generally sought by creditors, the German GAAP comprises of numerous principles which together form a prudent accounting system. An important feature of this accounting system is the imparity principle, which splits up into the realization principle and the anticipation of loss principle. The realization principle ensures that only realized gains are recognized as profits; the anticipation of losses principle requires accounting for unrealised losses. For instance, property (cost = €1 million), whose value increased over time (fair value = € 2 million) is still measured at cost in the balance sheet. If the value decreases (fair value = € 0.5 million) the property is impaired and has to be written down in the balance sheet to the lower value, with the impairment loss recognised in profit and loss. As a result, increases and decreases in value are treated differently, as German GAAP follow a strict “lower of cost or market principle”. Further examples of the importance of prudence are non-recognition of internally generated intangible fixed assets (see article 248 (2) of the HGB) and no revenue recognition according to the percentage of completion method.[6] The same

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3 While the current IASB Framework acknowledges many different users of financial statements, IFRS focus on the investors. It is assumed that other users’ needs are satisfied by providing information according to the investors’ needs.

4 In this paper separate financial statements refer to the individual accounts of legal entities (non-consolidated).

5 The conformity principle states that the separate financial statements are used for tax purposes, unless specific tax regulations require to depart from German GAAP.

6 Instead, the completed contract method is used.

principles and accounting regulations apply to consolidated financial statements even though they only serve information purposes.

The German Commercial Code in the light of European accounting regulations

8. The objective of the European Union has always been to harmonize legal requirements in its Member States in order to create a more efficient European market.[7] With regard to a more transparent and hence more efficient capital market the need for harmonized accounting regulations was acknowledged. The EU published the Fourth (on annual accounts) and Seventh (on consolidated accounts) Council Directives,[8] a legal measure which each Member State is required to implement into national law. The directives did not succeed in fully harmonizing accounting requirements throughout the European Union due to numerous Member State options in the directives and different national interpretations. As a result, the directives did not meet the needs of companies that wished to raise capital on pan-European or international securities markets.[9]

9. In 2000 the EU chose a different legal measure, i.e. a regulation as opposed to a Directive. It concluded that the vision of a single European financial market based on transparent and comparable financial statements called for unambiguous accounting standards. While the European Commission had expressed its preference for IFRS as the set of standards for listed European companies as early as 1995,[10] it was not before 2000 that the European Commission announced its intention to require the application of IFRS for consolidated financial statements from 2005 onwards. The regulation on the application of international accounting standards[11] was finally adopted in 2002. The IAS-Regulation directly entered into force in all Member States with regard to the mandatory application of IFRS for listed companies preparing consolidated accounts.[12] Member State options were solely granted with regard to the requirement or permission of IFRS for non-listed companies preparing consolidated accounts and/or for companies preparing annual statutory accounts. Without member state options or possible delayed implementation, a basis for uniform and comparable financial statements on the European capital market was established.

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7 The first treaty creating a European Community was signed on 18 April 1951. The Treaty on the European Union was signed in Maastricht on 7 February 1992.

8 Fourth Council Directive of 25 July 1978 (78/660/EEC), OJ L 222, 14.8.1978, p. 11; Seventh Council Directive of 13 June 1983 (83/349/EEC), OJ L 193, 18.7.1983, p. 1. See p.2 of the Fourth Directive for details about reasons. The directives were implemented in Germany in 1985 through the Bilanzrichtliniengesetz (BiRiLiG). With the implementation of these directives otherwise fragmented German accounting laws were restructured to form a broad accounting regulation for all companies (Third Book of German Commercial Code).

9 This conclusion is also drawn by the EU. See for example European Commission, COM (2000) 359, 13.6.2000. More details on the options: *Roques* (1996) Service Statistics and the International Harmonisation of Accounting Rules, p. 284 seq.

10 See European Commission, COM (1995) 508, 14.11.1995 “Accounting Harmonisation: A new strategy vis-à-vis international harmonization”.

11 See Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002, OJ L 243 of 11.9.2002, p. 1 (IAS-Regulation).

12 See Article 4 of the IAS-Regulation.

Enforcement of German GAAP

10. The German Commercial Code requires the annual financial statements and the management report of corporations to be audited by auditors.[13] Auditors are securing the proper application of the accounting standards. Furthermore, to ensure the conformity with the applicable accounting standards penalties (imprisonment of up to three years or a monetary fine) are imposed if accounting standards are violated.[14] In addition to the audit requirements within the German Commercial Code, the Law regulating the Profession of Certified Auditors[15], which addresses admission requirements as well as the rights and duties of a certified auditor, have to be complied with.

11. All legal requirements are reviewed and updated on a regular basis. For example, in 1998 civil penalty provisions were tightened (Article 334 of the HGB) and a mandatory auditor rotation system was introduced (Article 319a (1) Nr. 4 of the HGB); in 2001 peer reviews were introduced, which represent an external quality control by other auditors.

12. The Chamber of Public Accountants (Wirtschaftsprüferkammer, WPK) and the Institute of Public Accountants in Germany (Institut der Wirtschaftsprüfer in Deutschland e.V., IDW) are the authoritative institutions to ensure the efficiency of audits of financial reporting instruments. The WPK is a public body under public supervision in which public accountants/auditors and accounting firms are organised on a mandatory basis. The tasks of the WPK are codified and include quality control of the members or conduction of aptitude tests.[16]

13. The IDW, on the other hand, is a private-sector association in which public auditors and auditing companies are organized on a voluntary basis. Technical issues of the profession are analysed and generally accepted auditing principles are predominantly developed by this institution. With auditing standards and auditing guidelines the IDW significantly contributes to standardized audits of financial reports with a high level of quality in Germany.

The need for internationally accepted standards: first movers

14. In the course of globalization of business activities large German companies had an increased demand for capital and were thriving to participate in large international capital markets, especially the New York Stock Exchange – the largest capital market in the world.

15. However, financial reports prepared according to German GAAP were not accepted. In the beginning, the problem of acceptance arose mainly due to the fact that German GAAP was not known outside of Germany. In due course, companies were to prepare additional financial statements in accordance with US-GAAP in order to be listed at the NYSE.

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[13] In 1931 the obligation to audit annual financial statements was adopted in the German Commercial Code. See Article 316 HGB.
[14] See Article 331 HGB.
[15] Gesetz über eine Berufsordnung der Wirtschaftsprüfer (Wirtschaftsprüferordnung).
[16] For further information see http://www.wpk.de/english/home/home.asp and http://www.idw.de.

16. DaimlerChrysler AG (formerly listed as Daimler Benz AG) was the pioneer, preparing additional consolidated annual financial statements in form of reconciliation to US-GAAP. In 1996 many other companies such as Deutsche Telekom, Fresenius Medical Care AG, Pfeiffer Vacuum Technology AG, followed DaimlerChrysler to the NYSE; Digitale Telekabel AG for instance got listed on the NASDAQ.[17]

17. But companies were not solely driven by access to new sources of finances. Several other reasons drove them to seek a listing at the NYSE:
   → listing as a marketing instrument (no other listing involves such publicity and makes the company known worldwide);
   → improve company image and presentation to investors;
   → align external financial reporting and internal management accounting to allow for a more efficient internal planning and control;[18]
   → preparation for buy-outs abroad, if shares are to be used as acquisition currency.

18. In 1994 the first "dual consolidated financial statements" were prepared by companies in the pharmaceutical and chemical industry such as Schering AG. A dual financial report is prepared under HGB using all accounting choices that were available in IAS. [19] At that time, IAS tended to be closer to German GAAP and compared to US-GAAP, IAS provided more accounting options. Therefore, to prepare the necessary dual group accounts, German GAAP group accounts were still required and as a result, it appeared to be less burdensome to follow International Accounting Standards than US-GAAP.

19. These first movers were followed by other companies, which were listed on the "Neuer Markt" (New Stock Exchange) in Germany that was established in 1997 to give smaller "growth companies" the opportunity to raise equity. One of the prerequisites to access this market segment was to prepare financial statements in accordance with internationally accepted accounting standards (IFRS or US-GAAP).

20. Just how much the international accounting systems differed from national GAAP became obvious when financial statements were prepared in accordance with national GAAP and the figures were compared with those prepared under IFRS or US GAAP. Substantial discrepancies in the given information and specific accounting positions were revealed. DaimlerChrysler for example had an increase in equity of 8 billion DM (= €4.1 billion), the resulting profit decreased by 2.5 billion DM (= €1.3 billion). The main differences and effects will be presented in section III of this study.

21. Consequently German GAAP was not particularly enjoying a high publicity. Looking at German GAAP from an international accounting perspective (of capital market investors) they are not popular, in part because of the following features of German GAAP:

   → too creditor-oriented and thus too much emphasis on the prudence principle;

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[17] Seventeen German companies are currently listed on the NYSE and two on the NASDAQ.

[18] In Germany the external financial reporting and internal management accounting are completely separated systems. Due to the focus of external financial reporting on creditor protection, it is not of much use for internal management purposes.

[19] Any remaining differences were usually immaterial, thereby allowing the financial statements to be labelled as IFRS financial statements.

- → artificial stabilization of profits by building-up and reducing hidden reserves, thereby making it difficult to identify a company crisis and then only possibly with a time-lag (until hidden reserves are used up);
- → tax accounting affects commercial accounting and distorts the objectives of the commercial balance sheet;
- → major recognition and measurement issues are not explicitly addressed within the German Commercial Code;
- → too many accounting policy choices (e.g. in relation to goodwill or measurement of inventories);
- → distortion of results of operations (e.g. provisions for certain expenses permitted).

III. Integration of IFRS into the German financial reporting system

Regulatory framework

The way towards IFRS

22. The German legislator (parliament) realized that both previous European efforts to harmonize accounting regulation and existing German GAAP did not live up to the expectations and demands of German capital market-oriented companies. Germany responded accordingly and opened up its accounting system to internationally accepted accounting standards long before any European legal measure on the application of IFRS was decided upon. In 1998 the national legislator allowed listed[20] companies to prepare consolidated financial statements in accordance with internationally accepted accounting standards (IFRS or US-GAAP) instead of German GAAP.[21] As laid out above, consolidated financial statements – contrary to separate financial statements – are prepared solely for information purposes. Therefore this concession did not seem to interfere with other national accounting issues.[22]

23. The legislator – expecting European developments – viewed this permission as an interim solution, which was effective only until 31 December 2004. Until then German requirements regarding consolidated accounts were to be brought in line with international requirements. To support the legislator with this ambitious task, a privately organized institution was established in 1998: the Accounting Standards Committee of Germany (ASCG) and its standard setting body, the German Accounting Standards Board (GASB). The ASCG is authorized by Article 342 of the HGB to:

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[20] This initially only included companies which were issuing equity. Later all capital market-oriented companies were included (issuers of equity as well as issuers of debt).

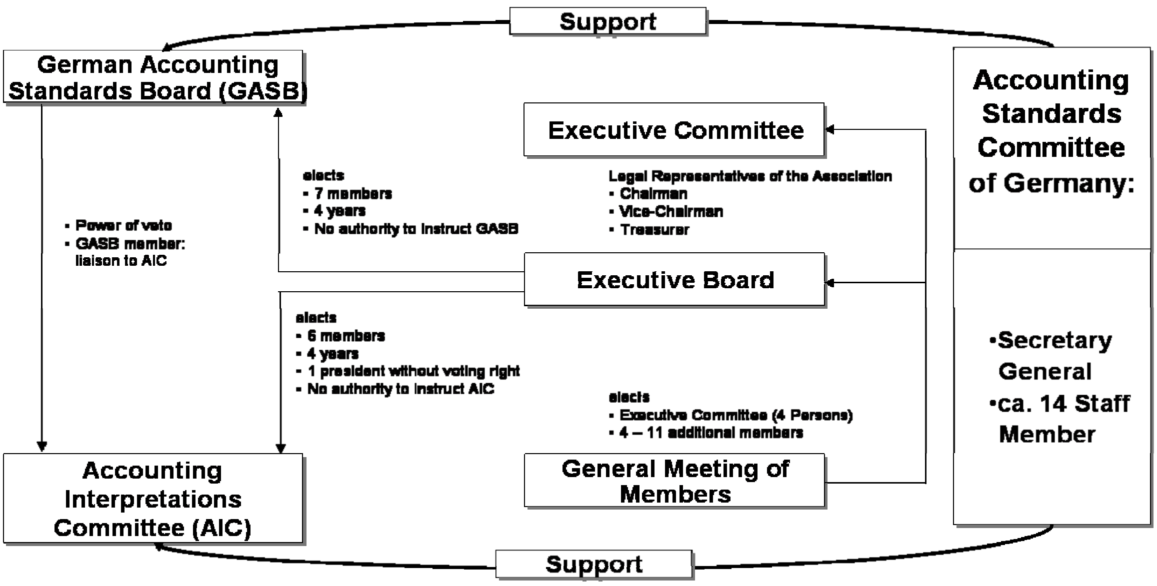
[21] The legislator temporarily (until 31 December 2004) adopted article 292a HGB through the KapAEG, BGBl. I 1998 of 20.4.1998, p. 707 seq.

[22] However, accounting experts predicted impacts on separate financial accounts since legal requirements concerning consolidated accounts refer to recognition and measurement requirements for separate accounts. See Article 298 (1) of the HGB.

→ develop recommendations on the application of German accepted group accounting principles (German Accounting Standards, GASs);
→ advise the Federal Ministry of Justice on accounting regulations;
→ represent Germany in international standard-setting bodies.

24. For the first time a private institution was assigned by the legislator to attend to accounting issues. There were several reservations, especially to independence and credibility of a privately organized accounting standard setting body and the legal effect of standards developed by this institution. However, a private accounting standards body allowed a greater flexibility in the development of accounting and financial reporting principles and a quick adaptation of such principles to meet the changing needs of preparers and users of financial statements. Furthermore the due process allowed the integration of all parties interested in accounting issues.

25. The ASCG is organised similar to the IASC Foundation. The GASB comprises independent accounting experts with different backgrounds, including academics, preparers (industrial and financial businesses), analysts and auditors. To round off the structure of the GASC the Accounting Interpretations Committee (AIC) was founded in 2004. The AIC picks up on national issues regarding the application of IFRS. It subsequently analyses whether this is a solely national or internationally relevant issue. Depending on its conclusion it will refer the issue to the respective international organisation (IFRIC) or develop a specific national guideline for application of the IFRS in question. The following chart gives an overview of the structure of the ASCG:



26. The GASs have had a big impact on the preparation of financial reports under HGB up to present day. In particular, the standards fill gaps within legal requirements, e.g. on management report, risk report, cash flow statements, segment reporting or statement of changes in equity, have changed and harmonized the national financial reporting tremendously. However, there are still doubts as to the degree of legal authority of these standards. This is due partly to preparers and auditors questioning the legal authority of GASs and partly to lack of enforcement. In particular standards which limit accounting choices existing under HGB are rarely being applied (e.g. GAS 4 on Acquisition Accounting in Consolidated Financial Statements).

27. At the same time, the HGB has undergone some further developments. For example Article 297 of the HGB expanded requirements with regard to the elements of consolidated financial reporting by cash flow statements and statement of changes in equity.

Current Situation: Coexistence of IFRS and German GAAP

28. With the IAS-Regulation the permission in HGB to prepare IFRS or US-GAAP consolidated accounts became obsolete and was replaced by the requirement for listed companies to prepare consolidated accounts in accordance with IFRS. As mentioned above, member states had the options to allow or require IFRS for other companies as well. Due to the objectives of separate financial statements (see section II) which IFRS accounts supposedly were not adequately designed to fulfill, Germany has chosen a less rigorous approach on the implementation of the options:

Figure 1. German GAAP and IFRS

<table>
<tr><th></th><th>Group Accounts</th><th>Individual Accounts</th></tr>
<tr><td rowspan="2">LISTED Companies</td><td>IFRS
MANDATORY
since 2005</td><td>IFRS: Prohibited
⇨ German GAAP Accounts Still Mandatory</td></tr>
<tr><td>Obligation Effective from 2007 for Listed debt instruments and users of US GAAP</td><td rowspan="2">Large Companies may file IFRS financial statements with the Federal Gazette</td></tr>
<tr><td rowspan="2">NON-LISTED Companies</td><td rowspan="2">IFRS: Option</td></tr>
<tr><td>IFRS: Prohibited
⇨ German GAAP Accounts Still Mandatory</td></tr>
</table>

As shown in the above figure, German GAAP and IFRS (until 2007 also US-GAAP) currently co-exist when dealing with consolidated accounts.

Problems of further expansion of IFRS

29. IFRS are only required for a small number of about 1 500 German companies. Compared to the larger number of roughly 3 million non-listed companies, which prepare separate or consolidated financial statements, German GAAP appears to be the predominant GAAP at present and in the future. Due to the number of functions a separate financial statement has to fulfil (profit distribution, serving as a base for tax accounting and information) IFRS are not applicable for these statements at the moment. However, there are discussions about splitting up these contradictory functions by

establishing a solely separate tax accounting law or implement other means of determining distributable profits (such as the solvency test).

30. While these discussions are still at a relatively early stage other measures to update German GAAP are being taken in the meantime. The explicit objective of the legislator is to further develop German GAAP towards an information oriented accounting system, harmonising the requirements in accordance with IFRS.[23]

31. In addition, most companies do not yet see the benefits of converging to IFRS, which is perceived as a voluminous and complex set of accounting standards. There are major concerns – in particular in small and medium-sized enterprises (SMEs) – as to the applicability of these standards, which are intended to serve the purposes of capital market investors. The IASB has considered the concerns and responded by setting up a project to develop an IFRS for SMEs.[24] In addition to national developments this could enhance and accelerate the expansion of IFRS, contributing to the harmonization of accounting regulations in Germany. So far, SMEs are not very supportive of a possible IFRS for SMEs due to the additional benefits that separate financial statements prepared in accordance with national GAAP provide in the form of multi-purpose financial statements.

Enforcement of IFRS

Enforcement through audit requirements - application of International Standards of Auditing (ISA)

32. In principle the requirements of the German Commercial Code (presented in section II.2 of this paper) have to be applied. However, with standardized accounting provisions the need for standardized audit requirements evolved. In contrast to internationally harmonised accounting standards, standardised auditing requirements were only recently discussed and developed. The relevant international organizations are the International Federation of Accountants (IFAC) and its International Auditing and Assurance Standards Board (IAASB), which are developing and issuing International Standards of Auditing (ISA). Both German organizations, WPK and IDW (see section II) are members of IFAC.

33. So far the IDW has transformed ISA into national auditing standards. However, the recent EU Directive[25] on statutory audits of annual accounts and consolidated accounts stipulates that Member States shall require statutory auditors and audit firms to carry out statutory audits in compliance with ISA. The EU Commission – in accordance with the procedure specified by the European Council[26] – will have to adopt these international auditing standards. It is probable that the German Commercial Code will soon incorporate a reference to ISA. In compliance with the EU-Directive additional national auditing

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[23] The legislator plans to publish a draft law: Accounting Modernization Act. (Bilanzrechtsmodernisierungsgesetz, BilMoG) later in 2006.

[24] See http://www.iasb.org/uploaded_files/documents/16_33_0601SMEProjectUpdate.pdf for a full project report.

[25] Directive of the European Parliament and of the Council of 17 May 2006 (2006/43/EC), OJ L 157, 9.6.2006, p. 87; here Article 26 No 1 of the Directive.

[26] So-called *Comitology Process*. See Council Decision of 28 June 1999 (1999/468/EC), OJ L 184, 17.7.1999, p. 23. The Comitology Process is also applied to adopt IFRS.

standards will apply if they cover subject-matters for which the Commission has not adopted an ISA. [27]

Enforcement through supervisory bodies (FREP and BaFin)

34. The legal requirements on securities or stock exchange regulation of the European Member States are lacking consistency at the moment. In addition, the corporate governance structures of companies differ significantly throughout Europe. Due to these differences in legal requirements and companies' structures a pan-European enforcement institution does not seem feasible at the moment. Nevertheless, it is believed that harmonization of enforcement systems throughout Europe is an effective tool to create an efficient capital market and a level playing field within the Union. To this end, IAS regulation states that "a proper and rigorous enforcement regime is key to underpinning investors' confidence in financial markets. […] The Commission intends to liaise with Member States, notably through the Committee of European Securities Regulators (CESR) to develop a common approach to enforcement." [28]

35. The principles on the structure of national enforcement institutions as laid out in CESR's no 1 standard[29] were implemented into German law in 2004 through the Accounting Enforcement Act.[30] The fundamental approach installed with this act is a two-tier enforcement system.

36. The first tier is the German Financial Reporting Enforcement Panel (FREP), a privately organised institution. In accordance with the article 342b of the HGB representatives of fifteen professional and industry associations,[31] under the lead of the German Federal Ministry of Justice, have founded FREP, which is to serve as the sponsoring organization for an independent body (panel) enforcing financial reporting requirements in listed entities. In a next step to build up the necessary resources 12 members of the panel were elected and appointed. The appointed members had to satisfy high job specifications with regard to expertise, experience, independence and integrity. The panel operates under the lead of a president and vice-president, who both are distinguished accounting experts in Germany. Legal requirements also provide funding provisions. Since all entities listed[32] at a national stock exchange are subject to examination by the enforcement panel, all of these entities need to contribute to financing the FREP.[33]

37. The panel examines both consolidated financial statements and separate financial statements of entities listed in Germany. But the national legislator has recently published

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27 For example guidance on auditing a management report.

28 See recital no. 16 of the IAS regulation.

29 So far CESR has published two standards. The first of which establishes minimum requirements with regard to the organisation, competencies and methods of enforcement by which harmonization on the institutional oversight systems in Europe may be achieved. Standard no 2 attends to financial information coordination of enforcement activities.

30 Accounting Enforcement Act (Bilanzkontrollgesetz, BilKoG).

31 At present 17 associations are registered FREP members.

32 This includes both issuers of equity and issuers of debt.

33 There is a spectrum for the amount to be contributed by the entities reaching from a minimum of 250 € to a maximum of 15 000 € per year, depending on the annual turnover of the entity.

a draft law (Entwurf-Transparenzrichtlinienumsetzungsgesetz, TUG-E) to implement the requirements of the European Transparency Directive. Article 24 (4) h) of the Transparency Directive requires the Member States to enforce all reporting requirements within the Directive. Therefore the TUG-E proposes half-yearly financial statements to be subject to enforcement. This would significantly broaden the range of functions of the FREP.

The enforcement panel shall conduct its examination:

→ if there are concrete indications of an infringement of financial reporting requirements, including IFRS; this may also include complaints brought forward by whistle-blowers (motivated audit);
→ upon request by the Federal Financial Supervisory Authority (BaFin); or
→ without any particular reason (regular sampling audit).

38. If non-conformity with accounting standards is detected, the panel is asked to seek a solution together with the entity under examination. If, however, infringements or even violations done on purpose are discovered, the panel is to advise the Federal Financial Supervisory Authority (BaFin) – the second tier of the enforcement structure – of the result of its examination. In accordance with Article 342b of the HGB the panel does not have any authority to impose sanctions, its remit is solely to discover infringements of financial reporting requirements by listed entities.

39. The FREP has to report to BaFin on the overall volume and the results of their examinations. Beyond these general reports the BaFin – as the second tier – is only called upon when further actions are needed. The BaFin has to take further action if the panel discovers infringements or in case of non-cooperation of the entity (no correction of the erroneous accounting policy) under examination. Being a federal authority, the BaFin (and only the BaFin) is authorized to impose sanctions upon the entities. It is believed that combining private and public elements in a two-tier structure demonstrates that the best expertise can be brought together when dealing with ever more complex issues of financial reporting.

40. FREP's first report illustrates its work in 2005. The enforcement panel began its work on 1 July 2005. During the second half of 2005 a total of seven motivated audits and 43 regular sampling audits were conducted. All entities examined agreed to cooperate with the enforcement panel. Three of the motivated audits and four of the regular sampling audits were completed within 2005. In two cases, non-compliance with accounting requirements was discovered. One of those entities was instructed by the BaFin to announce the non-compliance. The other case is still pending, as the institutions are assessing whether the entity rightly claims a legitimate intrest to refrain from the announcment. The WPK (see section I) was informed that possibly an ineligible auditor was elected. FREP intends to conduct 120 to 160 audits per year.

41. In general, enforcement aims at ensuring a consistent application of the IFRS. Inherent in every accounting system is the problem of possible lack of regulation: since no single set of accounting standards can address every existing or possible accounting issue, standards requiring further interpretation or regulatory gaps are issues not covered by a specific accounting standard are inevitable. Therefore, enforcement institutions often

necessarily have to interpret the relevant accounting standards to evaluate whether the standards have been appropriately applied. Consequently, next to discovering infringements and taking the appropriate measures, enforcement institutions in fact also interpret existing accounting standards.

42. However, CESR advises national enforcement institution not to publish national interpretations or guidelines, but to forward the issue to the International Financial Reporting Interpretations Committee (IFRIC) or the IASB for clarification. This approach is strongly supported by the German enforcement institutions. Arising accounting issues are to be discussed at the recently established European Roundtable. The roundtable is coordinated by the Accounting Regulatory Committee (ARC) and aims at a consistent application of IFRS. If applicable, the accounting issues are referred to IFRIC.

43. To ensure a uniform application of accounting standards throughout Europe, CESR introduced a database, which will comprise enforcement decisions. These former decisions ought to be considered for future cases to allow for consistent enforcement over time.[34]

IV. Issues regarding the transition to IFRS in Germany

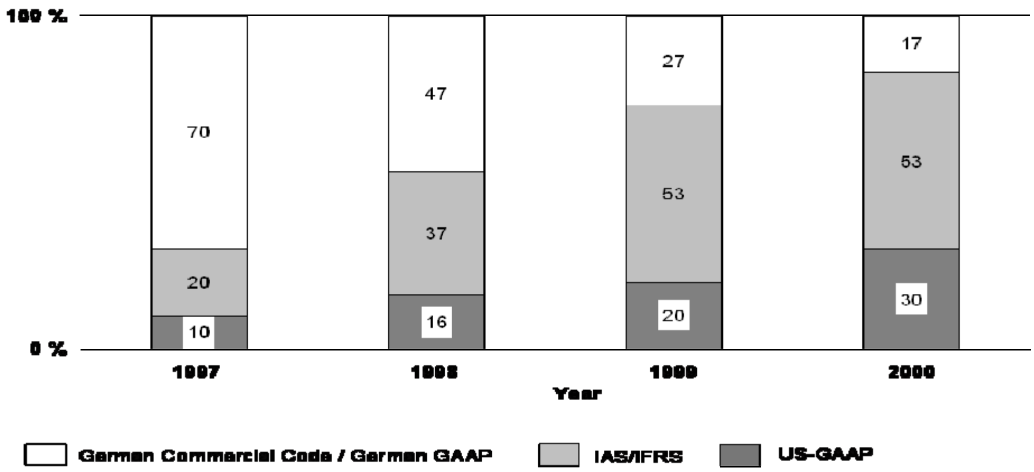
Developments of transition to IFRS

44. As mentioned in section II, international accounting standards became relevant in connection with listings of German companies at the NYSE (US-GAAP) and dual consolidated financial statements (HGB/IFRS). In 1997, already 20 per cent of the 30 companies listed at the German Primary Index (DAX-30)[35] published financial statements in accordance with IFRS; 10 per cent of the companies listed at this index published financial statement in accordance with US-GAAP. The following table gives an overview of the development until the year 2000, when the EU announced its intention to make IFRS mandatory for all listed companies preparing consolidated financial statements. The numbers demonstrate that German companies had favoured IFRS even prior to the EU announcement.

[34] Moreover it is planned to open up the database to other interested parties such as auditors, auditing companies, preparers or securities regulators outside of Europe.

[35] This index was developed in 1988 and encompasses Germany’s 30 largest-volume and most actively traded stocks. The DAX-30 is the leading index of the German stock exchange.

Figure 2. Accounting systems applied by DAX-30 companies until 2000



45. For the decision on the international accounting system companies for instance took into consideration:

- → European and national influence on IFRS standard setting process (no influence on US-GAAP, which in the end are a form of national GAAP);
- → explicit options within IFRS;
- → IFRS closer to German Commercial GAAP;
- → IFRS more principle-oriented than rule-based US-GAAP; IFRS therefore less detailed.

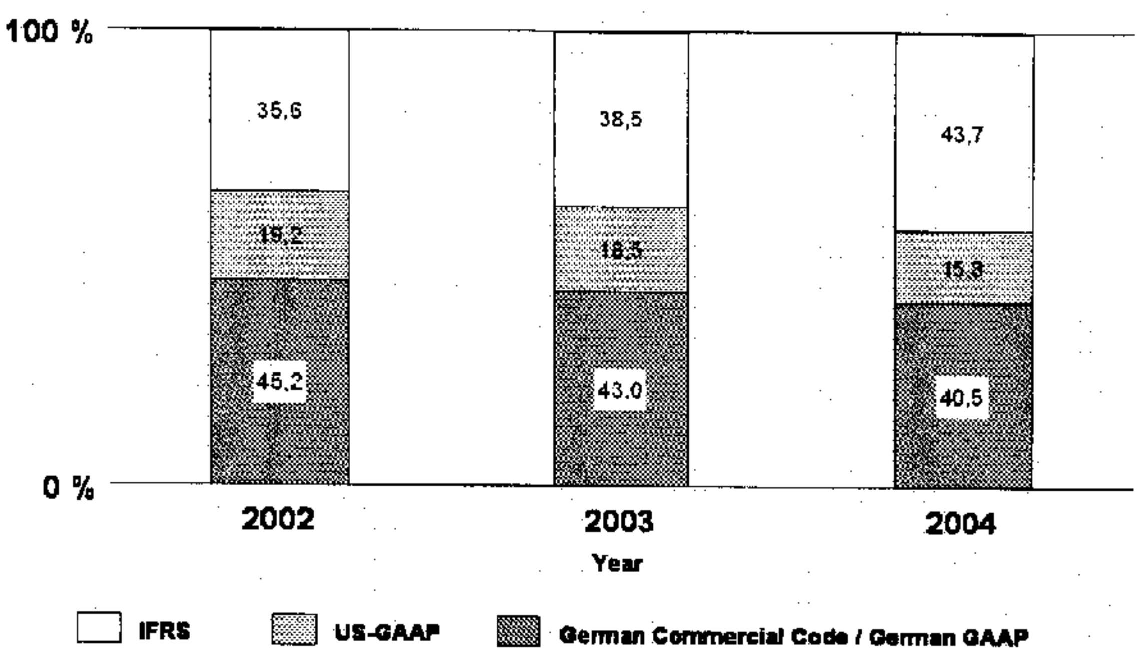
46. US-GAAP is mostly appropriate for companies seeking a listing on a US stock exchange or if their business activities are focused on the US market. IAS regulation state that companies applying US-GAAP will have to perform another transition: from US-GAAP to IFRS (effective for financial years starting 1 January 2007). Therefore, for those companies listed in the USA there is again a potential risk to have to prepare multiple financial statements and to reconcile from IFRS to US-GAAP, as IFRS are currently not accepted by the Security Exchange Commission (SEC). As a result, the convergence program of both the US-American FASB (Financial Accounting Standards Board) and the IASB[36] and the efforts to achieve mutual acceptance are extremely relevant for the German companies.

47. In 2002, the year of the IAS-Regulation, about 36 per cent of all group companies required to prepare IFRS consolidated financial statements by article 4 of that regulation, were applying IFRS already.[37] Compared to the total of 5 per cent (350 out of about

[36] The so-called "roadmap" for developing common accounting standards by 2008 was published on 27.2.2006.
[37] 45 per cent of those companies were still applying German GAAP.

7000) of all European companies addressed by Article 4 of the IAS regulation German companies were ahead of most other European companies.[38] After the adoption of the IAS regulation the application of accounting systems was spread as illustrated in the following figure:

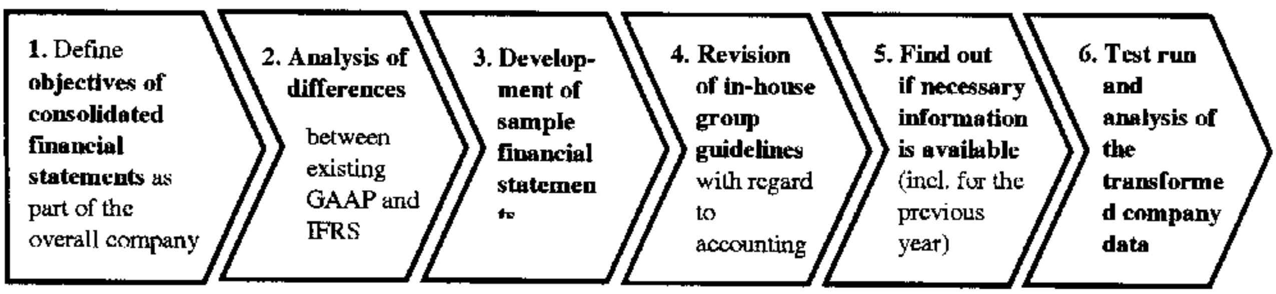
Figure 3. Accounting systems applied by German subject to Article 4 of the IAS regulation



Procedure of transition to IFRS

48. The transition to IFRS is a complex procedure which does not affect only the accounting department of a company. It is to be carefully planned and implemented. The following figure illustrates a possible breakdown into six phases.

Figure 4. Possible phases of a transition process



[38] See research conducted by PwC (2004), *IAS/IFRS – capital market oriented companies in Germany*, p. 6-7.

49. In 2004 a survey[39] of 88 companies listed at the prime standard of the Frankfurt Stock Exchange showed that on average companies needed 5.7 months to plan the conversion and 7.7 months to implement the new accounting standards.[40] In general, a total of 12 – 18 months should be allowed to complete the transition process. Next to the one-time costs of the conversion, there are recurring costs of applying the new accounting standards to be considered. While these touch some of the same sectors, following are illustrations of main sectors subject to increased costs occurring during the process of conversion:

- → hiring and training of staff, coordination with external consultants;
- → IT-reorganization, revision of in-house guidelines and costs of test-run.

50. The most significant share of the conversion costs are expenses for knowledgeable staff and adjustments of accounting-related information technology systems. The following table gives an overview of major conversion expenditures incurred in 88 companies of the German prime standard: [41]

Table 1. Major cost components of transformation process

Cost component	Average expenditure (in thousands of Euro)
in-house staff	255,52
Information technology	247,62
external consultants	154,20
training	59,47
Total Costs	**716.81**

51. All companies agreed that it is crucial for a successful implementation project to provide sufficient financial resources and staff during the conversion process.

Implication of the transition on the statements of financial reporting

52. A general statement about the effect of the conversion of the accounting system to IFRS is not possible due to opposing effects on separate positions. However, any impact on the presented company profit represents a one-time only effect. The value of net assets or the financial position of a company will not constantly be higher or lower compared to national GAAP. Any impact of the accounting transition signifies only temporary changes. Substantial differences between German GAAP and IFRS consist for example in the following cases:

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39 Research conducted by Deloitte (2004). "*Turning away from German GAAP – Accounting Transition Experiences, from German GAAP to IFRS or US-GAAP*", p. 9.

40 These data show a high statistical spread, therefore the average numbers are only approximate.

41 See Deloitte (2004), *op. cit.*, p. 12.

Table 2. Impact of IFRS on the presentation of profit & loss and equity

	P & L	Equity
Capitalisation of Development Cost	↑	↑
Non-Amortisation of Goodwill	↑	↑
Change of Depreciation Methods	↑	↑
Reclassification of Leases	—	—
Fair Value Measurement of Securities and Derivatives	↑↓	↑↓
Changes in Measuring Inventory	↑	↑
Change in Recognition of Provisions	↑	↑
Increase in Pension Liabilities	↓	↓
Comprehensive Recognition of Deferred Taxes	↑↓	↑↓
Consolidation of SPEs	↑↓	—

Predominant technical issue: classification of equity and debt

53. The predominant issue concerning the application of IFRS by German companies is the differing classification of equity and liabilities. This has an extremely problematic impact on the balance sheet, namely significant reduction of equity. As a result, it appears to be the main obstacle on the way to an overall acceptance of IFRS in Germany. The distinction between equity and liabilities according to IAS 32 follows an approach based on the existence of an obligation of the entity. Therefore, any instruments that are repayable within the lifetime of the entity are classified as liabilities. But the term “obligation” encompasses both present and contingent obligations. Therefore, if an instrument is repayable at the option of the holder (the holder has a right to put the instrument back to the entity), this instrument will also be classified as a liability. Even if the put is exercisable in a number of years or if the put option has a remote probability of being exercised, this would not change the liability classification.

54. On the contrary, under German GAAP other criteria are important for the classification. As German accounting aims at capital maintenance, risk capital remaining with the entity even for a short period of time, will be classified as equity. To be classified as equity, the capital must be loss absorbing, and it must be subordinated to straight debt on liquidation. In contrast to IAS 32, the capital may be repayable or the instrument may be puttable by the holder. For example, every member in a private partnership has a legal right to quit the partnership and the law grants the member the right to put back his or her share. Consequently, due to this legal right German private partnerships may not present equity in their financial statements if prepared under IFRS. As the legal form of the partnership is quite common in Germany for all types of businesses, and also as subsidiaries of listed companies, this IFRS implementation issue is of high importance. In addition, co-operative societies are affected, as their members also have the legal right to put back their shares.

55. Some hybrid instruments which may be classified as equity under German GAAP would be classified as debt under IAS 32. At present, the IASB is discussing possibilities for granting exemptions for certain kinds of capital instruments which would undoubtedly be classified as debt under current the principle of IAS 32. The exposure draft deals with instruments puttable at fair value. Since they are puttable, there is a contingent obligation for the entity to repay the instrument. But, there are additional criteria which cannot be fulfilled due to legal peculiarities of some partnerships, for example, such as those in Germany. Therefore, this exposure draft will arguably not solve the German companies' equity problem. This exposure draft is regarded as a short-term problem fix by the IASB. In addition, the IASB and the FASB are currently working on a joint project dealing with a completely new distinction between equity and debt. Preliminary views are not expected before 2007.

56. The ASCG is also working on the issue and tries to develop an alternative approach to IAS 32. The GASB set up a working group comprising of academics, practitioners and auditors. Furthermore, the ASCG is the project leader of the EFRAG working group on the same issue under the Proactive Accounting in Europe (PAAinE) initiative.

V. Conclusion and outlook

57. In recapitulating the developments of the past two decades, a tremendous change to the German accounting environment is evident. Due to globalisation and internationalisation of the business environment and increasing demand to access capital markets outside of Germany, alternatives to traditional German GAAP were needed. The initial European strategy towards harmonised accounting regulations through convergence of national requirements did not succeed fully in meeting the needs of companies that wished to raise capital on pan-European or international securities markets. Regardless of lack of legal requirements to do so, many capital market-oriented companies turned towards internationally accepted accounting standards driven by general economic conditions.

58. Significant differences between financial statements according to International Accounting Standards and financial statements according to German GAAP were revealed. While German GAAP was designed and perceived to be creditor oriented and therefore ruled by the prudence principle, DaimlerChrysler's profit had decreased under US-GAAP by €1.3 billion. A negative impact on the profit was obviously contrary to the strong emphasis on prudence, which suggested hidden reserves. This particular effect resulted from a lack of recognition and lower measurement of pension benefit plans.

59. However, it was hard to communicate any of the causes of differences in the annual accounts. From an international investor's perspective, German GAAP with its strong emphasis on a prudence principle was looked upon as incompatible with value oriented financial reporting.[42] German GAAP did not stand up to compete with other accounting systems for international acceptance. In the light of obvious shortcomings, the many merits of the systems remained unnoticed.

[42] The provisions with regard to pension benefit plans, which admitted that all liabilities need not be recognized and measured at lower than market value, were seen by international investors as an important shortcoming of German GAAP.

60. German capital market oriented companies were exposed to burdensome, cost intensive dual accounting, until the German legislator allowed consolidated financial statements to be prepared following internationally accepted accounting standards. This decision was confirmed by the European legislator with the IAS-Regulation of 2002.

61. At present, multiple accounting systems are coexisting, the inefficiency of which being obvious from an economical point of view. Therefore the challenge lies in:

- → enhance acceptance of IFRS;
- → further explore possibilities to open up separate financial statements to IFRS.

62. When converting to IFRS, companies have to: a) gain knowledge of a fundamentally different accounting system; b) apply more complex accounting standards with an increasing tendency to market valuation; and c) cope with constant changes of the accounting regulation. In 1998, German legislators decided to allow listed companies to prepare consolidated financial statements in accordance with internationally accepted standards (IFRS or US GAAP). Thus, listed companies in Germany embarked on the implementation of IFRS many years ahead of other entities outside Germany. For example, most listed entities in the European Union began the process later – in response to the IAS regulation that became effective in 2005. As a result, German listed companies had relatively more time to adopt IFRS and to build up the necessary resources. The capacity building process in the form of establishing public and private accounting and enforcement institutions has helped to set the frame for German GAAP that is increasingly becoming internationalized.