Federal Ministry
of Justice

New accounting law: billion scale financial relief for small and medium-sized enterprises in Germany

Berlin, 26 March 2009

Today the Federal Parliament passed the Act to Modernise Accounting Law (in German: "Bilanzrechtsmodernisierungsgesetz - BilMoG"). This legislation substantially eases financial strains in the economy and strengthens Commercial Code accounting law for competition with international accounting standards. Provisions that are central to the proven, inexpensive and straight-forward accounting law of the Commercial Code will be retained. The annual financial statement drawn up under commercial law remains the basis for distributing profits and for calculating profits for tax purposes.

In Berlin Federal Minister of Justice Brigitte Zypries said "Through BilMoG we are easing the strain on enterprises in Germany, especially small and medium-sized enterprises (SMEs), and by taking the necessary steps we are setting free forces of innovation and investment. One focal point of the reform consists in deregulation and cost reduction, particularly for SMEs. Financial relief running to the billion dimension will ensue from, for instance, our provision of full exemption from duties to keep accounts and records in the case of small and medium-sized sole merchants as well as through our threshold increases for share capital companies." Zypries went on to say that "The new accounting law provides small and medium-sized enterprises with modern and efficient accounting rules. We are enhancing the qualitative validity of annual financial statements drawn up under commercial law and, in doing so, we are also easing the pressure, particularly on German SMEs, to use international accounting standards. Accounting law for enterprises operating in Germany is being developed into a fully adequate alternative to international accounting standards. This means that we can avoid the disadvantages of international accounting standards - their high levels of complexity, their time-consuming processes and their high costs. And through BilMoG we are taking the steps that are necessary for responding to the financial markets crisis. In future, the economic risks of so-called special purpose entities can be better exposed."

Here are the most important individual points in the Bill:

1. Deregulation

The reform legislation exempts enterprises from avoidable balance sheet operations. Sole merchants conducting only a small business operation are made exempt from the commercial law duty to keep accounts, inventories and records. For share capital companies like the Public Limited Company (PuLC) and the Private Limited Company (PrLC) there is also provision for accounting exemptions and relief. All in all, by virtue of these measures, an annual cost reduction of about Euro 1.3 billion is to be reckoned with. If we also bear in mind the facilitation of accounting and stocktaking, the 2008 Annual Report of the Federal Government on Reduction of Bureaucracy states that there is even a savings potential totalling about Euro 2.5 billion, according to calculations made by the Federal Statistical Office. We are concerned here with the following specific measures:

- Sole merchants who do not cross certain thresholds (Euro 500,000 turnover and Euro 50,000 profit per financial year) are exempted from the obligation to keep accounts, inventories and records in accordance with the provisions of commercial law.
- Existing thresholds creating different categories of enterprise size and thus determining which obligations to provide information are to apply to a particular enterprise have been raised: thresholds for the balance sheet total and for turnover revenue, in section 267 of the Commercial Code (ComC), have been increased by 20%. This means that a larger number of enterprises than before will be able to enjoy the relief already afforded to small and medium-sized share capital companies. Such enterprises will, in future, have fewer accounting obligations under commercial law. Depending on whether a share capital company is to be classified as small, medium-sized, or large, it has to fulfil more or less far-reaching duties to provide information. Small share capital companies do not need, for instance, to have their annual financial statement checked by an auditor, and they have to disclose only their balance sheet, but not the profit and loss account. Medium-sized share capital companies can dispense with some of the specific information that has to be provided by large share capital companies, and they are allowed to combine balance sheet items.

  - In future, corporations are to be classified as "small" where they do not have a balance sheet total of more than approximately Euro 4.8 million (hitherto about Euro 4 million), turnover revenue of more than approximately Euro 9.8 million (hitherto about Euro 8 million), or more than 50 employees on annual average. A corporation must fulfil at least two of these criteria to be classified as "small".

  - In future, corporations are to be classified as "medium-sized" where they do not have a balance sheet total of more than approximately Euro 19.2 million (hitherto about Euro 16 million), turnover revenue of more than Euro 38.5 million (hitherto about Euro 32 million), or more than 250 employees on annual average.

2. Improving the qualitative validity of financial statements under the Commercial Code
The modernised ComC accounting law is also an answer to the International Financial Reporting Standards (IFRS), published by the International Accounting Standards Board (IASB). The IFRS are geared to suit capital market oriented enterprises; in other words, they also serve information needs of financial analysts, professional investors and other participants in the capital markets.

By far the majority of those German enterprises that are required by law to keep accounts and records do not take part in the capital market at all. For this reason, there is no justification for committing all the enterprises that are required to keep accounts and records to the cost-intensive and highly complex IFRS. Also the draft recently discussed by the IASB of a standard "IFRS for Small and Medium-Sized Entities" is not a good alternative for drawing up an informative annual financial statement. Practitioners in Germany have strongly criticised the IASB draft because its application - compared with ComC accounting law - would still be much too complicated and costly.

The Act to Modernise Accounting Law therefore takes a different approach: it has developed the tried and tested accounting law of the Commercial Code into a body of rules that is on a par with international accounting standards but much cheaper and easier to handle in practice. In particular, the Commercial Code balance sheet remains the basis for calculating taxable profits and dividends. This makes it possible, especially for small and medium-sized enterprises, to continuing drawing up just one calculation - the so-called "uniform balance sheet" - which forms the basis for all stated purposes.

The qualitative validity of the annual financial statement made under commercial law will be improved by the following measures:

- **Internally generated intangible fixed assets**
  In future, internally generated intangible assets forming part of fixed assets, such as, for instance, patents or know-how, can be marked in the Commercial Code balance sheet. This is important, above all, for innovative enterprises involved in intensive research and development - for instance in the chemical or the pharmaceutical industry or in the automobile industry together with their ancillary (supplier) industries. So-called "start-up" enterprises, too, where they are small and medium-sized, are particularly going to reap the benefit of this provision. In future they, too, will be able to point to their developments - show their potential - in their financial report. This means that enterprises can expand their shareholder equity base and improve their capacity to acquire more capital at low cost on the market. In tax terms, the expenses incurred remain deductible; they are also not available for profit distribution. This promotes Germany's competitiveness as a business location for innovative enterprises.

  Examples:
  (1) A large proportion of the costs arising in the pharmaceutical industry is attributable to research and development of new drugs. In future, where it becomes apparent, for instance from clinical studies, that a particular drug is going to be licensed for sale, the costs of developing that drug can be entered on the assets side of the balance sheet as the costs of producing a self-constructed asset forming part of fixed assets, e.g. a patent or just know-how. This means that the enterprise's profit and loss account will not be burdened and the balance sheet profit will be higher.
  (2) A start-up enterprise, concerned for instance with the development of software, can enter the costs of developing the software as software production costs for self-constructed intangible assets, forming part of fixed assets, and it will not, as in the past, have to enter these costs as effective expenditure.

- **Valuation of financial instruments at fair value**
  In future, credit institutions will on principle have to assess financial instruments like shares, debt securities, units held in funds, and derivatives so far as they are acquired for trading purposes at their fair market value on the closing date for the balance sheet. This is in line with the present practice of credit institutions; it simplifies and unifies commercial law accounting, is internationally customary and will now also be established in the accounting law of the Commercial Code. This means a strengthening of the qualitative validity of the annual financial statement with reference to profits and losses that are realisable at any time. Credit institutions will have to make account for a fair reduction for risk and enter a special reserve subject to a bar on distribution, as an additional protection against risk. This special reserve has to be built up from part of the enterprise's trading profits when times are good and can then be used to offset trading losses when times get worse. Hence this special provision has an anticyclical effect. Here the necessary steps have been taken in order to respond to the financial markets crisis.

  Example: A bank buys 10 shares at a price of Euro 100 per share. These shares were acquired with the goal of making a profit on sale and can be sold again on any stock exchange trading day. On the closing date for the balance sheet these shares are priced at Euro 125 per share. On evaluation of these shares according to their fair market value (Euro 125) minus a deduction for risk (e.g. Euro 5), they are to be marked with a total of Euro 1,200 (10 shares x Euro 120) in the balance sheet. The resulting profit for the bank is Euro 200. 10 % of total trading revenue must then be allocated to a barred special item which can be written back in the event of trading losses.

- **Change in the valuation of provisions**
  An enterprise's provisions for future obligations will be assessed more realistically in future. In the course of public

discussion, the current handling of provisions under accounting law has repeatedly been identified as a weak point in commercial law accounting. Particularly with regard to provisions for post-employment benefits so the argument goes it is not possible nowadays to infer from the accounts drawn up under commercial law what amount actually composes the burden affecting an enterprise because, by common consensus, valuations are considered to have been too low. So, in respect of the valuation of provisions, future developments (salary / wage, price and personnel developments) are going to be taken into greater account than in the past. Moreover, provisions have to be discounted in future. Hence the more future-oriented measurement of provisions will particularly affect post-employment benefits. The reform will lead to an increase in the valuation of provisions, at least in the case of post-employment benefits. However, this is imperative if we want to have an provisions valuation that reflects reality. In order to cushion the effects, the Act makes it possible for provisions to be accumulated over a period of several years. The tax provisions remain unchanged on this point, so that there will be no shortfall in tax revenues.

Example: An enterprise's real estate is contaminated with chemicals. The authorities instruct the enterprise to eliminate the contaminated site as soon as the enterprise stops business operations. This is to be reckoned with in five years' time. On the balance sheet closing date the costs of employing an excavator amount to Euro 100 per hour. It is to be assumed that an excavator hour will cost Euro 120 in five years' time. Under the present legal position - abiding by the closing date principle - the sum that has to be taken here for accrual valuation is Euro 100 per hour; however, in future, that sum will amount to Euro 120 in the example given, because account has to be taken of future developments.

- **Abolition of accounting options no longer reflecting current circumstances**
  In addition to the above, Commercial Code accounting law will be relieved of the "ballast" of past years. Accounting options once enjoyed by enterprises but no longer reflecting current circumstances have been made subject to restriction or have been repealed. Having these options was partly detrimental to information content and to the comparability of annual financial statements. This applies, for instance, to the option - which also does not enjoy recognition for tax purposes - of building up reserves to help cover one's own future expenditure on repairs, renovations and the like.

  Example: At ten-year intervals, an enterprise renovates the administrative and works buildings in its ownership. The sum of money required for carrying out these renovations is collected by the enterprise over a period of ten years in an accrual fund to cover future expenditure (in German: "Aufwandsrückstellung") without agreements having already been entered into with third parties regarding the carrying out of such renovations; such provisions are not recognised for tax deduction purposes. In future this sort of accrual fund, with no tax recognition, can no longer be accumulated.

- **Transparency of special purpose entities**
  The Act also contains provisions requiring more information and transparency in the balance sheet handling of special purpose entities. The financial situation of the special purpose entity and the economic risk undertaken by the group are to become more visible from the group's own annual consolidated financial statement. On the one hand, enterprises must in future be included in the consolidated financial statement when the parent enterprise can, directly or indirectly, exercise a controlling influence. This will be the case particularly when, on an economic substance-over-form analysis, the enterprise concerned is shouldering the majority of the special purpose entity's risks and chances. Until now inclusion has depended on whether the parent enterprise has a partnership or company law holding in the special purpose entity. On the other hand, in their consolidated statement notes, enterprises are required to report on the type, purpose and financial effects of business transactions that do not appear on the balance sheet so far as this is necessary for an assessment of their financial position. This implements a requirement under EU law. In addition, enterprises are required in future to set out the considerations underlying their risk assessment with regard to contingent liabilities. Here it is not sufficient merely to inform financial statement users about the sum total of existing contingent liabilities and about the underlying risks, whilst leaving them in the dark regarding the enterprise's assessment of eventual materialisation of these liabilities.

- **Further amendments resulting from EU legal requirements**
  Other EU legal requirements, especially those concerning the enterprise management report as well as the establishment of an audit committee, will be implemented "one to one" in German law - i.e. with minimum strain on the enterprises themselves. Here is an example: capital market oriented enterprises that already have a supervisory body do not have to set up an audit committee in any situation where the latter's functions are being performed by the supervisory body itself. Enterprises are also not made subject to requirements for establishing an internal risk management system. The decision on whether to set up such a system and on the type and extent thereof falls within the responsibilities borne by the management bodies of an enterprise.

3. Entry into force
The Act is to enter into force straight after consent by the Federal Council, signature by the Federal President, and promulgation. The new accounting provisions are obligatory in respect of financial years beginning after 1 January 2010. On a voluntary basis, the new accounting provisions can already be applied to the 2009 financial year - but only in their entirety. Some of the provisions, particularly those implementing EU legal requirements, are already binding for the 2009 financial year. Where this is still possible, the accounting relief furnished to small and medium-sized enterprises can already be claimed in respect of the 2008 financial year.

Glossary:

Fixed assets: part of property, i.e. shown on the assets side of the balance sheet. Fixed assets are the property that is intended to serve the purpose of maintaining constant business operations. They include, for instance, the buildings and machines used for production by an enterprise that produces goods.

Balance sheet: report in respect of a merchant's property (assets side of the balance sheet) and of liabilities with shareholder equity (liabilities side of the balance sheet) at the end of a financial year.

Derivatives: classificatory term denoting financial products such as options, swaps or forwards regarding, for instance, the purchase or sale of securities on a predetermined future date.

Shareholder equity: assets - liabilities = shareholder equity (net assets or worth).

Contingent liabilities: possible legal recourse, on a contractual basis, to a merchant, which, when viewed from the perspective of the closing date for the annual financial statement, is actually not to be reckoned with.

Financial instruments: Contractual obligations directly or indirectly focused on the exchange of means of payment (shares, debt securities, derivatives).

Forwards: contract requiring the purchase or sale of securities etc. at a predetermined price on a predetermined future date.

Profit and loss account: report in respect of expenditure and revenue during the financial year.

Trading portfolio: trading portfolio financial instruments are the financial instruments of credit institutions that are not part of either the liquidity reserve or the asset pool.

International accounting standards: used here as a synonym for the International Financial Reporting Standards (IFRS). Within the EU the IFRS are mandatory for capital market oriented enterprises required to draw up a group consolidated financial statement.

International Accounting Standards Board (IASB): institution set up under private law, with its headquarters in London, drawing up the International Financial Reporting Standards (IFRS). The objective of the IASB is to achieve enforcement of the IFRS as accounting standards with uniform application throughout the world.

Annual financial statement: umbrella term covering the balance sheet, the profit and loss account and, in the case of share capital companies, the notes supplemental to, and forming part of, the financial statement.

Capital market oriented enterprise: enterprises that have issued shares or debt securities for dealing on a regulated market.

Regulated market: market segment on the German stock exchanges.

Options: (optional) right to purchase a security at a predetermined price.

Swaps: business transaction concerning the exchange of one cash flow stream against another (for example: exchanging a fixed rate of interest for a floating rate).

Special purpose entity: independent legal entity (mostly a legal person or a foundation) serving to achieve a purpose of the parent enterprise, which purpose is strictly limited and precisely defined.

Further information can be found at www.bmj.de/accountinglaw