Effects on accounting legislation by an EU-wide implementation of the IFRS for SMEs – the case of Germany

MASTER'S THESIS

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DECLARATION OF HONOUR:

I declare that this thesis is my own work, and that all references to, or quotations from, the work of others are fully and correctly cited.

(Signed) ……………………………………

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ABSTRACT

Harmonisation of companies' financial reporting obligations is essential to economic decision-making in an international business environment. The degree of harmonisation for small and medium-sized entities (SMEs) is still relatively low but the acceptance for the IFRS for SMEs is increasing in recent years. Currently, the standard is being revised and its standard-setting body is awaiting comments from its stakeholders. While the European Union is reluctant to adopt the IFRS for SMEs, the success of its internal harmonisation attempts by the EU Accounting Directive is doubtful and often criticised by the Directive's stakeholders and researchers. The excessive number of options led to 27 different accounting systems and left the comparability of small and medium-sized entities' financial statements across the Union flawed.

This thesis aims to provide a theoretical background for a harmonised regulatory framework for SMEs' financial reporting obligations, to identify significant incompatibilities between the IFRS for SMEs and EU accounting legislation as well as national accounting legislation of Germany, and to recommend legislative changes necessary for an EU-wide IFRS for SMEs implementation – on EU level and Member State level demonstrated at the case of Germany.

The research is based on methods of legal and comparative analysis using primary and secondary sources of law, scientific literature, official documents and websites.

The main findings reveal that the harmonisation of accounting legislation for SMEs can be significantly improved by the implementation of IFRS for SMEs in the EU. The author suggests that, at the outset, the most appropriate way of implementation would be a "permission to apply", i.e. a discretionary choice for SMEs to apply the standard. For this purpose, the provisions on the following accounting topics in the EU Accounting Directive need to be changed: extraordinary items, measurements of financial instruments, the useful life of goodwill, recognition of negative goodwill, and presentation of unpaid called-up subscribed capital. The necessary changes in the German legislation depend on the current use of the Directive's Member State Options and must be implemented in the Commercial Code.

Key words: IFRS for SMEs, financial reporting, harmonisation of law, accounting standards, SMEs

SUMMARY

This thesis provides an analysis of the legal framework for financial reporting of the European Union and Germany by comparing selected accounting provisions with the IFRS for SMEs. The research proposes legislative amendments to achieve compatibility with the standard, arguing that the harmonisation of accounting standards for small and medium-sized enterprises is currently in a strong need of improvement and is essential to the growth of this specific category of companies, and stressing the potential of the IFRS for SMEs in this regard.

Following the introductory and restrictive text passages in chapter 1, chapter 2 provides the theoretical setting. The wide-ranging rationale behind the harmonised regulatory environment for financial reporting obligations is described by analysing the existing academic research in that area. After defining the levels of accounting legislations, IFRS are introduced and their current applicability is explained on supranational (EU) and national level. Subsequently, the standard IFRS for SMEs is brought into focus, discussed, and examined regarding its current spread and applicability criteria. In this context, the importance of SMEs for the economy of the European Union and the differing definitions by the European Commission and the standard setter are analysed.

Chapter 3 reviews the current accounting legislation for small and medium-sized entities in the EU and on Member State-level (the case of Germany). While focusing on the so-called Accounting Directive on the EU-level, on the national level, an overview of the relevant authorities and rules in Germany is provided with a focus on the implementation of the Accounting Directive into the German Commercial Code. It proceeds with the analysis of the existing identification of incompatibilities between the IFRS for SMEs and the Fourth and the Seventh EU Directives on company law and their impact.

Based on those incompatibilities, chapter 4 contains a comparison of the EU Accounting Directive and German national accounting legislation with the revised version of the IFRS for SMEs. The outcome of the two comparisons leads to the development of necessary legislative changes on EU- and Member State-level necessary for an EU wide implementation of the standard. Furthermore, implementation options of the IFRS for SMEs are suggested.

Finally, chapter 5 provides a conclusion of the research findings and gives an outlook on the expected future development.

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List of Abbreviations

ARC	Accounting Regulatory Committee
ASCG	Accounting Standards Committee of Germany
CMU	Capital Markets Union
EC	European Commission
EEC	European Economic Community
EFAA	European Federation of Accountants and Auditors for SMEs
EFRAG	European Financial Reporting Advisory Group
EU	European Union
FASB	Financial Accounting Standards Board
GAAP	Generally Accepted Accounting Principles
HGB	Handelsgesetzbuch (Commercial Code of Germany)
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards
MSO	Member State Option
SEC	Security Exchange Commission
SME	Small and Medium-sized Entity
US	United States

List of Authorities

Accounting Regulatory Committee	Regulatory function of providing an opinion on the European Commission proposals to endorse an international accounting standard. Composed of representatives from Member States and chaired by the European Commission.
ASCG	National standard setter in the area of group financial reporting in Germany
EFRAG	Private association with the encouragement of the European Commission to serve public interest by developing and promoting European views in the field of financial reporting and ensuring a proper consideration of these views in the IASB standard-setting process.
European Commission	The executive branch of the European Union
FASB	Standard-setting body whose primary purpose is to establish and improve Generally Accepted Accounting Principles within the United States.
IASB	International independent accounting standard-setting body that develops and issues the IFRS standards.

1 INTRODUCTION

Small and medium-sized enterprises (SMEs) are the backbone of the European economy. They significantly contribute to economic output, technological innovation, and job creation. Within the non-financial part of the EU's economy, SMEs constitute 99,8 % of all companies and generate 54,8% of the value-added.[1] Whilst currently performing their business operations predominantly on national territory, SMEs carry an unexploited growth potential, related to widening their geographical scope of operations and better access to funding from international investors. The success of a cross-border expansion as well as attracting foreign capital is typically related to the stakeholders' ability to understand the financial reporting of the respective company – the investment decisions are often based on financial statements' analysis. However, SMEs can be difficult to analyse for a foreign stakeholder who is not familiar with the national accounting regulations and the financial statement analysis of SMEs in different jurisdictions might easily lead to confusion and faulty conclusions.

The *topicality* of this thesis is supported by several factors. The *first* factor is the disputed ability of the EU to harmonise its accounting legislation for small and medium-sized entities internally while being reluctant to adopt the international standard that has been developed particularly in this regard – the IFRS for SMEs. This reluctance persists mainly because the former EU accounting legislation was found to be incompatible with the IFRS for SMEs. The legislative accounting framework for SMEs within the EU, and in particular, the development of Directive 2013/34/EU, the so-called Accounting Directive, was intended to harmonise and ease the financial reporting obligations of SMEs but has been found to be unsatisfying in this regard by many of its stakeholders as well as researchers. The Accounting Directive led to 27 different accounting systems resulting from the nature of a Directive leaving the means of achieving the instrument's intended results to the Member States, and in particular, because it provides for a large number of Member State Options (MSOs).

Germany was among the rather active stakeholders in various initiatives of the European Commission, which sought feedback on its accounting rules for SMEs. When assessing the standard for SMEs in its early phase, the German standard-setting committee considered the incompatibilities with the EU regime, which were in part held responsible for the rejection of the standard, to be negligible.

[1] Eurostat. *Number of persons employed by enterprise size class* (2017). Available on: https://ec.europa.eu/eurostat/cache/digpub/keyfigures/vis/DIR_KF2_24_1/index.html?country=EU28. Accessed March 09, 2020.

Secondly, the practice among listed companies proves the feasibility of a considerable degree of harmonisation of accounting laws. Financial reporting regulations for publicly traded companies are already harmonised on a global level: 144 jurisdictions require most listed companies to prepare their financial statements in accordance with the International Financial Reporting Standards (IFRS).[2] Among them are the Member States of the EU. For SMEs, however, the situation looks different. Although an international standard for SMEs has already been developed and issued in 2009, implementation is almost exclusively observed in developing countries[3] and harmonisation on a global level is therefore not achieved.

Thirdly, the absence of excessive accounting differences between jurisdictions could further stimulate cross-border development of business operation through increased comparability and transferability.

The *fourth* factor concerns the ongoing development of the IFRS for SMEs. Since the EU Accounting Directive entered into force in 2013, the IFRS for SMEs has been revised once in 2015 and is currently subject to the next revision. As the EU has a significant influence on the standard-setting board (International Accounting Standards Board), it could urge the International Accounting Standards Board (IASB) to shape the standard in a direction that is more compatible with the Accounting Directive. In adopting the full IFRS (for the consolidated statements of listed companies) the EU was a significant constituent in helping the IASB gaining its current status. Thus, the adoption of the IFRS for SMEs by the EU is considered beneficial for the IASB in order to further enhance global harmonisation and it is, therefore, conceivable for the IASB to consider taking a step towards the EU and its needs.

The *fifth* factor concerns the ongoing EU policy in the area of creating an integrated single market for capital across the union – a so-called Capital Markets Union (CMU). At the heart of this initiative is the objective of improving access to market-oriented sources of finance for European companies at every stage of their development. The harmonisation of accounting practices is specifically addressed by this initiative, as the lack of harmonisation is one of the main obstacles to an integrated capital market.

The *aim of this thesis* is to provide a theoretical background for a harmonised regulatory framework for SMEs' financial reporting obligations, to identify significant incompatibilities between the IFRS for SMEs and EU accounting legislation as well as national accounting legislation of Germany, and to recommend legislative changes necessary for an EU-wide IFRS

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[2] IFRS Foundation. *Use of IFRS Standards around the world (2018)*. Available on: https://cdn.ifrs.org/-/media/feature/around-the-world/adoption/use-of-ifrs-around-the-world-overview-sept-2018.pdf. Accessed February 17, 2020.

[3] IFRS Foundation. *Who uses IFRS Standards?* (2017). Available on: https://www.ifrs.org/use-around-the-world/use-of-ifrs-standards-by-jurisdiction/. Accessed March 20, 2020.

for SMEs implementation – on EU level and Member State level in Germany demonstrated at the case of Germany.

Research methodology

In this thesis, legal and comparative analysis *research methods* are used. The study is descriptive and explanatory in nature. A review of literature aims at providing the reader with a solid background to better evaluate the rationale behind the standard for SMEs. The development and current status of the IFRS for SMEs are analysed based on secondary legal sources: scientific publications, law reviews, official documents and papers, and official websites. The currently applicable EU Accounting Directive is analysed regarding its development and its perceived suitability for a harmonised accounting framework. For this purpose, mainly sources from the European Commission and work mandated by it are considered.

For the comparative analysis of the IFRS for SMEs with the EU Accounting Directive and its implementation into German national law, the already conducted analysis on the standard's compatibility with former EU accounting legislation is reviewed. The most significant incompatibilities are determined as criteria for the comparisons. For the comparison of the national accounting law of Germany with the international standard for SMEs, a vertical top-down comparison is used. The comparison is complemented by Member States' and, in particular, Germany's resonance on the standard in order to obtain a complete picture of the challenges ahead.

Primary sources of law required for this research comprise legislation of the European Union and the Federal Republic of Germany as well as standards issued by the International Accounting Standards Board. The following laws and standards are used for the comparisons during this thesis:

1) *IFRS for SMEs* (2009) – first issued version
2) *IFRS for SMEs* (2015) – first revised version
3) *Directive 2013/34/EU*, the EU Accounting Directive which stipulates the financial reporting and accounting obligations of certain undertakings with limited liability
4) *Fourth Council Directive 78/660/EEC* and *Seventh Council Directive 83/349/EEC* which together constitute the predecessors of the Accounting Directive
5) *German Commercial Code* which contains the core of the commercial law and stipulates the financial reporting and accounting obligations of companies in Germany

6) *Act on the Implementation of Directive 2013/34/EU* which stipulates the implementation of the provisions of the Accounting Directive into German national legislation

Limitations

The comparison of EU and German accounting legislation with the IFRS for SMEs is limited to certain financial reporting issues based on previous research on incompatibilities of the IFRS for SMEs with the former EU accounting framework. The research referred to was focused on indisputable mismatches.

The EU framework for public corporate reporting is based on several Directives, Regulations and Recommendations including a range of financial and non-financial reporting requirements. This thesis focuses on Directive 2013/34/EU. The German framework for public corporate reporting also consists of several legal acts. This thesis focuses on the provisions in the German Commercial Code and the Act on Implementation of Directive 2013/34/EU because the issues analysed are governed therein.

2 THEORETICAL AND LEGISLATIVE BACKGROUND TO THE RESEARCH

2.1 The need for a legal framework for accounting

Financial reporting has always been a complex topic that requires constant adaptation to the current challenges of the business world. The term *financial reporting* is defined as the process of recording, summarising, and reporting the financial position, transactions, and performance of a company through financial statements.[4] The pursued objectives of financial statements are not limited to providing information for investors in capital markets but also give an account of past transactions and strengthen corporate governance.[5] The users of financial statements include both internal and external stakeholders. That distinguishes financial accounting from managerial accounting the beneficiary of which is a company's internal management.[6] For the purpose of this thesis, the term *accounting* and its synonym *financial reporting* shall be regarded exclusively in the sense of *financial* accounting.

A legal framework of rules for accounting is necessary to ensure the credibility of and to foster the comparability between financial statements of several undertakings.[7] According to the European Commission, rules for accounting contain

> … provisions concerning the presentation and content of annual financial statements and management reports, the measurement bases used therein and their publication …[8]

It should be noted that the framework of rules encompasses different elements: laws, delegated legislation, judgments, standards, listing rules and sometimes also professional recommendations, interpretations, and guidelines. Whilst laws are at the top of the hierarchy of these elements and constitute the foundation of a regulatory system, standards are a characteristic supplement in the field of financial reporting regulation.[9] This thesis focuses on laws and standards.

There are different levels of accounting legislation – Grosu and Chersan[10] identify three different sets of regulations: national, European, and international legislation on accounting,

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[4] This definition is based on the entry *Accounting* in the Merriam-Webster dictionary. Available on: https://www.merriam-webster.com/dictionary/accounting. Accessed February 20, 2020.

[5] The 4th recital of Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC Text with EEA relevance
OJ L 182, 29.6.2013, p. 19–76. Available on: http://data.europa.eu/eli/dir/2013/34/2014-12-11. February 20, 2020

[6] Eddie McLaney, *Accounting* (Upper Saddle River: Financial Times / Prentice Hall, 2009), p. 161.

[7] *Ibid.*

[8] *See* The 3rd recital of Directive 2013/34/EU.

[9] Stuart McLeay, *Accounting Regulation in Europe* (Rochdale: Palgrave Macmillan, 1999), pp. 5 ff.

[10] Maria Grosu and Ionela-Corina Chersan, "Critical analysis of current national accounting regulations - compliance or non-compliance with European Directives," *The USV Annals of Economics and Public*

which serve a similar function of providing a normative framework for financial statements' form and content. Legislation on the level of the European Union also referred to as the supranational level, comprises rules to enhance the global convergence of accounting standards and provide consistency and comparability of financial reporting across the EU.[11] National accounting rules are partly made by the national legislator and stipulate the local requirements, also known as local Generally Accepted Accounting Principles (GAAP), while also partly implementing regulations issued at supranational or international level. International accounting rules are a set of globally common rules by international standard setters. Differences between national accounting legislation are regarded as a major obstacle to cross-border economic integration.[12] In an international business environment that is characterised by cross-border transactions and the free flow of capital, the need for a global set of harmonised accounting standards is evident. Companies seek capital in foreign markets, conduct business globally, or maintain affiliated entities abroad. Investors seek new investment opportunities to diversify on a global scale. The comparison and analysis of financial statements that are based on different national accounting standards entail a high level of complexity, costs, and eventually expose economic decisions that were based on these statements to a greater risk. International Financial Reporting Standards (IFRS) intend to approach these challenges by promoting the harmonisation of international financial accounting standards.

2.2 IFRS and its application

International Financial Reporting Standards are a set of common rules for the "general purpose financial statements and other financial reporting of profit-oriented entities".[13] General purpose financial statements are intended to provide a reliable representation of an entity's business performance expressed in financial terms. The provided information shall facilitate the decision-making process of existing and potential investors, creditors, and other interested parties regarding the provision of resources to the respective entity. Information accompanying but being outside financial statements is classified as *other financial reporting*. The IFRS Foundation describes the purpose of that other financial reporting as assisting in the

Administration 11 (2011): pp. 211-218. Available on: http://annals.seap.usv.ro/index.php/annals/article/view/386/395. Accessed June 8, 2020.

[11] European Commission. *Financial Reporting. EU IFRS endorsement process*. Available on: https://ec.europa.eu/info/business-economy-euro/company-reporting-and-auditing/company-reporting/financial-reporting_en. Accessed February 12, 2020.

[12] Elliot Posner, "Sequence as explanation: The international politics of accounting standards," *Review of International Political Economy* 17 (October 2010). Available on: https://datubazes.lanet.lv:3977/doi/full/10.1080/09692291003723748. Accessed March 29, 2020.

[13] IFRS Foundation. *Preface to the IFRS* (2018): p. 1, para 5. Available on: http://eifrs.ifrs.org/eifrs/bnstandards/en/preface.pdf. Accessed February 20, 2020.

interpretation of a complete set of financial statements and improving efficient economic decision-making.[14]

IFRS are developed and issued by the independent private-sector International Accounting Standards Board which since 2001 is the standard-setting body of the IFRS Foundation. The IFRS Foundation is a non-profit public interest organisation based in London and the legal entity under which the IASB operates.[15] The standards establish the recognition, measurement, presentation, and disclosure requirements concerning transactions and events that are essential to general purpose financial statements. Although some standards may allow for different treatments for particular transactions and events, generally, the IASB aims to require that like transactions and events are accounted for and reported in a similar manner, as opposed to, unlike transactions and events. Consequently, the IASB envisages not to allow for any choice in accounting treatment.[16]

The very basis for the entirety of its standards is defined as the contribution to transparency, accountability, and efficiency. The transparency aspect is supposed to be achieved by improving the international comparability and quality of financial information. That will allow investors and other market participants to derive informed economic decisions. Thereby allocation of capital is expected to be improved, thus increasing overall economic efficiency. Furthermore, by narrowing the gap between capital investors[17] and the entrusted users within an entity – the management –, the latter's accountability shall be enhanced. Finally, as a result for the preparers of financial statements (reporting business entities), the use of a single and trusted accounting language is intended to decrease their capital costs and international reporting costs in the long run.[18]

In order to achieve the above-stated results, the IFRS Foundation supports the basis of its standards by two fundamental qualitative characteristics of useful financial information: relevance and faithful representation. Those must be followed while developing new standards or revising existing ones.[19] Additionally, comparability, verifiability, timeliness, and

[14] IFRS Foundation, *supra note* 13, para 7.

[15] IFRS Foundation. *Who we are*. Available on: https://www.ifrs.org/about-us/who-we-are/. Accessed February 20, 2020.

[16] IFRS Foundation, *supra note* 13, p. 2, paras 10-11.

[17] Existing and potential investors, lenders and other creditors constitute the primary users of financial statements, according to the IFRS Foundation.

[18] IASB. *Conceptual Framework for Financial Reporting* (2018): p. A15, SP1.5. Available on: http://eifrs.ifrs.org/eifrs/bnstandards/en/framework.pdf . Accessed January 30, 2020.

[19] *Ibid*, p. A23, para. 2.5.

understandability constitute the main criteria that further enhance the usefulness of information.[20]

The IASB's conceptual approach for their standards is principle-based. In contrast, the equivalent standard-setting body within the United States, the Financial Accounting Standards Board (FASB) develops and issues rule-based standards – the so-called U.S. GAAP. Principle-based standards contain a lower level of detailed guidance than standards under the rule-based approach. This can be interpreted, on the one hand, in a positive sense as providing more discretionary powers to the preparers of financial statements, which allows for a better understanding of the underlying business activity but, simultaneously, enabling the standard's intention to be fulfilled.[21] On the other hand, the principles-based approach requires professional judgment and is dependent on the prudence of those preparing financial statements.[22]

Literature concerning the two different sets of accounting standards is wide-ranging and the harmonisation and convergence of accounting standards is not a recent idea. Since 2002, the FASB and the IASB have been committed to making their standards compatible where the FASB tends to move towards a principle-based approach, as suggested by the U.S. Securities and Exchange Commission (SEC). The latter is a consistent supporter of the convergence of global accounting standards. From 2013 onwards, Japan and China also worked on aligning their standards with IFRS.[23] The author concludes from the aforementioned that IFRS provide for a qualitative, internationally recognised, and widely acknowledged set of rules.

A major supporter of the IASB's work to develop a single set of high-quality accounting standards is the World Bank.[24] In promoting the development of IFRS standards including the IFRS for SMEs and their application throughout the world, it has played a leading role.[25] By recommending the adoption of IFRS to those countries that seek financing from it (mainly

[20] IASB, *supra note* 18, p. A26, para. 2.23.

[21] Dennis Sundvik, "The impact of principles-based vs rules-based accounting standards on reporting quality and earnings management," *Journal of Applied Accounting Research* 29 (2019): p. 78, accessed April 5, 2020, doi: 4876/10.1108/JAAR-05-2018-0063.

[22] Oris Guillaume and Denel Pierre, "The Convergence of U.S. GAAP with IFRS: A Comparative Analysis of Principles-based and Rules-based Accounting Standards," *Scholedge International Journal of Business Policy & Governance* 3 (2016): p. 66, accessed April 3, 2020, doi: 10.19085/journal.sijbpg030501.

[23] Financial Accounting Standards Board. *Comparability in International Accounting Standards – a brief history*. Available on: https://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1176156304264. Accessed April 5, 2020.

[24] See Kees Camffermann and Stephen A. Zeff (2018): That support included the deployment of teams to developing and emerging economies to conduct studies on the comparability of IFRS with national standards and concluded by recommending accelerating and enhancing the convergence or adoption of IFRS where this has already commenced and the development and implementation of an action plan for adoption or convergence where no such convergence or adoption has commenced.

[25] IFRS Foundation. *Memorandum of Understanding between the International Financial Reporting Standards Foundation and the World Bank* (2017). Available on: https://cdn.ifrs.org/-/media/feature/around-the-world/memoranda/world-bank-memorandum.pdf. Accessed April 3, 2020.

developing countries and emerging economies), the World Bank is considered a source of international institutional pressure in IFRS adoption.[26]

Despite the support of international organisations and the widespread adoption of the IFRS, the IASB and its standard-setting process are also met with criticism by some authors. Camffermann and Zeff[27] criticised the IASB itself regarding different aspects. They stressed that the IASB's legitimacy had been called into question by many of its constituents, as it is considered a de facto legislator. One aspect of that is the fundamental reconsideration of the IASB's expertise. For one thing, the approach by the IASB of having a board of independent experts could be regarded as the source of legitimacy. However, the composition of this board was also questioned, being accused of not taking sufficient account of the geographical diversity of its members. From the European point of view, a much larger board with members chosen to be representative for the constituency interests as well as being geographically representative was desirable.[28]

Since the technical quality of its standards and the mere existence of an independent expert board seemed not to be sufficient as a source of legitimacy to its constituents, the IASB highlights its due process, and the intention to further enhance it, as the main source of legitimacy. Thereby it seeks an appropriate balance between sustaining the board's technical authority to decide on standards and ensuring that all interested parties who wish to voice an opinion on an issue on the board's agenda are heard.[29]

Further criticism is targeting IFRS's lacking ability to generate the usefulness of financial information. Whilst some studies have identified improving effects of the IFRS adoption on the usefulness of financial information, Lev[30] counterargued that, this is only because in most adopting countries, the IFRS replaced inferior accounting rules. He referred to a statistical meta-analysis of 57 IFRS studies one of the results being that IFRS adoption is associated with improving analysts' earnings forecast accuracy.[31] However, he placed this result into context with the assumption that the improvement in analysts' forecasting accuracy is rather related to the increasing frequency with which companies provide forward-looking

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[26] Kees Camfferman and Stephen A. Zeff, "The Challenge of Setting Standards for a Worldwide Constituency: Research Implications from the IASB's Early History," *European Accounting Review* 27:2 (2018): p. 296, accessed April 5, 2020, doi: 10.1080/09638180.2017.1296780.

[27] *Ibid*, p. 297.

[28] *Ibid*.

[29] *Ibid*.

[30] Baruch Lev, "The deteriorating usefulness of financial report information and how to reverse it," *Accounting and Business Research* 48:5 (2018). Accessed April 3, 2020, doi: 10.1080/00014788.2018.1470138.

[31] Kamran Ahmed, Keryn Chalmers and Hichem Khlif, „A meta-analysis of IFRS adoption effects," *The International Journal of Accounting* 48 (2013): p. 208, accessed April 4, 2020, doi: 10.1016/j.intacc.2013.04.002.

information (profit and revenue forecasts) with their financial results than with the introduction of IFRS itself.[32] In Lev's view, there is a continuous deterioration in the usefulness of financial information to investors, and not only the IASB but also the FASB in the U.S. have failed to reverse that.

The author concludes from the foregoing shows that there is considerable divergence of opinion on the efficacy of IFRS. Nevertheless, IFRS are widely accepted and applied.

2.2.1 Global spread of IFRS

As of the year 2018, 144 out of 166 profiled jurisdictions require IFRS Standards for all or most companies with public accountability. That results in a total number of 27,000 domestically listed companies on 88 major stock exchanges around the world using IFRS.[33]

What appears to be a widespread adoption is, however, misleading to some extent. While some major capital markets still do not require or even allow their domestic companies to report under IFRS,[34] even in adopting jurisdictions, restrictions to the standards and the emergence of national versions can be observed.[35] That corroborates critics such as those of Kothari *et al*[36] that a globally dominant standard setter is rather incapable of meeting the heterogeneous political and economic demands of the global economy, and thus it ultimately results in a situation where IFRS are developing into country-specific rules.[37]

Notably, an entity can only assert its financial statements' compliance with IFRS if it applies the full set of issued standards as well as the related interpretations. Therefore, a country's national law for financial reporting which an entity is required to comply with must have no amendments to IFRS in order to ensure that entity's full compliance with IFRS.[38]

Notwithstanding the indicated partial inconsistency in implementation across different jurisdictions, among the EU Member States, reporting under IFRS is mandatory to certain financial statements.

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[32] Baruch Lev, *supra note* 30, p. 471.
[33] IFRS Foundation, *supra note* 2, pp.2 ff.
[34] The main capital markets without an IFRS mandate are the US, where there are currently no plans for change for local reporting entities (full IFRS is allowed for non-US filers), Japan, which permits voluntary adoption but has not set a mandatory transition date, and China, where domestic accounting standards have been further amended resulting in many of its principles generally being in line with IFRS. (See PWC, 2019).
[35] Christopher Nobes, "The continued survival of international differences under IFRS," *Accounting and Business Research* 43 (April 2013): p. 85, accessed March 30, 2020, doi:10.1080/00014788.2013.770644.
[36] S.P. Kothari, Karthik Ramanna, and Douglas J. Skinner, "Implications for GAAP from an analysis of positive research in accounting," *Journal of Accounting and Economics* 50 (2010). Accessed March 02, 2020, doi: 10.1016/j.jacceco.2010.09.003.
[37] *Ibid*, p. 251.
[38] Ernst & Young LLP, *International GAAP 2020* (John Wiley & Sons, 2020), p. 17.

2.2.2 Application of IFRS in the EU

The legal basis for the applicability of IFRS within the Member States of the EU is provided through *Regulation 2002/1606/EC of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards*. As stipulated by the Regulation's Article 4, companies whose securities are admitted for trading on a regulated market within any Member State must prepare their consolidated accounts in accordance with IFRS, starting from January 1st, 2005. Consolidated financial statements are the aggregated statements for the multiple divisions or subsidiaries (e.g. parent and subsidiary) belonging to the same reporting entity (also called group or parent company).[39]

The accounts of *unconsolidated* financial statements (also referred to as annual financial statements) reflect the separate financial performance of a single reporting entity.[40] Such an entity may be the parent of a group, a subsidiary of a group, or a single stand-alone entity. Regarding the annual unconsolidated statements of publicly-traded companies as well as both consolidated and unconsolidated statements of *non*-publicly-traded companies, the Regulation 2002/1606/EC lays down a discretionary provision, thus leaves it to the Member States to decide whether or not to require or permit their preparation in accordance with IFRS.[41]

In Germany, the use of IFRS is permitted also for the consolidated financial statements of non-listed companies.[42] For annual statements (i.e. unconsolidated), the German legislator permits the use of IFRS for both listed and non-listed companies. However, the use of IFRS for the latter two is permitted only in addition to the preparation of the financial statements in accordance with national GAAP, not as an alternative.[43] Consequently, if the respective entities choose to report in accordance with IFRS, they are facing a so-called double reporting burden.

The IFRS are constantly evolving yet do not themselves have legally binding character. Therefore, in accordance with Regulation 2002/1606/EC, each time the IASB is issuing a new standard, amending an existing one, or issuing an interpretation of a standard, the EU needs to follow an endorsement process for the respective standard to come into force. Involved parties in that process are the independent consultative organization *European Financial Reporting*

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[39] IASB, *supra note* 18 p. A33, para. 3.11.

[40] *Ibid*, p. A33, para. 3.11.

[41] Article 5 Regulation (EC) No 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards *OJ L* 243, 11.9.2002, p. 1–4. Available on: https://eur-lex.europa.eu/legal-content/en/ALL/?uri=CELEX%3A32002R1606. Accessed February 25, 2020.

[42] Ernst & Young LLP. *supra note* 39, p. 18.

[43] European Commission. *Overview of the use of options provided in the IAS Regulation (1606/2002) in the EU as at December 2018*. Available on: https://www.iasplus.com/en/publications/europe/implementation-of-ias-regulation. Accessed April 27, 2020.

Advisory Group (EFRAG) and the *Accounting Regulatory Committee* (ARC) which is composed of representatives of EU countries.

After the EFRAG has advised the Commission on the endorsement and in case the Commission decides to endorse the new standard, interpretation or amendment, it drafts a regulation and submits it to the ARC. If the ARC's opinion is favourable, the Commission submits the draft regulation to the European Parliament and the Council for a three-month review period. In the absence of objections from the European Parliament or the Council, the Commission adopts the endorsed amending regulation.[44] As a Regulation, this has a direct effect on the targeted subjects - reporting entities - without the need for further national implementation.[45]

In 2018, the EC started an initiative to gather feedback by its stakeholders on the EU framework for public reporting by companies – a so-called fitness check.[46] One of the questions asked in the questionnaire was whether the EU IFRS endorsement process should allow for carve-ins. An EU carve-in would be a modification to the IFRS standards for usage in the EU. This would extend the EU's existing powers to carve out, that is, to decide against endorsing an IFRS standard or parts thereof. However, a majority of respondents were against the introduction of EU carve-ins arguing that it could lead to EU-specific IFRS which ultimately would have an adverse effect on companies that are globally active and to foreign investment into the EU. Moreover, such EU-specific IFRS would hamper the objective of a harmonised global accounting framework. Nevertheless, the view to increase EU involvement in the IASB standard-setting process was also strongly represented among respondents.[47] As discussed below, however, from the IASB's and different authors' point of view, an influence from the EU is already present.

According to Camfferman and Zeff[48], Member States' different views and their interaction in the complex endorsement process as well as occasionally tense relations between the EC and the European Parliament, sometimes turn Europe into a rather difficult constituent

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[44] European Commission, *supra note* 11.

[45] This current endorsement process prevents the EU from modifying the content of the IFRS standards as issued by the IASB. Either a standard is rejected or implemented.

[46] European Commission. *Fitness check of EU Supervisory Reporting Requirements {SWD(2019) 403 final}* (2019). Available on: https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/191107-fitness-check-supervisory-reporting-staff-working-paper_en.pdf. Accessed April 28, 2020.

[47] European Commission. *Summary Report of the Public Consultation on the Fitness Check on the EU framework for public reporting by companies 21 March 2018 - 31 July 2018* (2018): pp. 8-9. Available on: https://ec.europa.eu/info/sites/info/files/business_economy_euro/banking_and_finance/documents/2018-companies-public-reporting-feedback-statement_en.pdf. Accessed April 28, 2020.

[48] Kees Camfferman and Stepfen A. Zeff, *supra note* 26.

to the IASB. As a strong part of the group of IFRS-adopting jurisdictions, the EU exerts considerable pressure on the IASB and its standard-setting process.[49] To give an example, before the IASB's Conceptual Framework was revised in 2018, the concept of prudence was absent.[50] In 2013, the EU demanded an explicit reference to the notion of prudence as a qualitative characteristic in the framework, otherwise, it would stop its funding. The IASB perceived that as a highly worrisome threat to its independence.[51] However, the latest revision of the framework (2018) reintroduced the concept of prudence eventually. Prudence is defined as the "exercise of caution when making judgements under conditions of uncertainty"[52]. Exercising prudence implies that assets and income are not overvalued, and liabilities and expenses are not undervalued. Equally, the exercise of prudence cannot allow for assets or income to be undervalued or for liabilities or expenses to be overvalued.[53] Whether the decision of reintroducing the concept was due to the pressure from the European Parliament is beyond the scope of this thesis. Nevertheless, the reader should be aware of the EU's potential influence on the IASB.

Furthermore, the EFRAG exerts part of the European influence by sending comment letters to each of the IABS's exposure drafts as an element of the due process. While any constituent can submit comment letters, the ones issued by the EFRAG are likely to be given greater than average weight. This is due to the letters carrying a signal of potential difficulties in the earlier mentioned EU endorsement process. Besides, EFRAG's letters are published and, given the expertise and technical capability EFRAG has acquired over time, may inspire other constituents when writing their letters.[54]

Notwithstanding the difficulties Europe may impose on the IASB, the EU's initial decision to adopt the IFRS is considered significant. According to Camfferman and Zeff, it was crucial for the IASB's longevity. Besides establishing a significant number of companies obliged to report according to IFRS, the EU's adoption also encouraged other jurisdictions to follow suit.[55]

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[49]See Kees Camfferman and Stephen A. Zeff (2018): Pressure from the EU has caused the IASB to develop its due process to include, for example, impact assessments and post-implementation reviews.

[50] The reference to the notion of prudence was dropped in 2010 to move forward the alignment of the standards by IASB and FASB.

[51] Reuters. *IASB accounting body rejects EU parliament's funding conditions* (2013). Available on: https://www.reuters.com/article/us-accounting-iasb/iasb-accounting-body-rejects-eu-parliaments-funding-conditions-idUSBRE99D0KU20131014. Accessed April 26, 2020.

[52] IASB, *supra note* 18: p. A25, para. 2.16.

[53] *Ibid*.

[54] Kees Camfferman and Stephen A. Zeff, *supra note* 26, p. 302

[55] *Ibid*, p. 293.

2.3 The need for a separate IFRS standard for SMEs

SMEs are playing a crucial role in the economy, especially by providing jobs and growth opportunities. Within the EU, that becomes apparent from an overview of the composition of the EU's non-financial business economy[56] that was published for the year 2017 by Eurostat. According to that data, in 2017, SMEs constituted 99,8% of all companies within that non-financial part of the economy and they generated 54,8% of the value added. Furthermore, 65,1% of all employees were employed in an SME.[57]

2.3.1 Small and medium-sized entities (SMEs)

Frequently, for a definition of an SME, quantitative size criteria such as the number of employees, annual turnover, or balance sheet total are applied. However, there is no universally shared definition in place. The European Commission has established thresholds defining micro, small and medium-sized companies based on quantitative criteria which it considers appropriate for providing objective evidence for the size of an undertaking. These criteria are subsequently updated. The latest update came with the adoption of Directive 2013/34/EU in 2013. To summarise the EC's definition, an SME within the EU is an entity that has a balance sheet total not exceeding EUR 20 000 000, a net turnover not exceeding EUR 40 000 000 and/or an average number of employees during the financial year not exceeding 250, at least two of those criteria being fulfilled. In order to classify as one of the subcategorised company forms, an entity shall not exceed at least two out of the three thresholds.

	Micro	Small	Medium-sized
Balance sheet total	≤ € 350 000	≤ € 4 000 000 (or max. € 6 000 000)	≤ € 20 000 000
Net turnover	≤ € 700 000	≤ € 8 000 000 (or max. € 12 000 000)	≤ € 40 000 000
Average number of employees during the financial year	≤ 10	≤ 50	≤ 250

Table 1: EC's thresholds defining micro, small and medium-sized companies. Source: European Commission. Thresholds defining micro, small and medium-sized companies based on Directive 2013/34/EU, Art. 3.[58]

[56] Eurostat. *Glossary:Non-financial business economy*. Available on: https://ec.europa.eu/eurostat/statistics-explained/index.php/Glossary:Non-financial_business_economy. Accessed March 09, 2020.
[57] Eurostat, *supra note* 1.
[58] European Commission. Thresholds defining micro, small and medium-sized companies based on Directive 2013/34/EU, Art. 3. Available on: https://ec.europa.eu/info/law/accounting-rules-directive-2013-34-eu/implementation/guidance-implementation-and-interpretation-law_en. Accessed March 2, 2020.

For small companies, the EC leaves it to the Member States to impose higher thresholds for the financial criteria (balance sheet total and net turnover). However, those shall not exceed the numbers in brackets, i.e. EUR 6 000 000 for a balance sheet total and EUR 12 000 000 for a net turnover. Germany opted for the maximum permissible size thresholds setting the upper limits at EUR 12 000 000 for turnover and EUR 6 000 000 for assets. These thresholds are applicable both for determining the scope of the required disclosure for financial reporting and for establishing the exemption of small companies from having their annual accounts audited.

When compared to the EC, the IASB has adopted a wider definition in its standard for SMEs, neither using quantitative size nor legal form as criteria. Instead, according to the IASB's definition, SMEs are all entities that are not publicly accountable, yet publish general purpose financial statements for external users. As external users, it lists non-managing owners, creditors, and credit rating agencies.[59] Further, it defines public accountability of an entity as trading its debt or equity in a public market,[60] as being in the process of issuing such instruments for those trading purposes, or as holding assets in a fiduciary capacity for a broad group of outsiders as one of its main business activities. The latter applies to most banks, credit unions, insurance companies, securities brokers, and mutual funds,[61] to which the IFRS for SMEs is therefore not applicable.

Due to the existing divergence in the definitions used by the IASB and the EC. In the hypothetical case of an EU adoption of the IFRS for SMEs, that would result in two potentially problematic scenarios which are illustrated in the following figure.

[59] IFRS Foundation. *IFRS for SMEs Standard 2015*, para 1.2. Available on: http://eifrs.ifrs.org/eifrs/sme/en/IFRS%20for%20SMEs_Standard_2015.pdf

[60] A domestic (including local or regional) or foreign stock exchange market or an over-the-counter market.

[61] *Ibid*, para 1.3.

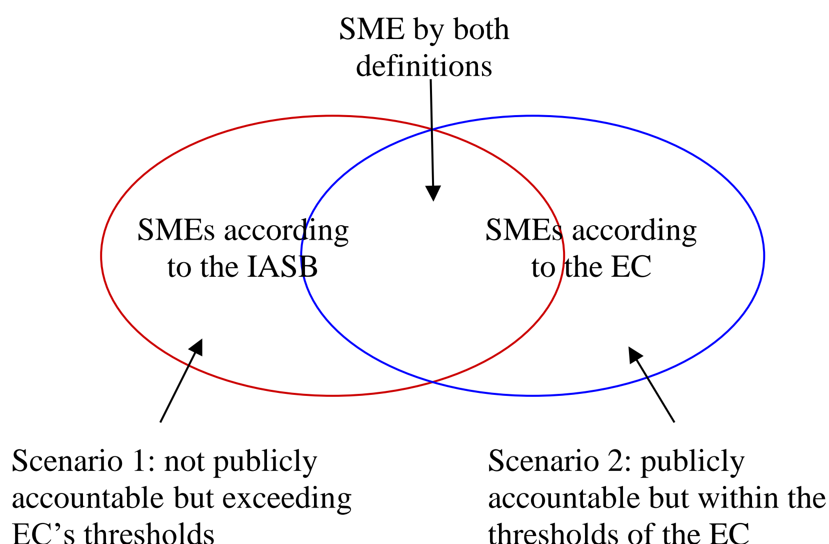

Figure 1: Divergent definitions of an SME by the IASB and the EC. Source: Author's work based on IFRS for SMEs and Directive 2013/34/EU, Art. 3.

In the first scenario, a company that under the EC's definition ceases to be an SME because it exceeds more than one of the size criteria may still qualify as an SME as defined by the IASB. Therefore, in case of an implementation of the IFRS for SMEs, it would be unclear whether the Standard applies to such an entity or not. Most likely, the definition of the EC would prevail and serve as the jurisdiction's individual restriction of the scope of application of the Standard. Ultimately, the Standard would not apply to those entities exceeding the threshold of the EC, even if they are not publicly accountable.

Conversely, in a second scenario, a company that is not an SME under the IASB's definition because it is publicly accountable can still be considered an SME under the EC's definition provided it does not exceed two of the three thresholds from the table above. However, since a publicly accountable entity as defined by the IASB (thus no SME) is equivalent to an entity to which full IFRS apply through Article 4 of Regulation 2002/1606/EC, that entity would have to prepare its consolidated accounts in accordance with full IFRS no matter whether it is an SME according to the EC or not. Nevertheless, even its unconsolidated annual accounts would then be excluded from the scope of the IFRS for SMEs as it does not qualify as an SME according to the IASB. Therefore, an additional set of rules for such an entity's unconsolidated annual statements would still be necessary. As per the discretionary provision of Regulation 1606/2002/EC, the Member States may permit or require full IFRS to those companies' statements. Thus, the entity in this second scenario would either report according to the full IFRS or to the respective national accounting rules, depending on the Member State. However, it would also be conceivable for the EU to exert pressure on the IASB

for an extension of the applicability of the IFRS for SMEs to the unconsolidated annual accounts of publicly accountable entities that qualify as an SME under the EC definition.

Under the existing setting, however, only if an entity qualifies as an SME under both the EC's and the IASB's definitions would it be permitted to use the standard.

2.3.2 The standard and its scope of application

The IFRS Foundation defines the standard *IFRS for SMEs* as a stand-alone document[62] being independent of the full IFRS (the complete list of IAS, IFRS, and interpretations issued by the IASB), yet based upon the same concepts and principles as the full IFRS, those being established in the Conceptual Framework.[63] Therefore, the nature of the disclosures required for a complete set of financial statements under IFRS for SMEs is very similar to the nature of those required by IFRS for listed companies. However, there are significantly fewer disclosure requirements for SMEs. The IFRS for SMEs consists of about 230 pages, compared to more than 3,000 pages of full IFRS. There are also some changes to recognition and measurement requirements.[64] Recognition and measurement principles are simplified for the IFRS for SMEs in areas such as (but not limited to) financial instruments, goodwill and intangible assets with indefinite life, research and development costs, property, plant and equipment and intangible assets.[65] Topics such as earnings per share are logically not included in the SME standard since an SME under the definition of the IASB does not issue shares.

The first issuance of the standard in 2009 was the outcome of a five-year development process and, according to the IASB, a response to strong international demand to cater to the specific needs of smaller companies.[66] Worth to mention is that the European Commission as well as the EU Member States were among the supporters of the IASB's project to develop a standard for SMEs when in 2001 the IASB was authorized to develop such a standard.[67] The standard is regularly revised. Its latest revised version with limited amendments was issued by the end of 2015 and came into effect on January 1st, 2017.[68]

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[62] A jurisdiction can make the IFRS for SMEs a requirement even if it has not adopted the full IFRS. IASB. Supporting materials for the IFRS for SMEs Standard. Available on: https://www.ifrs.org/supporting-implementation/supporting-materials-for-the-ifrs-for-smes/. Accessed March 12, 2020.

[63] IFRS Foundation, *supra note* 59, P17, p. 8.

[64] Ram and Newberry, „Agenda entrance complexity in international accounting standard setting: the case of IFRS for SMEs," *Abacus* 53:4 (2017): p. 30. Accessed May 16, 2020. doi: 10.1111/abac.12122.

[65] Hana Bohušová, "The implementation of the IFRS for SMEs in the EU," *Acta Universitatis Agriculturae et Silviculturae Mendelianae Brunensis* 59:2 (2011): p. 45. Accessed May 17, 2020. doi: 10.11118/actaun201159020043.

[66] IASB, *supra note* 62.

[67] Hana Bohušová, *supra note* 65.

[68] Most amendments from 2015 either clarified existing requirements or added supporting guidance, rather than changing the underlying requirements in the IFRS for SMEs.

As indicated above, the standard for SMEs has been developed with the intention to be significantly less complex than the full IFRS, in order to reduce the compliance burden for SMEs while taking into consideration their costs and capabilities in preparing financial information.[69] However, according to Kaya and Koch, switching to the IFRS for SMEs as the primary body of accounting standards would be particularly costly in European civil law countries, as they tend to link their accounting legislation closely to regulatory matters, such as insolvency or taxation. Thus, a change in accounting rules would imply either a reform of tax and commercial laws[70] or a double reporting burden for companies in meeting the obligations of national tax and commercial laws as well as the accounting requirements imposed by the IFRS for SMEs.[71] Similarly, Bautista-Mesa *et al* highlight that the main drawback of the conversion from local accounting standards to IFRS for SMEs is still seen in the cost burden for SMEs.[72] More precisely, opponents of the standard within the EU argue that implementation would result in increased costs for financial statement preparation and the training of employees.[73]

On the other hand, the costs faced by an external potential capital provider in analysing a company's financial statements tend to increase with the existence of cross-country differences in national accounting standards. Conversely, harmonised accounting rules would decrease those costs. Whether this means that the implementation of the standard increases the country's ability to attract loans can, according to Kaya and Koch, not be empirically proven.[74] The latter is, however, frequently used as a supporting argument: By applying the IFRS for SMEs, a country would improve its financial statements' transparency and make a contribution to improved international comparability. That would facilitate SMEs' access to international financing, ultimately resulting in positive growth.[75]

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[69] Devrimi Kaya and Maximilian Koch, "Countries' Adoption of the International Financial Reporting Standard for Small and Medium-sized Entities (IFRS for SMEs) – Early Empirical Evidence," *Accounting and Business Research* 45:1 (2015): p. 110., accessed May 17, 2020, doi: 10.1080/00014788.2014.969188. & IFRS for SMEs Standards 2015, P9, p. 7.

[70] Devrimi Kaya and Maximilian Koch, *supra note* 69, p. 96.

[71] IFRS Foundation, *supra note* 59, P12, p.7.

[72] Rafael Bautista-Mesa, Juan María Muñoz-Tomás, María Paz Horno-Bueno, "Does the IASB know the needs of SMEs? A comparative analysis between the IFRS for SMEs and full IFRS due processes," *Spanish Accounting Review* 22:2 (2019): p. 204. Accessed March 21, 2020, doi.org/10.6018/rcsar.382261.

[73] Eva Hýblová, "The current problems of harmonization of accounting for small and medium-sized enterprises," *Economic Research-Ekonomska Istraživanja* 32:1 (2019): p. 608, accessed April 5, 2020. doi: 10.1080/1331677X.2018.1561317.

[74] Devrimi Kaya and Maximilian Koch, *supra note* 69.

[75] Salma Damak-Ayadi, Nesrine Sassi, and Moujib Bahri, "Cross-country determinants of IFRS for SMEs adoption," *Journal of Financial Reporting and Accounting* 18 (2020): p. 164, accessed March 17, 2020, doi: 10.1108/JFRA-12-2018-0118.

Moreover, the standard is supposed to specifically reflect the information required by external users of SMEs' financial statements, that being primarily about cash flows, liquidity, and solvency.[76] Consequently, the IFRS for SMEs requires the reporting entity to prepare a cash flow statement.[77] While this certainly improves the informational content from the perspective of an external user, it would constitute additional work for the preparer, especially within the EU since the current EU accounting rules do not require SMEs to prepare a cash flow statement.[78]

Furthermore, the complexity of the standard is deemed yet too high for small companies, although it has been already significantly reduced compared to the full IFRS.[79] This type of critique is to a certain extent relatable to the fact that the IABS does not make any differentiation in the size of SMEs. Therefore, small companies with 40 employees would be facing the same reporting efforts as a medium enterprise with 240 employees (if they are both not publicly accountable, thus classifying as an SME according to the IASB). However, here it must be considered that the IASB designed the IFRS for SMEs for companies that choose or are required to publish general purpose financial statements. As stated in subchapter 2.1, these are addressing a wide range of users within as well as outside the company. If a small company, however, is obliged to report solely to owners, tax, or other governmental authorities, the IASB does not consider these reports as general purpose financial statements.[80] Thus, the IASB did not intend the IFRS for SMEs to replace the rules for those non-general purpose financial statements. The decision about which entities are required to publish general purpose financial statements is with each jurisdiction and not the IASB.

Another point of critique is targeting the IASB's due process in the development of the SME standard. The due process has been subject to a critical review regarding its suitability for representing SMEs. As discussed before, the due process is aimed at enhancing the IASB's legitimacy by allowing stakeholders to voice their opinion in the standard-setting process. The authors Bautista-Mesa *et al* argue that this due process failed in the case of the IFRS for SMEs

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[76] IFRS Foundation. *The IFRS for SMEs Standard*, available on: https://www.ifrs.org/issued-standards/ifrs-for-smes/

[77] IFRS Foundation, *supra note* 59, Section 7.

[78] Art. 4(1) of Directive 2013/34/EU of the European Parliament and of the Council of 26 June 2013 on the annual financial statements, consolidated financial statements and related reports of certain types of undertakings, amending Directive 2006/43/EC of the European Parliament and of the Council and repealing Council Directives 78/660/EEC and 83/349/EEC Text with EEA relevance *OJ L* 182, 29.6.2013, p. 19–76. Available on: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32013L0034. Accessed March 2, 2020.

[79] Eva Hýblová, *supra note* 73, p. 608.

[80] IFRS Foundation. *A Guide to the IFRS for SMEs* (2016). Available on: https://cdn.ifrs.org/-/media/feature/groups/smes/major-documents/guide-to-the-ifrs-for-smes-march-2016.pdf?la=en. Accessed April 16, 2020.

and thereby leaves the IASB with a lack of legitimacy. This failure is attributable to an inadequate representation of SMEs' preferences. Financial statement preparers' participation in the due process for the IFRS for SMEs was significantly lower compared to the due process for the standards for listed companies. Therefore, the authors accuse the IASB of not knowing the real preferences of the users of the standard. Eventually, they suggest that attempts must be made to adapt the IFRS for SMEs to the actual preferences of SMEs by improving the IABS's due process and shifting the focus to gathering SMEs' opinions and needs.[81] Whether the board has taken steps to better engage the preparers of statements, i.e. SMEs themselves into the process of revising, remains unclear at this moment.

The IFRS for SMEs is intended to apply exclusively to entities that meet the definition of an SME provided by the IASB, thus having no public accountability. Other than that, even if an entity had the right or obligation under the law of its national jurisdiction to apply the standard, it could not claim compliance with IFRS for SMEs.[82] Within that group of non-publicly accountable entities, each jurisdiction may further narrow the scope of entities that may apply the standard. In other words, although there is no size threshold in the IFRS for SMEs, a national legislator may add such.[83] Furthermore, if an entity asserts conformity of its financial statements with the IFRS for SMEs, the IASB requires it to comply with *all* the provisions of the standard.[84] Consequently, an amended version in order to comply also with another set of regulations will result in a non-conformity with the standard.

Warren *et al*[85] pointed out the contradiction between the title of the standard and its SME definition which does not refer to typical characteristics of small or medium-sized entities, such as not exceeding a certain turnover, balance sheet total or the number of employees, but instead appears to cover all entities which are not already subject to the full IFRS.

2.3.3 Global spread of the IFRS for SMEs

Compared to the full IFRS, the implementation of IFRS for SMEs is unevenly spread. Despite the relatively large number of 86 out of 166 profiled jurisdictions requiring yet mostly only *permitting* the use of it,[86] these are currently almost exclusively developing countries.[87] The

[81] Rafael Bautista-Mesa, Juan María Muñoz-Tomás, María Paz Horno-Bueno, *supra note* 72, p. 211.
[82] IFRS Foundation, *supra note* 59, para. 1.5.
[83] IASB, *supra note* 62.
[84] IFRS Foundation, *supra note* 59, para. 1.6.
[85] Rebecca Warren, David B. Carter, and Christopher J. Napier, "Opening up the politics of standard setting through discourse theory: the case of IFRS for SMEs," *Accounting, Auditing & Accountability Journal* 33 (2019): p. 125. Accessed March 23, 2020, doi: 10.1108/AAAJ-04-2018-3464.
[86] IFRS Foundation, *supra note* 2, p.2.
[87] IFRS Foundation. *supra note* 3.

IASB is providing only an aggregated number and does not, as it does for full IFRS, provide easy access to a detailed overview of the jurisdictions which made compliance with the SME standard a requirement, instead of an option.

In literature, a great number of writings[88] is focusing on developing economies as they appear to be more likely to implement the IFRS for SMEs or have already done so. However, existing studies often disagree on the factors determining a country's decision regarding adoption. For example, Kaya and Koch found that the existence of local accounting standards and high quality of governance negatively impacts adoption of IFRS for SMEs. Moreover, in common law jurisdictions and where full IFRS are applied to private companies, the likelihood of IFRS for SMEs adoption increases.[89] In addition, they concluded that developing economies can enhance their ability to attract loans from international organisations[90] can be facilitated by adopting IFRS for SMEs. Bonito and Pais came to similar results regarding some factors, stating that the absence of a national accounting system, having experience of applying full IFRS and a common-law environment favour adoption of the standard. However, contradictory to what Kaya and Koch found, foreign aid, quality of national financial accounting standards, and the relationship between tax rules and accounting standards are identified as nonsignificant factors. Furthermore, they found a low level of education in a country to increase the likelihood of adoption.[91] The latter, however, was deemed nonsignificant by Sellami and Gafsi. These authors also disagree with a country's prior adoption of full IFRS impacting its decision to adopt the IFRS for SMEs. Similar to Kaya and Koch, they found the reliance on external funding to be a significant factor favouring a country's decision, and they add the overall importance of SMEs in a country as well as an external openness degree as positively impacting factors.[92]

From the dissent of studies on the factors influencing adoption of the IFRS for SMEs, the author concludes that the accuracy of a prediction on the decision of a country is limited.

An adoption by the EU Member States has been found to be less likely due to the EU's reluctance to adopt the standard. Apart from the aforementioned potential factors, the EU justifies its attitude towards the standard mainly with the existing inconsistencies with its Accounting Directive.

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[88] *See* Bautista Mesa *et al*; Bohusova; Kaya and Koch.

[89] Devrimi Kaya and Maximilian Koch, *supra note* 69.

[90] International organisations such as the World Bank or the International Monetary Fund.

[91] Ana Bonito and Cláudio Pais, "The macroeconomic determinants of the adoption of the IFRS for SMEs," *Spanish Accounting Review* 21 (2018). Accessed March 20, 2020, doi: 10.1016/j.rcsar.2018.03.001.

[92] Yosra Mnif Sellami and Yosra Gafsi, "What Drives Developing and Transitional Countries to Adopt the IFRS for SMEs? An Institutional Perspective," *Journal of Corporate Accounting and Finance* 29:2 (2018). Accessed June 2, 2020, doi: 10.1002/jcaf.22331.

3 ANALYSIS OF THE LEGISLATIVE FRAMEWORK

The group of countries that neither adopted nor are considering to adopt the IFRS for SMEs is dominated by the Member States of the EU.[93] As the EU establishes a significant number of companies and is a potential pioneer for other jurisdictions, its reluctant attitude towards the IFRS for SMEs would appear detrimental to the IASB's goal of global harmonisation of accounting standards and the success of its standard for SMEs. However, the current level of acceptance and spread of the full IFRS throughout the world was also not predicted as such from the outset.[94] The IASB's most recent communication provides that from April 2020 a request for information was issued, which is the first step of the second comprehensive review of the standard for SMEs. It remains open whether the upcoming revision affects the existing incompatibilities with EU accounting legislation.

3.1 SME accounting rules on EU level

The existing EU legislation on financial reporting is aimed at ensuring consistency and comparability across the EU. Furthermore, according to the European Commission, it promotes the global convergence of accounting standards,[95] that is achieved mainly through Regulation 1606/2002/EC and the implementation of full IFRS for consolidated statements of listed companies.

An implementation of the IFRS for SMEs, however, is currently not under consideration. Incompatibilities of the EU Accounting Directive with the provisions of the IFRS for SMEs are amongst the main reasons for the EU's reluctant attitude. Since the IASB issued its standard for SMEs for the first time in 2009, the EC has been seeking the opinion of EU stakeholders on the standard and has evaluated its suitability for the EU as part of the review of the two then applicable Directives on accounting, the predecessors[96] of the currently applicable one (Directive 2013/34/EU). The review of the accounting Directives aimed at the reduction of administrative burden on small companies, thereby freeing up resources for growth and job creation. Moreover, it intended to increase the effectiveness, relevance, and understandability of financial reporting and to protect the needs of the Directives' users. The improvements

[93] IASB, *supra note* 3.
[94] Kees Camfferman and Stephen A. Zeff, *supra note* 26, p. 308.
[95] European Commission, *supra note* 11.
[96] The predecessors of today's Accounting Directive are the Fourth (78/660/EEC) and the Seventh company law Directive (83/349/EEC).

should facilitate the functioning of the EU Single Market by encouraging cross-border business activities.[97]

Upon request of the European Commission, in 2010 the EFRAG submitted advice and a working paper where it ultimately identified six incompatibilities of the IFRS for SMEs with the EU accounting Directives. For that purpose, an incompatibility means an accounting treatment required by the IFRS for SMEs but not being permitted under the EU Accounting Directives.[98] The incompatibilities concern the following: extraordinary items, financial instruments at fair value, amortisation of goodwill and the underlying useful life, recognition of negative goodwill in profit or loss, presentation of unpaid subscribed capital and the reversal of goodwill impairment losses.

As a further step in reviewing and developing the EU accounting regime, in 2011 an *impact assessment accompanying the original proposal from the Commission for Directive 2013/34/EU* was carried out. In line with the objectives of the accounting Directives' review, this assessment established several policy options by which the accounting framework of the EU could have been improved. One of those options considered the creation of a wholly new accounting framework by adoption of the IFRS for SMEs for mandatory use within the EU, except for micro-companies. Within this option, the paper elaborates that an approval mechanism and an endorsement procedure would be needed, suggesting that it could be similar to the one being in place for the full IFRS. Eventually, however, the assessment of the available policy options for replacing the previous accounting Directives resulted in a rejection of adopting the IFRS for SMEs at the EU level arguing that the objectives of simplification and reduction of administrative burden would not adequately be met by adoption of the IASB's standard.[99] Thus, notwithstanding the efforts in analysing the suitability of the IFRS for SMEs, in 2013 the Commission chose another option: the adoption of its new Accounting Directive 2013/34/EU by merging and improving its predecessors.

Nevertheless, the EC provides Member States with the option to adopt the IFRS for SMEs, however, subject to the condition that the standard is modified to comply with the

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[97] European Commission. *Impact Assessment accompanying the original proposal from the Commission for Directive 2013/34/EU SEC(2011) 1289 final* (2011): pp. 21 ff. Available on: https://eur-lex.europa.eu/resource.html?uri=cellar:6fd0296f-2992-4b0d-8d0e-8e2db360c27d.0001.01/DOC_1&format=PDF. Accessed April 3, 2020.

[98] EFRAG. *Advice on compatibility of the IFRS for SMEs and the EU Accounting Directives* (2010): p. 1. Available on:https://www.efrag.org/Assets/Download?assetUrl=%2Fsites%2Fwebpublishing%2FProject%20Documents%2F172%2FLetter%20to%20European%20Commission.pdf. Accessed March 21, 2020.

[99] European Commission, *supra note* 97, pp. 27 ff.

Directive.[100] The only Member State that the IASB reports as permitting SMEs to apply IFRS for SMEs, is Ireland. However, Ireland has merely developed a national standard that is based on the IFRS for SMEs but contains significant amendments in order to comply with EU legislation.[101] As stated earlier, a company that does not comply with all of the standard's provisions cannot assert compliance with it. Moreover, a modified standard would obviously deviate from the IASB's intention to globally harmonise accounting standards as the respective EU Member State would still apply a different version than other (i.e. non-EU) jurisdictions that permit or require the full use of an unaltered IFRS for SMEs. Thus, the goal of harmonising accounting rules for SMEs globally cannot be achieved under the current EU framework. Even the success in achieving the goal of harmonised accounting standards among the EU Member States is to be critically assessed. That is part of the following subchapter, where the EU Accounting Directive and its perceived success will be reviewed.

3.1.1 The EU Accounting Directive

Through the adoption of the Directive 2013/34/EU, the EC intended to provide a simplified accounting regime for small and medium-sized businesses, thus aiming at relieving them of administrative burden. Furthermore, micro-entities shall be provided with an even lighter regime.[102] The Accounting Directive stipulates the financial reporting and accounting obligations of certain undertakings with limited liability.[103] Thus, companies that are not subject to the full IFRS and would theoretically be eligible subjects to the IFRS for SMEs, currently fall within the scope of the Accounting Directive. National requirements in the following areas are intended to be harmonised by the Directive:

- "presentation and content of annual or consolidated financial statements
- presentation and content of management reports
- the measurement basis companies use to prepare their financial statements
- audit of financial statements
- publication of financial statements

[100] European Commission. *Financial reporting obligations for limited liability companies (Accounting Directive) – frequently asked questions*. Available on: https://ec.europa.eu/commission/presscorner/detail/de/MEMO_13_540. Accessed February 12, 2020.

[101] IASB. Jurisdiction profile of Ireland, available on: https://www.ifrs.org/use-around-the-world/use-of-ifrs-standards-by-jurisdiction/ireland/#application. Accessed February 12, 2020

[102] European Commission, *supra note* 11.

[103] Additionally, a significant number of partnerships and limited partnerships exist whose fully liable members are constituted either as public or as private limited liability companies. Such partnerships are also included in the scope of the Directive. Partnerships where members of a partnership which are not constituted as private or public limited companies, in fact, have limited liability for the partnership's obligations because that liability is limited by other undertakings, also fall within the scope of the Directive. *See* Directive 2013/34/EU, recital 5.

- the responsibility of management with regards to all above".[104]

As a minimum for their annual financial statements, the Accounting Directive requires the respective undertakings to prepare a balance sheet and the profit and loss account, complemented by the notes to the financial statements. Additional statements may be required by the Member States, yet not for small entities.[105] Thus, a cash flow statement for small entities may not be required by the law of a Member State which marks a significant difference to the IFRS for SMEs where such a statement is mandatory.

Recitals 3 and 4 of the Directive establish the grounds for the simultaneous coordination of national provisions regarding annual financial statements, their presentation and content, management reports, the measurement base used and publication by certain types of undertakings with limited liability: Firstly, some companies conduct business in more than one Member State and secondly, the third-party safeguards of limited liability companies are otherwise limited to their net assets.

While the further differentiation between micro, small and medium-sized entities is not provided for in the IFRS for SMEs, for the EU, the classification according to size thresholds is crucial for the differentiation of the accounting and reporting obligations to which each category is subject. For instance, the requirement to have an audit depends on the size-classification of an entity as well. According to the Directive's Article 34, only the financial statements of public-interest entities, medium-sized and large entities are subject to an audit. A company that classifies as small is not required to have an audit in order to be relieved of administrative burden. The Directive in its 43. recital argues that small companies require only to a limited extent the assurance of third parties regarding the financial statements, as in many cases the shareholders also act as management. However, the Directive does not prevent the Member States from imposing such an audit requirement on small entities.

According to the European Federation of Accountants and Auditors for SMEs (EFAA), the European Commission has neglected to maximise its opportunity to develop a better accounting framework for the EU. It argues that the Commission did not take into consideration its Small Business Act[106] which provides a comprehensive SME policy framework. Furthermore, the Commission focused on the *most commonly used* principles and policies within the Union when developing the Directive. That approach was criticised as not

[104] European Commission, *supra note* 11.

[105] Directive 2013/34/EU, *supra note* 78.

[106] The small business act is intended to improve the entrepreneurial approach in Europe, facilitate the regulatory and policy environment for SMEs and remove the remaining obstacles hampering their development.

constituting an appropriate means to achieve an innovative and future-driven development of the Single Market.[107] On a more fundamental level, the EFAA criticises that the principles of subsidiarity and proportionality were not sufficiently taken into account in the drafting process. The principle of subsidiarity holds that the EU may legislate only where action is more effective at EU level than at national, regional, or local level.[108] The principle of proportionality, which is closely linked to that of subsidiarity, aims at ensuring that the Union's actions do not exceed what is necessary to attain the agreed objectives.[109] While the Directive allows the Member States to impose further disclosure requirements for certain items of financial statements of medium-sized and large companies, it provides no such options for small undertakings although latter are less likely to participate in cross-border activities, thus their user base might be rather local and their accounting obligations may therefore rather be subject to legislation made on a national level. By harmonising the accounting requirements of the smallest of companies and the largest ones (by full IFRS) in Europe to the fullest extent, yet not for the medium-sized and large limited liability entities, the EU has created an illogicality, according to the EFAA.[110]

The Directive 2013/34/EU is one of twelve EU Directives on company law-related issues. Their impact on national company law, however, is rather small because the implementation and construction of EU law in that area tends to differ among the Member States, strongly influenced by prior corporate law provisions and the local legal culture.[111] That leads to a major criticism voiced by many authors. They claim that the EC has failed to achieve its desired comparability of financial statements across the EU.[112,113] At the heart of this criticism lies a large number of Member State Options (MSOs) as to how the provisions of the Accounting Directive are to be transposed into national law. These options either allow Member States to increase requirements or it has been left open for them to 'permit or require' certain

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[107] European Federation of Accountants and Auditors for SMEs. *EFAA Position Paper A Revision of the Accounting Directives – Missed Opportunity?* (2013). Available on: https://www.dstv.de/pruefende-berufe/pruefung-internationales/efaa-position-paper-missed-opportunity1. Accessed March 22, 2020.

[108] European Commission. Glossary. *Subsidiarity*. Available on: https://ec.europa.eu/regional_policy/en/policy/what/glossary/s/subsidiarity. Accessed on April 3, 2020.

[109] European Commission. Glossary. *Proportionality*. Available on: https://ec.europa.eu/regional_policy/en/policy/what/glossary/p/proportionality. Accessed April 3, 2020.

[110] European Federation of Accountants and Auditors for SMEs, *supra note* 108.

[111] Nicola de Luca, *European Company Law: Text, Cases and Materials* (Cambridge: Cambridge University Press, 2017), p. 25.

[112] Eva Hýblová and Alena Kolčavová, "The Consequences of "Options" in the Directive 2013/34/EU of the European Parliament and of the Council on the Financial Statements," Acta Universitatis Agriculturae et Silviculturae Mendelianae Brunensis 65:4 (2017): pp. 1349-1357.

[113] European Federation of Accountants and Auditors. Invitation to Comment – Enhancing Audit Quality in the Public Interest, June 3, 2016. Available on:https://www.efaa.com/cms/upload/efaa_files/pdf/Publications/Comment_letters/2016/20160603_IAASB_Comment_Enhancing_Audit_Quality_Public_Interest.pdf.

practices. Both increased requirements and exemptions may relate to a certain class of undertakings wholly or in part. In other words, an MSO may also allow a Member State to exempt only certain undertakings, for instance, small undertakings from certain requirements.[114] Harmonisation efforts and the capacity of financial statements to provide for comparable information to users across the European Union are deemed to be degraded by the high number of MSOs.[115]

One of the objectives of the EU is to build an integrated single market for capital across the Union. This includes public markets on which shares and bonds are traded, but also private markets such as private equity and private placement[116], for which no listing on a public exchange is required. It would help businesses, including SMEs, to raise financing more easily compared to the current situation in which most SMEs in Europe obtain their funding from banks. Whilst SMEs' need for financing often exceed banks' capacities since the financial crisis in 2008, an integrated capital market across the Union would improve that situation. Through the objective of creating a Capital Markets Union (CMU), the EU aims to remove obstacles to cross-border investment, diversify the financing of the economy, and reduce the cost of raising capital. This should support general economic growth and job creation in Europe.[117] As mentioned earlier, in 2018 the EC conducted a comprehensive assessment, called *Fitness Check of EU Supervisory Reporting Requirements*[118] for which it sought feedback on the EU public reporting framework from its stakeholders. The outcome showed that the Accounting Directive was overall regarded as effective in contributing to the protection of its stakeholders' interests but concerning its contribution to the objective of an integrated capital market it was regarded as less effective. This was mainly attributed to the high degree of flexibility offered to the Member States by the large number of MSOs.

The author concludes that it is, therefore, necessary to re-examine whether the Accounting Directive is an appropriate means of regulating and harmonising the accounting

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[114] *See* recital 11 of Directive 2013/34/EU.

[115] Eva Hýblová, *supra note* 73, p. 607.

[116] European Commission: Private placement is a form of direct lending typically between institutional investors and mid-sized firms which can take the form of loans or bonds with maturities between 3-15 years, but more commonly with 5-10 years. Private placements are considered to have the potential to increase the availability of finance for medium to large unlisted companies. Q & A on the Green Paper on building a Capital Markets Union (2015). Available on: https://ec.europa.eu/commission/presscorner/detail/en/MEMO_15_4434. Accessed June 7, 2020.

[117] European Commission. *What is the capital markets union?* Available on: https://ec.europa.eu/info/business-economy-euro/growth-and-investment/capital-markets-union/what-capital-markets-union_en. Accessed June 7, 2020.

[118] European Commission, *supra note* 47.

obligations of SMEs or whether the IFRS for SMEs could be of greater benefit in achieving the objectives of the Commission's CMU initiative.

3.2 SME accounting rules on Member State level: Germany

3.2.1 The Accounting Standards Committee of Germany

The national standard setter of Germany in the area of group financial reporting is the Accounting Standards Committee of Germany (ASCG). In accordance with the German Commercial Code[119], the Ministry of Justice[120] has delegated a legal mandate to the Committee to function as the private standardisation organisation. Its tasks include advising the government on domestic and EU legislative issues in the field of financial reporting, developing recommendations for the application of GAAP and interpretations of IFRS as well as enhancing the quality of accounting and financial reporting.

As part of the European Commission’s initiative on obtaining feedback the Accounting Standards Committee of Germany (ASCG) provided a comment letter on the EFRAG’s draft letter advice in 2010.[121] In the Committee’s view, the incompatibilities were only minor, and the EC should have therefore undertaken the necessary actions to enable companies to apply IFRS for SMEs. The ASCG stated significant doubts that the incompatibilities provided a sufficient basis for rejecting the application of the IFRS for SMEs for companies in the EU Member States. The Committee supported their position by assuming that the transactions for which the IFRS for SMEs and the Directives impose different requirements are unlikely to occur frequently in SMEs.

The author concludes from the German national standard setter’s positive attitude towards the standard that its successful implementation in Germany is entirely conceivable.

3.2.2 Relevant SME accounting rules in Germany

Entities potentially eligible to use the IFRS for SMEs currently must prepare their financial statements in accordance with the requirements of German GAAP which are stipulated in the Commercial Code. The German Commercial Code contains the core of German commercial law. In May 2009, the Accounting Law Modernisation Act came into force as an alternative to

[119] Handelsgesetzbuch (HGB) (Commercial Code of Germany) (12 December 2019): Art. 342. Available on: https://dejure.org/gesetze/HGB. Accessed June 6, 2020.

[120] Now it is the Ministry of Justice and for Consumer Protection.

[121] Accounting Standards Committee of Germany (DRSC). *Comment letter on EFRAG’s Draft Letter Advice on compatibility of the IFRS for SMEs and the EU Accounting Directives* (2010). Available on: https://www.efrag.org/Activities/172/Compatibility-Analysis-IFRS-for-SMEs-and-the-Council-Directives#. Accessed March 21, 2020.

the IFRS for SMEs in Germany. The act is a so-called article law, which revised regulations in several laws, including the Commercial Code. According to Berwanger[122], the Modernisation Act is widely regarded as one of the most far-reaching modernisations of the Commercial Code accounting law in recent years.

The revision to the Commercial Code was intended to provide considerable financial relief to the economy by bringing about deregulation effects and to strengthen the competitiveness of the accounting law of the German Commercial Code with international accounting standards, especially IFRS. Moreover, the revision should further develop the accounting rules of the Commercial Code into an adequate, but simpler and less costly alternative to the full IFRS.

A central function of the German GAAP financial statements is to provide the measurement basis for dividend distribution and to constitute the decisive factor for taxation.[123] This role has remained unchanged under the new law – the taxable profit of an entity in Germany is determined by its accounting profit.[124] Thus, a change in the accounting regulation, i.e. a different composition of the accounting profit would result in a different tax base.

The Commercial Code is divided into five different books each of which contains several sections. The second section of the third book sets out the provisions particularly applicable to those types of undertakings for which Member States' laws, regulations, and administrative provisions fall within the scope of Directive 2013/34/EU, according to its Annex I. Hence most of the transposed provisions of the Accounting Directive can be found therein, in accordance with the Act on the Implementation of Directive 2013/34/EU from July 2015.[125] Additionally, also other sections of the third book of the commercial code were affected by the implementation of the Directive, as well as the German Publicity Act, the German Stock Corporation Act, and a separate Act on Limited Liability Companies. However, the issues constituting the basis for the comparison can be found in the Commercial Code.

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[122] Jörg Berwanger, „Bilanzrechtsmodernisierungsgesetz (BilMoG)" (Accounting Law Modernisation Act), *Gabler Wirtschaftslexikon* (2018). Available on: https://wirtschaftslexikon.gabler.de/definition/bilanzrechtsmodernisierungsgesetz-bilmog-52201/version-275346. Accessed June 8, 2020.

[123] Jörg Berwanger, *supra note* 122.

[124] Einkommensteuergesetz (EstG) German Income Tax Act, Art. 5(1), available on: https://www.gesetze-im-internet.de/estg/__5.html. Accessed June 8, 2020.

[125] Gesetz zur Umsetzung der Richtlinie 2013/34/EU des Europäischen Parlaments und des Rates vom 26. Juni 2013 über den Jahresabschluss, den konsolidierten Abschluss und damit verbundene Berichte von Unternehmen bestimmter Rechtsformen und zur Änderung der Richtlinie 2006/43/EG des Europäischen Parlaments und des Rates und zur Aufhebung der Richtlinie 78/660/EWG und 83/348/EWG des Rates (Bilanzrichtlinie-Umsetzungsgesetz BilRUG) (Act on the Implementation of Directive 2013/34/EU) (17 July 2015). Available on: http://www.bgbl.de/xaver/bgbl/start.xav?startbk=Bundesanzeiger_BGBl&jumpTo=bgbl115s1245.pdf. Accessed June 6, 2020.

3.3 Incompatibilities - EU accounting rules and the IFRS for SMEs

The first comparison was the EFRAG's analysis (in 2010) on the incompatibilities of the IFRS for SMEs' initial version with the Fourth and Seventh EU Directives on company law (the predecessors of the Accounting Directive 2013/34/EU). This analysis has concluded with six incompatibilities which have been used as a strong argument against the implementation of the IASB's standard for SMEs in the EU.

However, as mentioned earlier, both the EU's accounting regime as well as the IFRS for SMEs have been further developed. The EU Member States had to transpose the new Accounting Directive 2013/34/EU until July 2015 and the IASB has issued the first revision of its standard for SMEs in 2015. Therefore, the identified incompatibilities by EFRAG need to be reassessed. Based on the incompatibilities remaining after that reassessment, the German legislation on the respective issues will be reviewed.

3.3.1 The first version of the IFRS for SMEs in comparison with the Fourth and the Seventh EU Directives on company law

As stated before, in 2010 the EFRAG conducted an analysis where it compared the requirements of the IFRS for SMEs with the requirements of the EU accounting regime. It concluded with a list of six incompatibilities between the standard by the IASB issued in 2009 and the EU accounting Directives as of February 2010 (the predecessors of the current one – the Fourth and the Seventh EU Directives on company law). It defined an incompatibility as an accounting treatment required by the IFRS for SMEs but not being permitted under the EU accounting regime.[126]

However, those six incompatibilities might not represent a comprehensive picture due to some limitations of the EFRAG's analysis. One of those limitations is that it is sufficient for an issue to be deemed compatible if only one of several options provided by the IFRS for SMEs is compatible with the Directives. That implies that in the case of an EU-wide implementation of the standard, the respective applying entity could not choose freely from all provided options in the IFRS for SMEs without risking an infringement of the EU accounting Directives. Furthermore, the compatibility of the standard has only been tested regarding the two accounting Directives, not with any other EU Directive. Incompatibility issues potentially arising from other Directives or Regulations can therefore not be covered. Further, the analysis was done merely theoretically and on a purely technical accounting basis, instead of taking into account whether the identified incompatibilities would arise in practice and how they would be

[126] EFRAG, *supra note* 98, p. 1.

handled in a potential court case. Moreover, where the accounting Directives were unclear and different interpretations would lead to different results, the respective issue has been deemed compatible. Also, the Member States' individual implementation of the Directives was not taken into consideration.[127] The latter implies that the individual Member States might face varying incompatibilities depending on their choices of MSOs, thus also different required changes to their legislation in the hypothetical case of an EU-wide IFRS for SMEs implementation.

Apart from the limitations outlined before, EFRAG's analysis has identified the following incompatibilities:

1: Extraordinary items

The IFRS for SMEs 2009 does not allow to present or describe any income or expense item as an *extraordinary item*.[128] The Fourth EU accounting Directive, however, requires items and charges to be recognised under *extraordinary income* and *extraordinary charges* if they arose otherwise than in the course of the company's ordinary activity.[129]

The Fourth Directive provides for several layouts of the profit and loss account from which the Member States can choose. Each of the layouts lists extraordinary items so as to allow them to be taxed separately.[130] This implies that extraordinary items are taxed differently than ordinary income and expenditure depending on the tax legislation of each Member State. If there is no separation of extraordinary items from ordinary ones, differentiation of tax rates is hampered and the profit after taxes would be different. Furthermore, a prohibition to present extraordinary items has direct and potentially far-reaching implications for users of financial statements concerning the information content of the item *turnover*.

However, the items to be recognised as extraordinary are not further specified under the EU Accounting Directives. Therefore, the cases for such recognition might be limited and rare which is why the EFRAG noted that this incompatibility might be neglectable, but the frequency of items being recognised as extraordinary has not been examined by its analysis. Thus, the author concludes that the significance of this incompatibility would depend on the Directives' implementation on Member State-level and the possible further specification of items being recognised as extraordinary.

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[127] EFRAG, *supra note* 98, p. 1 f.

[128] IFRS Foundation. *IFRS for SMEs Standard 2009*, para. 5.10. Available on: http://eifrs.ifrs.org/eifrs/sme/en/IFRSforSMEs2009.pdf.

[129] Art. 29 (1) of Fourth Council Directive 78/660/EEC of 25 July 1978 based on Article 54 (3) (g) of the Treaty on the annual accounts of certain types of companies *OJ L* 222, 14.8.1978, p. 11–31. Available on: http://data.europa.eu/eli/dir/1978/660/oj. Accessed March 16, 2020.

[130] Fourth Council Directive 78/660/EEC, *supra note* 129, Art. 22-26.

2: Financial instruments at fair value

According to the Fourth EU Accounting Directive, all financial instruments can be measured at cost.[131] On the other hand, it also provides a Member State Option to permit or require valuation at fair value for financial instruments.[132] Such an option is limited to liabilities held as part of a trading portfolio and derivative financial instruments.[133] Consequently, not *all* financial instruments may be permitted or required to be measured at fair value. According to the Fourth Directive, fair value is determined by reference to:

> (a) a market value, for those financial instruments for which a reliable market can readily be identified. Where a market value is not readily identifiable for an instrument but can be identified for its components or for a similar instrument, the market value may be derived from that of its components or of the similar instrument; or
>
> (b) a value resulting from generally accepted valuation models and techniques, for those instruments for which a reliable market cannot be readily identified. Such valuation models and techniques shall ensure a reasonable approximation of the market value.[134]

Under the IFRS for SMEs, fair value is defined as

> … the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (an exit price). When measuring fair value, an entity uses the assumptions that market participants would use when pricing the asset or the liability under current market conditions, including assumptions about risk. As a result, an entity's intention to hold an asset or to settle or otherwise fulfil a liability is not relevant when measuring fair value.[135]

The author concludes that the IASB's definition of fair value as such is compatible with the EU Directive. Instead, it is the application of the valuation method, where an incompatibility arises. According to the IFRS for SMEs 2009,

> … an entity shall measure all financial instruments within the scope of Section 12 at fair value and recognise changes in fair value in profit or loss, except as follows: equity instruments that are not publicly traded and whose fair value cannot otherwise be measured reliably, and contracts linked to such instruments that, if exercised, will result in delivery of such instruments, shall be measured at cost less impairment.[136]

Section 11 and section 12 of the IFRS for SMEs are governing the recognition, derecognition, measurement, and disclosure of financial assets and financial liabilities (collectively referred to

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[131] Fourth Council Directive 78/660/EEC, *supra note* 129, Art. 32.

[132] Art. 42a(1) of Directive 2001/65/EC of the European Parliament and of the Council of 27 September 2001 amending Directives 78/660/EEC, 83/349/EEC and 86/635/EEC as regards the valuation rules for the annual and consolidated accounts of certain types of companies as well as of banks and other financial institutions, *OJ L* 283, 27.10.2001, p. 28–32. Available on: http://data.europa.eu/eli/dir/2001/65/oj. Accessed May 27, 2020.

[133] *Ibid*, Art. 42a(3).

[134] Directive 2001/65/EC, *supra note* 132, Art. 42b(1).

[135] IFRS Foundation. IFRS 13 Fair Value Measurement. Available on: https://www.ifrs.org/issued-standards/list-of-standards/ifrs-13-fair-value-measurement/. Accessed May 28, 2020.

[136] IFRS Foundation, *supra note* 131, para. 12.8.

as financial instruments). Whilst section 11 deals with basic financial instruments, section 12 applies to non-basic, complex financial instruments and transactions.

As the quoted paragraph above displays, for those non-basic instruments that are not excluded by the paragraph itself, the fair value measurement principle shall be applied under the IFRS for SMEs 2009, as opposed to the cost principle required to be applied to some of those instruments by the Fourth EU accounting Directive. The EFRAG concluded that not *all* the financial instruments that are *required* to be measured at fair value under the IFRS for SMEs are *allowed* to be measured at fair value under the EU Directive. Therefore, the EFRAG considers that paragraph of the IFRS for SMEs incompatible with the EU accounting legislation.

The effect of that incompatibility could be seen in a diverging profit figure because changes in fair value are to be recognised in the profit and loss account under both EU and IFRS regime.[137] For those financial instruments that are not allowed to be measured and recognised at fair value there will be no such changes, thus no impact on the profit and loss account under valuation at cost.

What should be noted, however, is that paragraph 12.2 of the IFRS for SMEs provides for an option to apply the provisions of IAS 39 *Financial Instruments: Recognition and Measurement* (part of the full IFRS). If IAS 39 was compatible with the EU accounting Directives, it could be argued that the existence of the option leads to the issue being compatible. However, IAS 39 is one example of the EU being a difficult constituent to the IASB and its overriding goal of global harmonisation because it only adopted an EU version of it with two carve-outs, one being a carve-out of the full fair value option[138]. It is unclear whether the option provided by the IFRS for SMEs includes that EU version. Assuming the affirmative, the respective company would fulfil its accounting obligation in adherence to EU law, as the standard (EU version) has been endorsed by the EC. However, since there is more than just one version of that specific IAS standard and the IFRS for SMEs does not clarify to which version it refers, the EFRAG has decided to disregard the option to apply IAS 39 in their assessment of incompatibilities.

[137] *See* Directive 2001/65/EC, Art. 42c(1) for EU & IFRS for SMEs Standard 2009, para. 12.8 for IFRS.

[138] European Commission. *Accounting standards: Commission endorses IAS 39* (2004). Available on: https://ec.europa.eu/commission/presscorner/detail/en/IP_04_1385. Accessed June 3, 2020.

3: Amortisation of goodwill and the underlying useful life

Useful life is the expected period over which an asset will be available for use by an entity and over which it shall be written off.[139] Here, the asset is goodwill which is defined as the

> … **difference** [emphasis added] between the cost of the business combination and the acquirer's interest in the net fair value of the identifiable assets, liabilities and provisions for contingent liabilities so recognised.[140]

such as an entity's good reputation. The EC describes goodwill as a separate item which corresponds to a consolidation difference.[141] Thus, the definition of goodwill as such does not form part of the incompatibility, but rather its useful life. As an intangible asset, also for goodwill the determined value (i.e. depreciable amount) must be allocated systematically over its useful life. The resulting amortisation amount for each period is to be recognised as an expense,[142] thus lowering the taxable profit.

The IFRS for SMEs 2009 requires to presume the useful life of goodwill to be ten years if an entity is not able to reliably estimate the useful life.[143] The Fourth EU Accounting Directive required goodwill to be written off within five years[144] unless a longer useful economic life can be supported and the reasons for it are disclosed in the notes to the financial statement.[145] Thus, the EFRAG deemed the IFRS for SMEs' provision incompatible with the EU accounting rules.

A longer useful life as the basis for amortisation results in smaller amortisation amount each period, thereby reducing the expenses that can be deducted from taxable profit. Moreover, the lower the depreciation amount, the smaller the reduction in the respective underlying asset, so that the balance sheet total is larger than if a higher depreciation amount had been applied.

4: Immediate recognition in profit or loss of negative goodwill not related to a realised gain

Negative goodwill can be explained by referring to the above-mentioned description of goodwill, adding the amendment that the difference "… between the cost of the business combination and the acquirer's interest in the net fair value …"[146] is *negative*, meaning that the

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[139] IFRS Foundation. IAS 16 Property, Plant and Equipment. Available on: https://www.ifrs.org/issued-standards/list-of-standards/ias-16-property-plant-and-equipment/. Accessed May 28, 2020. & *See* Directive 2013/34/EU, Art. 12(11).

[140] IFRS Foundation, *supra note* 128, para. 19.14.

[141] Art. 19 (1) of Seventh Council Directive 83/349/EEC of 13 June 1983 based on the Article 54 (3) (g) of the Treaty on consolidated accounts *OJ L* 193, 18.7.1983, p. 1–17. Available on: https://eur-lex.europa.eu/legal-content/en/ALL/?uri=CELEX%3A31983L0349. Accessed March 20, 2020.

[142] *See* IFRS for SMEs Standard 2009, para. 18.21 and Fourth Council Directive 78/660/EEC, Art. 9(B), Art. 35.

[143] IFRS Foundation, *supra note* 128, para. 19.23 (a).

[144] Fourth Council Directive 78/660/EEC, *supra note* 129, Art. 34 (1) (a).

[145] Seventh Council Directive 83/349/EEC, *supra note* 141, Art. 37 (2).

[146] IFRS Foundation, *supra note* 128, para 19.14.

acquirer's costs in a business combination are below his interest in the value of the identifiable assets, liabilities, and provisions for contingent liabilities.

The IFRS for SMEs 2009 requires immediate recognition of negative goodwill in profit or loss.[147] The Seventh EU Accounting Directive, however, states the following:

> An amount shown as a separate item, … which corresponds to a negative consolidation difference may be transferred to the consolidated profit-and-loss account only:
>
> (a) where that difference corresponds to the expectation at the date of acquisition of unfavourable future results in that undertaking, or to the expectation of costs which that undertaking would incur, in so far as such an expectation materializes; or
>
> (b) in so far as such a difference corresponds to a realized gain.[148]

Thus, under the EU regime, *immediate* recognition is not permitted. Instead, an expectation must first be fulfilled, or a gain must be realised. Therefore, the provisions on the immediate recognition of negative goodwill are incompatible.

The result of this incompatibility consists firstly in the time component. Whereas negative goodwill affects the profit or loss immediately under the IFRS for SMEs, a recognition of the same event under the EU regime would appear at the end of a later reporting period, depending on the point in time of materialisation of the respective expectation or realisation of the gain. If two companies facing the same situation in the same reporting period, one reporting in accordance with the IFRS for SMEs, the other in accordance with EU legislation, their profit and loss figures would, therefore, be different. Secondly, it could even result in the fact that the respective gain or loss is not recognised at all if the expectation does not materialise. In that case, even the two companies' accumulated profit and loss figures of various reporting periods would diverge.

5: Presenting unpaid capital as an offset to equity

The IFRS for SMEs 2009 states that an entity that issues shares or other equity instruments, and where another party is obliged to provide cash or other resources in exchange for that issue, the issuer shall recognise it as equity.[149] In a case where the equity instruments are issued *before* the means of exchange are received (also referred to as unpaid capital[150] or subscribed capital unpaid[151]), the standard requires the issuing entity to present the amount receivable as an offset to equity in its statement of financial position, and *not* as an *asset*.[152] The Fourth EU accounting

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[147] IFRS Foundation, *supra note* 128, para 19.24 (b).
[148] Seventh Council Directive 83/349/EEC, *supra note* 141, Art. 31.
[149] IFRS Foundation, *supra note* 128, para. 22.7.
[150] EFRAG, *supra note* 99, p. 11.
[151] Fourth Council Directive 78/660/EEC, *supra note* 129, Art. 9-10.
[152] IFRS Foundation, *supra note* 128, para 22.7 (a).

Directive, which refers to that item as subscribed capital unpaid, requires the part of the capital called but not yet paid to be presented as an *asset*.[153] Thus, the issue is deemed incompatible.

The incompatibility could result in a potential discrepancy of balance sheet totals. Under the IFRS for SMEs' approach, the balance sheet amount would be lower (due to the offset) than the amount under the EU's approach where there would be an increase of the balance sheet total (due to the recognition of the outstanding means of exchange for the issued equity instrument as an asset).

6: Reversal of goodwill impairment losses

According to the IFRS for SMEs 2009,

> [a]n **impairment loss** occurs when the **carrying amount** of an asset exceeds its **recoverable amount**.[154]

The *carrying amount* is the amount recognised for an asset less any accumulated depreciation (or amortisation) and any accumulated impairment losses thereon, whereas the *recoverable amount* of an asset is measured as the higher of its fair value less selling costs and its value in use.[155] As an asset, also goodwill is to be reassessed and tested for impairment losses. However, a reversal of such recognised goodwill impairment loss in a subsequent period is prohibited by the IFRS for SMEs 2009.[156]

The Fourth EU accounting Directive also requires the value for goodwill to be adjusted but it prohibits the valuation at the lower of the values provided for in the relevant paragraph to be continued if the reasons for which the value adjustments were made no longer exist.[157] Thus, a reversal of goodwill impairment losses is required under the EU accounting regime and the issue is therefore deemed incompatible.

Since goodwill constitutes an asset[158], its impairment would result in a reduction of the balance sheet total. If such reduction cannot be reversed, the value of goodwill remains the same and the balance sheet total will not increase even if the reasons for the initial impairment have ceased to exist. However, if it is required to reverse an impairment loss on goodwill, the balance sheet total is increased as a result of this reversal.

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[153] Fourth Council Directive 78/660/EEC, *supra note* 129, Art. 9-10.

[154] IFRS Foundation, *supra note* 128, para 27.1.

[155] IFRS Foundation. *IAS 36 Impairment of Assets*, para 6. Available on: https://www.ifrs.org/issued-standards/list-of-standards/ias-36-impairment-of-assets/. Accessed June 2, 2020.

[156] IFRS Foundation, *supra note* 128, para 27.28.

[157] Fourth Council Directive 78/660/EEC, *supra note* 129, Art. 35.

[158] For example, it is listed as an intangible asset in the balance sheet layout in the Fourth Council Directive 78/660/EEC, Art. 9. & IFRS for SMEs 2009, para. 19.22 defines goodwill as an asset.

Furthermore, impairment loss constitutes an expense in the income statement.[159] A reversal of such would consequently result in an increase of the profit figure, whereas under the IFRS for SMEs, no such increase would appear.

[159] For example, value adjustments of intangible assets are listed as a component of the profit and loss account layout in the Fourth Council Directive 78/660/EEC, Art. 22-26. & IFRS for SMEs Standard 2009, para. 27.1.

4 LEGISLATIVE EFFECTS OF AN EU-WIDE IMPLEMENTATION OF THE IFRS FOR SMEs

As a preliminary remark to this chapter, it shall be noted that the practical impact of the incompatibility problems between different accounting frameworks is reflected in the different amounts reported for identical events in the financial statements. Given the size thresholds of the European Commission's SME classification, the recognition of different amounts than previously as a result of a change in legislation may cause a company to fall from one category into another (e.g. from being a small entity to being a medium-sized one) without the underlying business activity being responsible for this. That, in turn, could make the entity subject to different rules. If the EU were to implement the IFRS for SMEs only for medium-sized entities but not for small ones, it would be questionable based on which requirements the entity would be classified.

4.1 The EU Accounting Directive in comparison with the revised IFRS for SMEs

As the IFRS for SMEs 2009 has been revised in 2015, and the Fourth and Seventh EU Directives on company law have been replaced, the incompatibilities identified before are potentially obsolete and therefore need to be reassessed against the current set of rules – the IFRS for SMEs 2015 and the EU Accounting Directive.

1: Extraordinary items

The IFRS for SMEs 2015 retains the prohibition to describe or present any income or expenses as extraordinary items.[160] The EU accounting regime, however, changed its approach in this regard. The new Accounting Directive EU/2013/34 does not require a separate presentation of extraordinary items anymore.[161] It merely requires entities to disclose, in the notes to their financial statements, information on the amount and nature of individual items of income or expenditure that are of exceptional size or nature.[162] Thus, strictly applying the EFRAG's definition of an incompatibility (an accounting treatment required by the IFRS for SMEs but not being permitted under the EU Accounting Directive), it could be argued that the former incompatibility issue has been resolved. A separate presentation of extraordinary items under

[160] IFRS Foundation, *supra note* 59, para. 5.10.

[161] Inta Brūna and Inta Millere, "The Impact of the new Accounting Directive on the Normative Regulations of the Republic of Latvia." *International Scientific Conference - New Challenges of Economic and Business Development - 2014* (University of Latvia), (2014): p. 58. Available on: https://dom.lndb.lv/data/obj/763856.html. Accessed May 28, 2020.

[162] Directive 2013/34/EU, *supra note* 78, Art. 16(1)(f).

the EU rules is not required anymore, therefore an entity applying either set of rules would comply with both the Accounting Directive and the IFRS for SMEs in this regard. However, the absence of a requirement does not necessarily equal a prohibition. The Accounting Directive provides several layout options for the profit and loss statement as well as for the balance sheet. While it requires the items set out in these layouts to be shown separately and in the order indicated, Member States shall permit and may require a more detailed subdivision, additional subtotals, or new items.[163] Therefore, if a Member State requires a separate presentation of extraordinary items in the profit and loss statement, that would mean that the incompatibility is still existent on Member State-level.

2: Financial instruments at fair value

The Accounting Directive retains the provision for items recognised in the financial statements, here financial instruments, to be measured at cost.[164] The Directive further retains the MSO to permit or require the measurement of some financial instruments, including derivative financial instruments, at fair value.[165] The liabilities that are entitled to be measured at fair value as well as the items that are excluded from that option, remain the same as in its predecessor.[166] The financial instruments to which the fair value measurement method is applicable under IFRS for SMEs also remain the same in its revised version of 2015.[167] Therefore, as it was the case under the previous sets of rules, not *all* the financial instruments that are *required* to be measured at fair value under the IFRS for SMEs are *allowed* to be measured at fair value under the EU Accounting Directive.

Furthermore, the option to apply the recognition and measurement requirements of the IAS 39 instead of those stipulated by section 11 and 12 of the IFRS for SMEs also remains.[168] Notably, also the Accounting Directive includes an MSO that allows Member States to permit or require the recognition, measurement, and disclosure of financial instruments according to IFRS that are adopted in conformity with Regulation 1606/2002/EC.[169] If a Member State makes this MSO a requirement and a literal interpretation of the option in the IFRS for SMEs and the MSO in the Accounting Directive is applied, there would be no inconsistency. However, with reference to EFRAG's analysis, it remains unclear whether the application of the EU

[163] Directive 2013/34/EU, *supra note* 78, Art. 9(2).
[164] *Ibid*, Art. 6(1)(i).
[165] *Ibid*, Art. 8(1)(a).
[166] *See* Directive 2001/65/EC), Art. 42a & Directive 2013/34/EU, Art. 8(3-4).
[167] IFRS Foundation, *supra note* 59, para. 12.8.
[168] *Ibid*, 12.2.
[169] Directive 2013/34/EU, *supra note* 78, Art. 8(6).

version of IAS 39 would ensure compliance with IFRS for SMEs. The incompatibility of the valuation of financial instruments cannot, therefore, be declared resolved. Even if the EU-version was included in the permitted application of IAS 39 by the IFRS for SMEs, the global comparability of these aspects would still be imperfect due to the differences between the EU-specific IAS 39 and the original one.

3: Amortisation of goodwill and the underlying useful life

Both, the IFRS for SMEs and the EU Accounting Directive have changed in this regard. The Accounting Directive requires intangible assets to be written off within a period of not less than five but not more than ten years if the useful life cannot otherwise be reliably estimated. Within this range, Member States shall determine the maximum period.[170]

The IFRS for SMEs requires the useful life of goodwill to be determined based on management's best estimate but not to exceed ten years if it cannot be established reliably.[171] Consequently, the issue can be declared compatible provided that the management's estimate is not shorter than five years when complying with IFRS for SMEs. Depending on the implementation of the underlying option at Member State level, deviations from the standard may nevertheless occur. If a Member State sets the upper limit at less than 10 years, the IFRS for SMEs would still allow for a treatment not being permitted by the law of the Member State and this would have to be changed accordingly with an implementation of the standard.

4: Immediate recognition in profit or loss of negative goodwill not related to a realised gain

The provision on profit or loss recognition of negative goodwill has not changed in the IFRS revision – an immediate recognition is still required.[172]

The Annex VII of the Accounting Directive displaying correlated provisions with its predecessor refers the matter of negative goodwill recognition to the following article:

> negative goodwill **may** [emphasis added] be transferred to the consolidated profit and loss account where such a treatment is in accordance with the principles set out in Chapter 2.[173]

Chapter two of the Directive contains general provisions and principles. The author finds that the reference to the general provisions and principles of the Directive is rather vague compared to the provision in the Seventh Directive, which clearly defined the conditions for

[170] *Ibid*, Art. 12(11).
[171] IFRS Foundation, *supra note* 59, para. 19.23(a).
[172] *Ibid*, para. 19.24.
[173] Directive 2013/34/EU, *supra note* 78, Art. 24(3) point (f).

the recognition of negative goodwill. It is therefore difficult to assess whether the issue is still incompatible. However, the wording of the EU provision suggests that recognition in profit or loss is not a requirement, but rather a conditional possibility whereas it is a requirement under the IFRS for SMEs. Therefore, the author classifies the issue as remaining incompatible.

5: Presenting unpaid capital as an offset to equity

The provision on the subscribed capital unpaid has not changed in either set of rules. The IFRS for SMEs 2015 still requires the issuing entity to present the amount receivable as an offset to equity in its statement of financial position, and *not* as an *asset.*[174] The layout schemes related to the balance sheet in the Accounting Directive[175] require the part of the subscribed capital called but not yet paid, to be presented as an asset. There is no MSO that would allow for an offset to equity. Thus, the incompatibility remains.

6: Reversal of goodwill impairment losses

The IFRS for SMEs 2015 retains its prohibition of the reversal of recognised goodwill impairment loss in a subsequent period.[176]

The EU Accounting Directive contains a similar provision to that of its predecessor. It prohibits the valuation at the lower of the values provided for in the relevant paragraph to be continued if the reasons for which the value adjustments were made no longer exist, which implies a reversal of impairment losses. However, this provision has a significant addition which states that it shall *not* apply to value adjustments made in respect of goodwill.[177]

Article 27 of the Directive lists rules applicable to the item goodwill. None of them addresses the reversal of goodwill impairment loss. Considering the exclusion of value adjustments related to goodwill from the abovementioned provision and the absence of a replacing governing provision on that matter, it appears to the author that the recognised goodwill impairment loss shall not be reversed under the EU Accounting Directive and the incompatibility is resolved.

The outcome of the analysed incompatibility issues between the revised 2015 version of the IFRS for the SMEs and the Accounting Directive EU/2013/34 indicates that only three aspects are still incompatible while the compatibility of two aspects depends on the national treatment of Member States and one aspect can be declared compatible (table 2).

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[174] IFRS Foundation, *supra note* 59, para. 22.7(a).
[175] Directive 2013/34/EU, *supra note* 78, Annex III and Annex IV.
[176] IFRS Foundation, *supra note* 59, para. 27.28.
[177] Directive 2013/34/EU, *supra note* 78, Art. 12(6)(d).

Accounting issue	IFRS for SMEs 2015	Directive 2013/34/EU	Compatibility
1: Extraordinary items	Prohibition to describe or present any income or expenses as extraordinary items	No requirement to present extraordinary items separately; MSO to permit or require a more detailed subdivision, additional subtotals or new items in the profit and loss statement	Dependent on Member States' use of the MSO in Directive 2013/34/EU Art. 9(2) **Compatibility possible**
2: Financial instruments at fair value	Non-basic financial instruments (with few exceptions) to be measured at fair value; option to use IAS 39 instead	Measurement at cost; MSO to permit or require the measurement of certain financial instruments at fair value; option to use EU-version of IAS 39 instead	No full coincidence of instruments that may be measured at fair value; no guarantee of compatibility by an application of IAS 39 either. **Incompatible**
3: Amortisation of goodwill and the underlying useful life	Useful life to be determined based on management's best estimate but not to exceed ten years if it cannot be established reliably	MS to determine the maximum period of useful life within the range of five to ten years if the useful life cannot otherwise be reliably estimated	Dependent on Member States' use of the MSO in Directive 2013/34/EU, Art. 12(11), and on management's estimate **Compatibility possible**
4: Immediate recognition in profit or loss of negative goodwill not related to a realised gain	Immediate recognition required	No requirement but rather a conditional possibility in accordance with the basic principles of the Directive	**Unclear / incompatible**
5: Presenting unpaid capital as an offset to equity	Presentation as an offset to equity in the issuing entity's statement of financial position, and *not* as an *asset*	Presentation of subscribed called-up capital unpaid as an asset	**Incompatible**
6: Reversal of goodwill impairment losses	Prohibition of the reversal of recognised goodwill impairment loss	No intention of the legislator to allow for reversal of recognised goodwill impairment loss	**Compatible**

Table 2: Compatibility of the analysed accounting requirements on EU level. Source: Author's compilation based on own analysis (chapter 4.1).

4.2 German accounting legislation in comparison with the revised IFRS for SMEs

It is evident from the previous comparison that part of the six areas under consideration involve discretion at Member State-level. Depending on Member States' usage of the MSOs, the required changes that would make the national accounting framework compatible with the IFRS for SMEs, might, therefore, vary across the EU. Germany's implementation of the EU Accounting Directive in the analysed areas can be summarised as follows.

1: Extraordinary items

Prior to the coming into force of the implemented Accounting Directive, Article 277 of the HGB contained a paragraph that required extraordinary income and extraordinary charges to include income and charges which arise outside the company's ordinary activities.[178] However, that paragraph has been repealed with the Act on the implementation of Directive 2013/34/EU.[179] There is consequently no incompatibility with the IFRS for SMEs in this respect.

2: Financial instruments at fair value

The valuation of financial instruments under German GAAP is based on the general valuation provisions for fixed and current assets.[180] Analysing Germany's specific use of the MSO regarding permission or requirement of measuring some financial instruments at fair value is beyond the scope of this thesis. However, as stated earlier, the EU Accounting Directive does not allow for measurement at fair value of *all* the financial instruments that are *required* to be measured at fair value under the IFRS for SMEs. Therefore, the financial instruments that are allowed to be measured at fair value under the German GAAP cannot cover the ones required for fair value measurement under IFRS for SMEs either.

3: Amortisation of goodwill and the underlying useful life

The Act on the implementation of Directive 2013/34/EU[181] adds a sentence to Article 253(3) of the Commercial Code. This sentence establishes the expected useful life of an internally

[178] Wirtschaftsprüferkammer (German Chamber of Auditors). *Statement of the Chamber of Auditors on the Draft law on the Act on the Implementation of Directive 2013/34/EU (BilRUG)*: p. 4. Available on: https://www.bundesgerichtshof.de/SharedDocs/Downloads/DE/Bibliothek/Gesetzesmaterialien/18_wp/BilRUG/stellung_wpk_refe.pdf?__blob=publicationFile&v=1. Accessed June 6, 2020.
[179] Act on the Implementation of Directive 2013/34/EU, *supra note* 125.
[180] Armando Agusevski, *Bilanzierung von Finanzinstrumenten nach HGB und IFRS: Unterschiede in Ansatz und Bewertung* (Accounting for financial instruments under HGB and IFRS: differences in recognition and measurement) (Diplomica Verlag, 2015), p. 17.
[181] Act on the Implementation of Directive 2013/34/EU, *supra note* 125, Art. 1(3)(b).

generated intangible fixed asset, over which its amortisation should be scheduled, be ten years. The sentence applies accordingly to goodwill acquired for a consideration.[182] The Accounting Directive's MSO in this regard, however, stated the following:

> … That **maximum period** [emphasis added] shall not be shorter than five years and shall not exceed 10 years. An explanation of the period over which goodwill is written off shall be provided within the notes to the financial statements.[183]

From the author's point of view, the correctness of the German legislator's application of the Directive's provision is questionable, as the legislator defined the *absolute* period instead of a *maximum* period which the respective company may use and explain its choice in its notes to the financial statements. Therefore, the matter is incompatible with the IFRS for SMEs, as the latter permits the management to use its best estimate for determining the useful life within a range of *up to ten years*.[184] Hence a company may use a period below ten years under IFRS for SMEs whereas this is not an option under German national law.

4: Immediate recognition in profit or loss of negative goodwill not related to a realised gain

The Act on the implementation of Directive 2013/34/EU[185] defines the second paragraph of the relevant article in the Commercial Code[186]. That paragraph stipulates that the difference shown on the liabilities side of the balance sheet (referring to negative goodwill[187]) may be dissolved with an effect on profit or loss, provided that such a procedure complies with the basic principles of two articles in conjunction with the provisions of section one (of the second book of the Commercial Code). The analysis of those provisions constituting the precondition for recognition of negative goodwill in profit or loss is beyond the scope of this thesis. Nevertheless, it can be concluded that the German Commercial Code is incompatible with the IFRS for SMEs on that issue because recognition in profit or loss is not a *requirement* under German GAAP, but rather a conditional possibility whereas it is a requirement under the IFRS for SMEs.

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[182] Commercial Code of Germany, Art. 253(3), 3rd sentence.
[183] Directive 2013/34/EU, *supra note* 78, Art. 12(11).
[184] IFRS Foundation, *supra note* 59, para. 19.23(a).
[185] Act on the Implementation of Directive 2013/34/EU, *supra note* 125, Art. 1(35).
[186] Commercial Code of Germany, Art. 309(2).
[187] *Ibid*, Art. 301(3).

5: Presenting unpaid capital as an offset to equity

Following the provision of the Directive, the amount of the subscribed capital that has been called but not yet paid shall be shown separately under receivables[188] which constitute an asset – and an offset to equity is not allowed.

6: Reversal of goodwill impairment losses

Like the Accounting Directive, the HGB also contains a provision that, although non-scheduled depreciation (or amortisation respectively) must be applied to *fixed assets* in the event of a probable permanent reduction in value in order to report these at the lower value to be attributed to them on the balance sheet date,[189] and may *not be retained* if the reasons for this no longer exist, a lower value of *goodwill acquired for consideration* must be retained.[190] Thus, goodwill impairment losses may not be reversed and the treatment of that matter is compatible with the IFRS for SMEs.

4.3 Implementation options

An implementation of the IFRS for SMEs could take place in several forms. The following suggestions of the author are arranged according to the severity of the respective change. Within each option, the IFRS for SMEs could be made applicable to all SMEs, to a certain size class (for example medium-sized as the standard was deemed yet too complex for small entities), or to certain industries. Further, within each presented option the action is on the side of the EU. But the current revision of the IFRS for SMEs could also bring along changes to the provisions set in the 2015 version. The author, therefore, suggests that the revision and the possible reduction of incompatibilities should be awaited before choosing an implementation option. Moreover, the presented options imply that the decision to implement the standard is made at EU-level and does not vary among the Member States.

Mandatory applicable through an EU Regulation

The most extreme option of the IFRS for SMEs' implementation would be its mandatory application by all companies in the EU that meet the definition of an SME by both the European Commission and the IASB. This would largely render the EU Accounting Directive obsolete. However, as the definitions by the IASB and the EC do not coincide with each other, the entities that fall under the scope of the EU Accounting Directive but do not classify as an SME

[188] Commercial Code of Germany, Art. 272(1).
[189] *Ibid*, Art. 253(3), 5th sentence.
[190] *Ibid*, Art. 253(5), 2nd sentence.

according to the IASB would still need regulation other than that provided for by the standard. More precisely, entities that are publicly accountable, yet small based on their balance sheet, net turnover, and employee numbers, would still need to prepare their unconsolidated financial statements in accordance with the Directive. In a case where only a certain group of SMEs is required to apply the standard, the same would be true for the excluded companies. The abolishment of the Directive without a replacement in addition to that by the IFRS for SMEs, is therefore not feasible. However, the applicability of the standard through a Regulation is feasible. The approach could be similar to the existing Regulation 2002/1606/EC which stipulates the applicability of full IFRS to listed companies' consolidated statements. Taking into account, on the other hand, the argument that the IFRS for SMEs' complexity exceeds the capabilities of small entities, a mandatory use of the standard would not be in line with the goal of reducing the administrative burden and costs of SMEs' financial reporting.

Permission to apply

This way of implementation allows the application of the standard to be a decision of each entity and not a decision of a Member State or the Union. EU Member States would have to permit companies incorporated in their jurisdiction to prepare their financial statements in accordance with the IFRS for SMEs without forcing a double reporting burden on them. Therefore, an entity that chooses to apply the standard would be released from applying national GAAP.

As stated earlier, under the current EU framework an application of the IFRS for SMEs is not prohibited provided that the standard is modified to comply with the Directive. A modification of the standard, however, prevents the respective entity from asserting that its financial statements have been prepared in conformity with it. Therefore, the EC's current permission to apply must be amended in a way that the standard's full application without amendments or limitations is possible if chosen by the eligible entity. Therefore, and to achieve the goal of global harmonisation of accounting rules, the author suggests that under this option, the EU Accounting Directive should be amended resulting in a removal of the remaining incompatibilities.

Although the decision to apply the standard is left to the individual SMEs and would, therefore, result in fewer applications than under mandatory use, the author considers this option currently as the most appropriate taking into consideration the argument that the standard could be too complex for small entities. Entities that decide against the application of the standard would still have to comply with the EU Accounting Directive's implementation into the respective national GAAP, thus facing the proposed changes in the five currently

incompatible areas. However, as some of these accounting issues are rather unlikely to occur regularly for small companies, the effect on the latter would be insignificant.

In amending the Accounting Directive regarding the remaining incompatibilities, an important step towards global harmonisation would nevertheless be taken. In the long term, however, the Accounting Directive's existing provisions would need to be further harmonised, given that the vast number of available MSOs remains an obstacle to full harmonisation.

EU carve-ins

Eu carve-ins would constitute modifications of the standard on the side of the EC and accepted by the IASB. As opposed to the two other options, this would allow the EU to stick to its preferred treatment of the incompatible issues and nevertheless enable the applying companies, whether at their own choice or by the requirement of EU- or Member State-law, to assert compliance with the standard.

However, as stated earlier before the background of full IFRS, a majority of stakeholders were against EU carve-ins as these would lead to an EU-specific version of the standards, thus hampering the objective of a harmonised global accounting framework. Therefore, this option would be the least favourable in the author's opinion.

4.4 Proposed changes to the existing accounting legislation

The only accounting issue analysed that does not require a change in legislation at either EU or Member State level is the reversal of goodwill impairment loss. The Directive's approach that recognised goodwill impairment loss shall *not* be reversed should remain since it is compatible with the standard and thereby does not interfere with the harmonisation objective. For the other five aspects, the author proposes changes.

4.4.1 Proposed changes on EU level

Given the EU's current approach of permitting the use of IFRS for SMEs as long as it is modified to comply with the Directive, the remaining incompatible issues must be converged to enable entities asserting full compliance with the standard. From a European perspective, to ensure entities' ability to report their financial performance in conformity with the IFRS for SMEs, the standard cannot require accounting treatments that are not allowed under the Accounting Directive. However, from a different point of view, one could also argue that the EU Accounting Directive cannot contain provisions that are not allowed by the IFRS for SMEs. To converge the issues that are deemed certainly incompatible, the solution could be to include additional permissions for the Member States in the Accounting Directive, which would make

the issue compatible. However, the goal of the following recommendations should not be limited to the analysed issues becoming compatible, but rather be extended to effectively harmonise the legal requirements for SMEs' accounting practices globally. The inclusion of further options in the form of permissions in the Accounting Directive would increase the already large number of MSOs, which in turn is the main criticism of the existing EU accounting framework for SMEs. Therefore, the following proposals are rather drastic and focus on a reduction of MSOs, emphasising not only the convergence of the EU framework with the standard but also the overall objective of a globally harmonised accounting framework.

1: Prohibition to describe or present any income or expenses as extraordinary items

As the EU occurs not to intend a presentation of items as extraordinary anymore, it should turn its open approach into a prohibition. That would make the issue certainly compatible as the Member States would have no opportunity to require a separate presentation of extraordinary items in their national rules. The current MSO in Article 9(2) that leaves it open to the Member States to require a more detailed subdivision, additional subtotals, and new items in addition to the prescribed layout options, should be amended towards ensuring conformity of entities across the Union with the IFRS for SMEs, meaning that a more detailed subdivision, additional subtotals, and new items are only insofar possible as they would be allowed under the standard.

In a case where an application of the standard would be at the discretion of companies instead of being a requirement by EU- or Member State-law, the Directive could retain the MSO insofar as the Member States should *allow* for a more detailed subdivision, additional subtotals, and new items in addition to the prescribed layout options in the Directive, but the Member States should not be able to *require* that. Thereby, the respective entity's free decision and its ability to report in conformity with the standard would be ensured.

The direction of this proposal is mainly justified by the fact that the EU already abolished the requirement to disclose certain items as extraordinary. If the EU were to pursue a separate presentation of extraordinary items, the proposal would focus on using the EU's bargaining power towards the IASB and to change the IFRS for SMEs instead, because from an external stakeholder's perspective the disclosure of extraordinary income and expenses is of crucial importance for the analysis of results, enabling the development of ordinary business activities to be assessed in isolation.

2: Alignment of financial instruments that are permitted to be measured at fair value

A drastic approach would be for the EC to *require* measurement at fair value of those instruments that are to be measured at fair value under paragraph 12.8 of the IFRS for SMEs.

However, the author suggests retaining a choice between measurement at fair value and measurement at cost. In addition, the specific list of financial instruments eligible for this choice should be further aligned with the list in IFRS for SMEs.

Since this field appears to be a sensitive matter to the European Commission (derived from the fact that only an *EU-specific* IAS 39 was adopted), an alternative suggestion of the author is for the IASB to include in its option of applying the recognition and measurement requirements of the IAS 39 instead of those of the SME standard, the EU version of IAS 39. Although this approach would also interfere with the goal of global harmonisation, the author finds it justifiable, especially since the implementation of the EU-specific version of IAS 39 has attracted significant attention by policy makers and other stakeholders of the IASB and it can therefore, be assumed that international investors are aware of this detail.

3: A common maximum period of useful life of goodwill for amortisation purposes

The author finds the Accounting Directive's intention of leaving the determination of the useful life of goodwill in exceptional cases where it cannot otherwise reliably be estimated to the individual company, appropriate. The requirement to disclose the choice of the useful life period in the notes to the financial statements should also remain. However, the author suggests that the Accounting Directive should not leave it open to the Member States to define a maximum period within the range of five to ten years. Instead, this range should be available for selection by any entity in the Union.

4: Requirement of an immediate recognition of negative goodwill in profit or loss

The author suggests that the Accounting Directive should *require* immediate recognition of negative goodwill in profit or loss in order to be in line with the IFRS and to enhance harmonisation within the EU as well as globally. However, since the underlying issue might be rather unlikely to occur frequently in SMEs, and the incompatibility of the provisions could not certainly be confirmed by the author, this proposal should be regarded as subordinate to the others.

5: Presenting unpaid capital as an offset to equity

The author proposes that the amount of the subscribed capital that has been called but not yet paid should be required to be presented as an offset to equity and thus be adjusted to the provision of the IFRS for SMEs. Although this would mark a clear step by the Commission towards the approach of the IASB, the author believes that there should be no choice at either Member State- or company-level in order to avoid adding another MSO.

4.4.2 Impact of the proposed changes on German legislation

The proposed changes in EU legislation will clearly have an impact on Member State-level. In cases where the compatibility of an issue depends on a Member State's previous choice of MSOs, that choice determines the depth of the proposed change's impact on national law which could, therefore, vary across the Union. In Germany, the following consequences would arise.

1: Prohibition to describe or present any income or expenses as extraordinary items

Applying this proposal would have no significant effect in Germany as the legislator already removed the paragraph that required extraordinary income and extraordinary charges to include income and charges which arise outside the company's ordinary activities[191] through the Act on the implementation of Directive 2013/34/EU.[192] An explicit prohibition by EU legislation would, however, have to be implemented in national law.

2: Alignment of financial instruments that are permitted to be measured at fair value

The list of financial instruments, permitted to be measured at fair value instead of the cost, would be extended so that it includes the same financial instruments to be measured at fair value as the IFRS for SMEs. Thereby each company that chooses to prepare its financial statements in conformity with the IFRS for SMEs (in accordance with the suggested implementation option *permission to apply*) has the necessary permission to measure the respective financial instruments accordingly. At the same time, a company that does not opt for the IFRS for SMEs does not have to change its valuation of financial instruments.

3: A common maximum period of useful life of goodwill for amortisation purposes

Leaving the range of five to ten years for the useful life of goodwill, in cases where it could not be otherwise reliably estimated, for selection by any entity in the Union would require an amendment to Article 253(3) of the German Commercial Code as it currently prescribes an absolute period of ten years for those cases.

4: Requirement of an immediate recognition of negative goodwill in profit or loss

Applying this proposal would require an amendment to Article 309(2) of the German Commercial Code as it currently makes such recognition subject to conditions.

[191] Wirtschaftsprüferkammer (German Chamber of Auditors), *supra note* 178.

[192] Act on the Implementation of Directive 2013/34/EU, *supra note* 125.

5: Presenting unpaid capital as an offset to equity

Applying this proposal would require an amendment to Article 272(1) of the German Commercial Code as it currently does not allow for an offset to equity of the amount of the subscribed capital that has been called but not yet paid.

5 CONCLUSIONS

This research aimed to provide a theoretical background for a harmonised regulatory framework for SMEs' financial reporting obligations, to identify significant incompatibilities between the IFRS for SMEs and EU accounting legislation as well as national accounting legislation of Germany, and to recommend legislative changes necessary for an EU-wide IFRS for SMEs implementation – on EU-level and Member State-level demonstrated at the case of Germany. Having examined that the current EU legislation on financial reporting is not achieving a sufficient degree of harmonisation, both internally and with a view to global comparability, the author has presented the IFRS for SMEs as an effective alternative. As the most appropriate way of implementation, a "permission to apply", meaning a discretionary choice for SMEs to apply the standard, has been suggested. Specific amendments to the EU Accounting Directive have been proposed to enable the implementation. The effects of those amendments to the German Commercial code have been identified.

From previous academic work, this thesis concludes that the full IFRS provide for a qualitative, internationally recognised, and widely acknowledged set of rules that is intended to improve the international harmonisation of accounting legislation. Although its standard-setting body is sometimes met with criticism, and there is a divergence of opinion in scholarly writings on the efficacy of the IFRS, the majority of EU stakeholders is against an introduction of EU-carve-ins in the legally defined endorsement process of the IFRS for listed companies in the EU as this would hamper the objective of a harmonised global accounting framework. A stronger EU involvement in the IASB's standard-setting process is, however, considered desirable, even though the EU is already exerting considerable pressure on the IASB.

Due to SMEs' importance for the economy and a strong international demand to cater to their specific needs, the IASB developed the IFRS for SMEs. While the EU is reluctant to implement it, the IFRS for SMEs carries the potential to follow the example of the full IFRS and could improve the degree of harmonisation of accounting rules for SMEs. The current definitions of SMEs by the EC and the IASB are diverging. Therefore, only entities that qualify as SMEs under both definitions are eligible to apply the standard, so that an all-encompassing replacement of the EC accounting requirements for SMEs by the standard is not feasible.

The thesis further reveals that the main drawback of the IFRS for SMEs is seen in the cost burden for SMEs since the standard's complexity is deemed yet too high for small companies and there is no separation of small and medium-sized entities. The main counterarguments consist in the potential decrease of cost of capital and a country's improved ability to attract it through implementing the standard, which would result in economic growth.

Factors that influence a country's decision to adopt the standard are diverse and the accuracy to predict such decision is limited.

There is a necessity to re-examine the EU Accounting Directive due to its unsuccessful harmonisation attempts. In the review of the two predecessors of the Accounting Directive, the IFRS for SMEs was considered as a policy option to create a completely new accounting framework but was eventually rejected because of its accused shortcomings in meeting the objectives of simplification and reducing the administrative burden for small companies, and because of its incompatibility with the EU accounting rules. However, the current EU Accounting Directive is mainly criticised for its large number of Member State Options which are degrading the comparability of financial statements and hampering the overall harmonisation objective. Concerning its contribution to the EC's ongoing policy objective of creating an integrated capital market, the Directive was, therefore, deemed ineffective.

From the initial comparison of the first version of the IFRS for SMEs (2009) and the previous EU Directives on accounting, six incompatible topics have been identified: extraordinary items, measurement of financial instruments, amortisation of goodwill and the underlying useful life, recognition of negative goodwill, presentation of subscribed called-up capital unpaid, and the reversal of goodwill impairment losses.

The national standard-setting committee of Germany appears to have a positive attitude towards the standard and considered the identified incompatibilities as minor and doubted that they provide sufficient basis for the standard's rejection. In the German national legislation, the incompatible areas are stipulated in the Commercial Code.

From the comparison of the revised version of the IFRS for SMEs with the EU Accounting Directive, the analysis concludes that the issue regarding the reversal of goodwill impairment loss is compatible under the current set of rules. For extraordinary items, and the amortisation of goodwill and the underlying useful life, compatibility is possible depending on the individual Member States' transposition of the underlying option into national law. In the case of Germany, the treatment of extraordinary items is compatible with the current version of the IFRS for SMEs, but the transposed provision on the issue of amortisation of goodwill and the underlying useful life resulted in an incompatibility. The issues of measurement of financial instruments, the presentation of subscribed called-up unpaid capital, and the reversal of goodwill impairment losses remain incompatible on EU-level and consequently also on Member State-level.

As a result, the thesis proposes five legislative changes to the EU Accounting Directive: Firstly, the prohibition to describe or present any income or expense as extraordinary items and to amend the underlying MSO by reducing the margin of discretion regarding a more detailed

subdivision, additional subtotals, and new items in addition to the prescribed layout options for a profit and loss statement in the Directive. Secondly, the alignment of the specific financial instruments that are permitted to be measured at fair value. Within this proposal, the author also considers a possible step by the IASB towards the EC through including the EU-version of the IAS 39 in the option in the IFRS for SMEs, acknowledging that full harmonisation would be deteriorated by that. Thirdly, a common maximum period of the useful life of goodwill where the choice within the permitted range should be granted at company-level. As the fourth proposal, the author named the requirement of immediate recognition of negative goodwill in profit or loss. This proposal is subordinated to the others as the underlying incompatibility could not be confirmed with absolute certainty and due to the unlikeliness of the issue occurring frequently in SMEs. The fifth proposal is the presentation and recognition of the amount of the subscribed capital that has been called but not yet paid, as an offset to equity.

Moreover, three different implementation options of the IFRS are presented. An implementation of the IFRS for SMEs through an EU Regulation constitutes the most extreme option and would imply mandatory application of the standard by all SMEs in the EU. Due to diverging SME definitions, some companies would be left out by the Regulation, thus additional EU accounting legislation would remain necessary. Furthermore, forcing the standard's application may result in extensive reporting burden for certain SMEs. Therefore, the thesis suggests that the current EC's permission to apply must be amended in a way that the standard's full application without amendments or limitations is possible if chosen by the eligible SME. Under this option, the EU Accounting Directive should be amended resulting in a removal of the remaining incompatibilities. A third implementation option would be characterised by amendments to the IFRS for SMEs by the EC and accepted by the IASB – the EU-carve ins. Although that would enable SMEs to assert compliance with the standard, the global comparability of financial statements could not be achieved as the incompatibilities between an EU-version of the standard and the original IFRS for SMEs would remain.

For the case of an EU-wide permission to apply the IFRS for SMEs and the realisation of the proposed changes, the research identifies the effects on the national accounting legislation in Germany. The first proposed change would have no significant effect because the transposed MSO is already in conformity with the IFRS for SMEs. The second proposed change requires the list of financial instruments permitted to fair value measurement to be extended. The third proposed change requires an amendment to the relevant provision in the Commercial Code – no absolute period should be required anymore, but instead, the article should provide for an individual assessment within the range of 5 to 10 years. The fourth proposed change leads to the introduction of the requirement of immediate recognition of negative goodwill in profit or

loss in the respective article. The fifth proposed change also requires an amendment to the relevant article in the Commercial Code – presentation of the subscribed called-up capital unpaid as an offset to equity, and not as an asset.

Considering the remaining incompatibilities of the current EU accounting framework and the IFRS for SMEs as well as the proposed amendments in the legislation, a shift towards the IFRS for SMEs may appear to be extensive work for all parties involved. However, it also emerges that the current set-up is not satisfactory either and that the attempt to create a harmonised set of accounting rules for Europe through the Accounting Directive has been deemed a failure by some. Therefore, the potential case of an EU-wide implementation of the IFRS for SMEs is not limited to a scenario in which the EU amends its rules to overcome incompatibilities with the standard. Instead, considering the EU's bargaining power vis-à-vis the IASB, as well as the numerous points of criticism and areas for improvement raised by academics and institutions, changes within the IFRS for SMEs itself are also conceivable.

In referring to the EU's bargaining power, the author does not only intend to remind about the situation in which the EU threatened to stop its funding. A push by the EU to amend certain aspects in the standard could also be successful in a rather indirect way. Considering the central role of the EU's adoption of the full IFRS in 2002 for the IASB's longevity, moving towards the EU's needs could be tempting to the IASB as an adoption by the EU carries the potential to encourage other jurisdictions to follow suit.

However, even if the IASB made concessions during the current revision and converges with the EU accounting regime on certain aspects, some incompatibilities will most likely remain. Therefore, a legal environment within the EU that allows SMEs to fully comply with the IFRS for SMEs will certainly require changes on the part of the EU.

The dissemination of IFRS for SMEs is an ongoing process that requires the commitment of various stakeholders and involves a political debate, the outcome of which may change the picture in the future. As the IFRS for SMEs is still at a relatively early stage and the IASB is revising its standards constantly, a development in a direction that is more favourable to the EU is conceivable. Besides, it is also conceivable that the EU will revise its legislation in the area of financial reporting of SMEs, particularly with regard to greater harmonisation internally, but also with a view to improving comparability at a global level. Whether and which of the two sides will take a step towards reducing incompatibilities, or whether an EU version of the standard could be an option, can only be conjectured. It also remains an open question whether the IASB reacts to the criticism of its due process for the SME standard and places more emphasis on the involvement of SMEs in the process of obtaining opinions and preferences.

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