Germany. German Accounting and IFRS: Limitations in the Convergence Potential of German National Accounting Standards Towards International Accounting Standards

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Abstract Although several reforms of the German statutory accounting system in the last decades led to a moderate but ongoing harmonization with international accounting standards, there still remain significant—hence deliberate—differences between the two accounting systems. These differences mainly result from fundamental disparities in the underlying purposes and principles of accounting according to the German Commercial Code vs. IFRS. The article provides an overview of the current status of internationalization of German statutory accounting as well as the application and importance of German statutory accounting and of IFRS in Germany. Second, it aims to show the main obstacles for a further internationalization of German accounting standards by comparing the main purposes of the German and the IFRS accounting systems and by explaining some central characteristic principles of the German accounting system, which either do not exist or have a substantially different interpretation in the IFRS.

1 Introduction

Despite the prevailing relevance of national statutory accounting according to the German Commercial Code [Handelsgesetzbuch (HGB)][1] and the Generally Accepted Accounting Principles [Grundsätze ordnungsmäßiger Buchführung (GoB)], the German accounting system was not unaffected by the global internationalization and harmonization tendencies in the field of accounting during the last decades. Since the 1980s, several significant harmonization reforms of the German accounting system resulted mainly from the implementation of the Fourth, Seventh and Eighth Directives of the European Union. However, there still remained

[1] Hereafter referred to by the acronym GCC.

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significant differences between the national accounting systems of EU member states due to the existence of numerous accounting options for member states and different national interpretations of the regulations in the directives. These differences mainly result from fundamental disparities in the underlying aims, purposes and principles of the different national accounting systems, which in turn result from substantial disparities in cultural features of societies and their legal systems and traditions. Therefore, the degree of harmonization in a manner consistent with principles of national sovereignty is limited.

As a consequence, in November 1995 the EU Commission voted for a fundamental change in its strategy towards an internationalization of the accounting systems of EU member states. The new strategy comprised an intensified cooperation with the IASC and aimed at fostering the development of international accounting standards, which are generally in line with the existing EU Directives on accounting matters (Alvarez et al. 2014: note 125). Consequently, in 2002 the EU proclaimed a crucial step towards harmonization of accounting in Europe by announcing the Regulation (EC) No. 1606/2002, which generally required the mandatory application of IFRS as adopted by the EU for consolidated financial statements of public companies that are listed in any EU member state for financial years as of January 1, 2005 (EU 2002). As there was generally broad consensus among accounting standard-setting bodies, regulators and preparers of financial statements that “full IFRS” are not specifically designed to meet the needs and capabilities of non-capital market oriented small and medium-sized entities (SMEs), on 8th of July 2009 the IASB published a comprised standard with substantially reduced complexity in comparison to the full IFRS and with some more concerns about the reliability of the SME financial statements, the so called “IFRS for SMEs” (IASC Foundation 2009a: IFRS for SMEs BC.47, 2009b: 2–3). Under the IASB’s definition, all non-capital market oriented companies are considered SMEs and therefore are generally within the scope of application of this standard (Ballwieser 2013: 13).

As shown in more detail in Sect. 3, the application of IFRS in Germany is actually limited to consolidated financial statements of the round about one thousand capital market oriented companies as defined in the Regulation (EC) No. 1606/2002 plus a restricted small number of non-capital market oriented companies, who voluntarily prepare their financial statements in accordance with IFRS. The prevailing dominance of German statutory accounting according to the GCC for the almost three million German enterprises is mainly caused by significant differences between the underlying purposes and principles of the two accounting systems. This article first gives a short overview of the current status of internationalization of German statutory accounting and the actual role and importance of IFRS in Germany. Second, it aims to show the main obstacles for a further internationalization by comparing the purposes of both accounting systems and by explaining some central accounting principles of the GCC, which either do not exist or have a substantially different meaning or interpretation in the IFRS.

2 Moderate Internationalization of the German Accounting System Through BilMoG

In May 2009, the most important reform of the GCC within the last 20 years became effective, the so called “Bilanzrechtsmodernisierungsgesetz (BilMoG)”, which can be roughly translated as “Commercial Code Modernization Act”. Stipulated by the proceeding international adoption of the IFRS, the German legislator intended to modernize statutory German accounting law through an improvement of the quality of the Commercial Code and a moderate alignment with IFRS. The proclaimed objective of this reform was to develop German accounting standards towards a “permanent and equivalent but more cost-effective and less complex alternative to IFRS”, especially for non-capital market oriented companies (Bundesrat 2008: 69; Bundestag 2008: 34; 2009: 1). In addition, BilMoG should also strengthen the informative value and the reliability of GCC financial statements (Bundesrat 2008: 69; Bundestag 2009: 1; Solmecke 2009: 44–46). However, the legislator did not intend to change the well-established general principles of the GCC (Bundesrat 2008: 69–71; Bundestag 2009: 1). Overall, BilMoG achieved its objective to moderately align German accounting standards towards international accounting standards by removing antiquated recognition, valuation and disclosure options and by partially or completely aligning some accounting rules with IFRS rules, however, only to the extent permitted by the generally accepted accounting principles of the GCC (Bundestag 2009: 33–34; Böcking and Dutzi 2010: 798–799).[2] Specifically, there was no alignment at all concerning the mark-to-model fair value concept in the IFRS. Overall, there still remain significant accounting differences between GCC and IFRS. BilMoG on the one hand led to a moderate alignment with IFRS, but on the other hand officially gave the GCC the character of an equivalent alternative to IFRS, especially to the IFRS for SMEs. Consequently, there is currently no ambition for any further convergence, neither by the German legislator nor by preparers of financial statements in Germany.

[2] In a detailed study by Solmecke about the impacts of BilMoG on the system of German accounting principles as founded by Leffson and further developed by Baetge/Kirsch/Thiele, the author came to the conclusion that the existing GoB system as a whole was largely unaffected by the significant changes brought about by BilMoG and that it was even strengthened by the reform, as it overall led to a more consequent implementation of the GoB system in the GCC. See: Solmecke 2009: 263–264.

3 The Current Role of the IFRS in the German Accounting Practice

To further competition in European capital markets, the IAS Regulation 2002/1606/EG required all capital market oriented European parent companies to prepare consolidated financial statements in accordance with IFRS as endorsed by the European Commission for all financial reporting periods beginning on or after 1st of January 2005.[3] The regulation provided the option, that each member state may permit or require the application of IFRS also for separate financial statements of all kinds of companies and for consolidated financial statements of non-publicly traded companies. In Germany, this regulation was implemented and transformed into German law by the Bilanzrechtsreformgesetz (BilReG) in 2004. With the BilReG, the German legislator chose to permit non-publicly traded companies to present their consolidated financial statements voluntarily in accordance with IFRS as endorsed by the EU instead of GCC. Regarding the use of IFRS in separate financial statements, the German legislator decided to allow the preparation of supplementary separate financial statements in accordance with IFRS only for disclosure purposes. Moreover, the German legislator did not adopt the IFRS for SMEs, as they are still considered too complex and not appropriate to fulfill the purposes of financial statements as intended by the German legislator.[4] Furthermore, with the adoption of BilMoG the German legislator explicitly clarified that in the foreseeable future there will be no alternative to the preparation of separate financial statements according to GCC, particularly due to their comparably lower level of complexity as well as their central importance for tax-assessment and the calculation of payouts (Baetge et al. 2012: 155–156).

In Germany, small and medium sized companies, which are often family-owned, account for the vast majority of all business enterprises. These companies are typically financed via bank loans, while capital markets only play a minor role in their financing activities. In 2012, less than 1000 out of more than three million registered German entities were deemed to be capital market oriented and, therefore, are subject to mandatory IFRS accounting regarding their consolidated financial statements (Küting et al. 2013: 53–54). However, even the capital market

[3] The effective date for mandatory IFRS consolidated financial statements could be postponed to the 1st of January 2007 for European parent companies that solely issued debt instruments, that were only impending for securities trading in the EU on 1st of January 2005, that were publicly listed in the USA and therefore reporting under US-GAAP, or that were parent to only one debt issuing subsidiary.

[4] With the Directive 2013/34/EU of June 26, 2013, aimed at replacing and modernizing the existing EU Accounting Directives in order to further simplify accounting and disclosure requirements for SMEs, the EU stopped pursuing a mandatory adoption of IFRS for SMEs. This is justified by the findings of an Impact Assessment, which concluded that the IFRS for SMEs is still more complex than most existing national accounting regulations for SMEs and therefore a mandatory application of this standard would not serve the objectives of simplification and reduction of administrative burden for SMEs. See: EU 2011: 7.

orientation of bigger German companies tends to be less pronounced than in comparable economies (Ballwieser 2013: 6–8). In a representative study conducted by Küting and Lam (2012) regarding the actual exertion of the option for non-capital market oriented companies to prepare and disclose consolidated financial statements according to IFRS, in a random sample for the reporting period 2010 only 108 entities (5.74 %) out of 1883 parent entities exercised the option to replace GCC consolidated financial statements with IFRS consolidated financial statements (Küting and Lam 2012: 1041–1049; Küting et al. 2013: 57–58). These findings illustrate the continuing importance of the GCC, whereas the role of IFRS in the German accounting practice is largely limited to consolidated financial statements of a short list of global players.

4 Comparison of the Accounting Purposes of the German Commercial Code and the IFRS

4.1 Purposes of Financial Statements According to the German Commercial Code

With financial statements according to GCC a pluralistic system of purposes is pursued. These equally important purposes are documentation, stewardship and capital maintenance (Baetge et al. 2012: 93–104). The purpose of **documentation** stems from the codified duty to maintain comprehensible and complete records of all business transactions over the reporting period. Orderly kept records are a prerequisite for the other accounting purposes and constitute legal evidence and unfold a preemptive effect against fraud. The purpose of documentation is the main purpose of bookkeeping and constitutes a prerequisite to ensure the fulfillment of the purposes of stewardship and capital maintenance (Leffson 1987: 45–47). It requires that all business transactions of the reporting period are recorded completely and in a clear and comprehensible manner. The second purpose, **stewardship**, requires that financial statements provide information about the disposition of entrusted capital in a way that enables the users of those financial statements to gain detailed insights into the business activities and to draw their own conclusions about the assets under management and the results achieved from their disposal. Nevertheless, GCC financial reports do not only service third-party information needs, but also provide a basis for management to self-asses past investment decisions as well as to project future capital allocation decisions (Leffson 1987: 63–64).

The third accounting purpose, **capital maintenance**, refers to the determination of a profit for the period, which could be withdrawn by shareholders without reducing the nominal amount of equity capital (Leffson 1987: 92). Capital maintenance is a central purpose of financial statements prepared under GCC as the profit of the period determined under the provisions of the GCC regularly forms the basis for the calculation of payouts to shareholders as well as for the determination of taxable income. The purpose of capital maintenance serves the guiding idea of creditor protection in the GCC. The central aim of this purpose is to preserve the nominal liable equity capital. Capital maintenance urges company owners not to reduce liable equity as long as a positive net income is earned. This concept of capital maintenance via information is relevant for all types of legal entities and is achieved by disclosing the amount of distributable net income (Moxter 2003: 3–4). The specific legal provisions covering capital maintenance via information deal primarily with the valuation of assets and the determination of the annual result under the principles as shown in Sect. 5 (AKEU 1995: 95). In contrast, capital maintenance via regulation refers to idiosyncratic provisions contained in German Company Law and Commercial Code, which are only relevant for limited liability companies (in the legal form of "GmbH" or "AG"). These provisions establish maximum and minimum thresholds for profit distribution (Solmecke 2009: 31–32). Maximum profit distribution is generally restricted by a statutory minimum amount of earnings that have to be retained before any profit can be distributed. Minimum profit distribution aims to protect minority shareholders by granting shareholders certain veto rights with respect to management's proposal on the allocation of unappropriated profits (Baetge et al. 2012: 100–101). By integrating the purpose of capital maintenance into statutory accounting rules, the German legislator intended to safeguard the long-term existence of companies as well as to protect creditors' interests (AKEU 1995: 95–97).

The taxable income of German entities is determined via separate tax statements prepared according to German tax law. However, the calculation of taxable income is closely linked to commercial statements because of the codified principle that accounting treatments under GCC—subject to certain exceptions and adjustments—shall generally be adopted for tax accounts. Therefore, tax accounts of German companies are indirectly governed by the GCC-purpose of capital maintenance and resulting accounting principles, which are shown in detail in Sect. 5 (AKEU 1995: 97–98).

4.2 Purpose of Financial Statements According to IFRS

The general purpose of financial statements prepared according to IFRS is defined in chapter 1 of the IASB's Conceptual Framework for Financial Reporting (2010), (Wiedmann and Schwedler 2007: 693–694). According to this definition, the main purpose is to "[. . .] provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity" (IASB 2010: CF.OB2), which is commonly referred to as **"decision usefulness"** (Baetge et al. 2012: 142). Therefore, existing and potential investors, lenders and creditors are regarded as the primary users of IFRS financial statements, as they generally cannot require reporting entities to provide information directly to them but must rely on financial statements for most of the financial information they need (IASB 2010: CF.OB5) while the IASB views the interests of regulators and the general public as ancillary (IASB 2010: CF.OB9). The primary users base their capital allocation decisions on expected risk-adjusted returns and therefore are interested in information that enables them to estimate timing and amount of future cash flows from and to the entity (IASB 2010: CF.OB3 and OB10). The role of **stewardship** as a second accounting purpose of IFRS was controversially discussed during the Conceptual Framework project. Stewardship, which is alternatively referred to as accountability, is concerned with easing the principal-agency conflict between resource-providing owners and resource-administrating managers by giving information about management's performance (Wiedmann and Schwedler 2007: 704–706). While stewardship refers to retrospective information as a basis for performance assessment, the provision of decision useful information mainly serves as a basis for prospective estimates for future investment decisions (Küting et al. 2013: 13). The IASB decided not to explicitly state the term *stewardship* as an objective of IFRS financial statements in the revised Conceptual Framework of 2010. Instead, the term's meaning is only concretized in the Basis for Conclusions, noting that, in most cases, information designed for resource allocation decisions would also be useful for assessing management performance (IASB 2010: CF.BC1.24–1.28). This decision indicates that the IASB considers stewardship—if at all—as only a minor objective of IFRS accounting (Küting et al. 2013: 13; Pellens et al. 2001: 121).

4.3 Similarities and Differences

As documentation is a prerequisite for accounting in general, both accounting systems serve the purpose of documentation, despite the IASB omitting its explicit codification. However, the GCC is designed to follow pluralistic purposes in order to balance the divergent interests of all financial statement users, be it capital maintenance as a main interest of creditors or employees in conjunction with the determination of a taxable income for the tax authorities, or stewardship as a key need of owners (Baetge et al. 2012: 102–104). In contrast the IFRS rather focus on the single objective of providing decision useful information to investors, lenders and other creditors, identified as primary users. Thus, IFRS financial statements are prepared without the notion of capital maintenance and without any influence on national tax accounts. Furthermore, the IFRS concept of decision useful information is strictly investor oriented and forward-looking, whereas financial information provided in compliance with the GCC-purpose of stewardship rather have retrospective character (Busse von Colbe 2010: 559–560; Küting et al. 2013: 7). The focus on decision usefulness explains the distinct characteristics of IFRS: market-orientation, early revenue realization, and fair value as an important measurement concept (Küting et al. 2013: 12–13). In contrast, financial statements under GCC are governed by the dominating aim of creditor protection, which is manifested in certain codified principles of the GCC regarding the determination of a prudent—

hence objective—profit. The following chapter provides an overview over those principles and explains if and to what extent those principles are also implemented in the IFRS.

5 Accounting Differences Resulting from Differences in Selected Accounting Principles

5.1 Meaning and Functions of the German Generally Accepted Accounting Principles

The Generally Accepted Accounting Principles ("Grundsätze ordnungsmäßiger Buchführung" or "GoB") are general principles, that must be complied with in order to fulfill the purposes of financial statements prepared under GCC (Leffson 1987: 35). The GoB are needed to implement and complement general legal principles in case of missing suitable codified legal rules. There is no general definition of the term GoB in the GCC. Therefore, the term "Grundsätze ordnungsmäßiger Buchführung" or "GoB" is an undetermined legal notion, which has to be interpreted and construed. In case of missing specific rules, the GCC explicitly refers to the legally undefined GoB. However, through explicit references in paragraphs §§ 238 (1), 243 (1), 264 (2) and 297 (2) HGB these principles receive the rank of binding legal norms (Leffson 1987: 22; Solmecke 2009: 13). The GoB can be subdivided in formal principles, which govern the formal regularity of accounting and financial statements (documentation principles), and material principles, which refer to the correctness of the accounting figures (recognition, measurement and disclosure principles). Furthermore, they can be categorized in codified principles, which are explicitly mentioned in the GCC, and uncodified principles (Baetge et al. 2012: 105–107)[5]. In summary, the GoB constitute an adequate set of principles that help to concretize and supplement the legal provisions of the GCC.

As a detailed explanation of the whole GoB system of the GCC would go far beyond the scope of this article, we subsequently focus our paper on the explanation of three distinctive GoB which govern the determination of profits under GCC. These principles either have a very different meaning or are not existent at all in the IFRS and thus lead to decisive differences in recognition and measurement rules between the GCC and IFRS.

[5] Relating to the classification of GoB to different classes of norms see: Baetge and Zülch 1984: note 4–10.

5.2 Realization Principle

5.2.1 The Realization Principle of the German Commercial Code

The realization principle, alongside with the matching principle, constitutes one of the two definition principles for annual result (profit or loss) in the GCC. The definition principles for annual result mainly serve the purpose of stewardship of financial statements prepared under GCC (Baetge et al. 2012: 133). According to the realization principle, which is codified in § 252 (1) no. 4 HGB, revenues may only be recognized in the current financial period as long as they effectively have been realized up to the balance sheet date. The main purpose of this principle is on the one hand to avoid the disclosure and distribution of profits that are not yet realized and on the other hand to assure that no profit effects arise from procurement transactions (Baetge et al. 2012: 131). According to the GCC, procurement transactions generally have to be recorded as an exchange of assets with no effect on income and therefore assets have to be valued at purchase or production cost at the time of acquisition. As long as there is no “leap” to the sales market, assets have to be measured at no more than cost. Positive profit contributions result at the time of delivery of the sold goods or services in the amount of the difference between sales price and costs (expenditures). These profit contributions, however, may not be recognized until the decisive economic control over the transferred good or service and the risk of destruction or deterioration associated with that good or service are being passed over to the purchaser (Leffson 1987: 265–272; Baetge et al. 2002: note 189–190). On the one hand, due to the strict bonding of the realization date to the delivery of the asset associated with a transfer of economic power and risk, the realization principle serves the purpose of a prudent determination of income and therefore the purpose of capital maintenance. On the other hand, it also serves the purpose of stewardship, because it helps to objectify asset values and to prevent from subjective influences. In a strict interpretation of the purpose of capital maintenance the latest possible stage of the purchasing process, which is generally the date of payment receipt, should determine the realization date. However, this would conflict with the purpose of stewardship, as by the time of contract conclusion a fundamental part of the whole purchasing process is already accomplished. Therefore, the realization of revenues according to this principle can be considered as a compromise between the purpose of capital maintenance and the purpose of stewardship (Leffson 1987: 467–468; Baetge and Kirsch 2002: note 86; Baetge et al. 2002: note 141–142).

5.2.2 Meaning and Interpretation of the Realization Principle in the IFRS

In the IFRS, the realization principle is not explicitly specified as a separate accounting principle but rather constitutes a sub-category of the principle of accrual basis, which is codified in the Conceptual Framework (CF.OB17) and in IAS 1.27 (Baetge and Zülch 1984: note 216–217). The realization principle in the context of IFRS has a much broader scope than in the GCC. Thus, not only realized revenues are recognized but generally also revenues, which can be considered as realizable with a certain probability (Coenenberg et al. 2009: 6). Furthermore, in contrast to the GCC rules the IFRS allow to a large extent the determination of the fair value of assets and liabilities by present value calculation, which is generally characterized by a significant degree of uncertainty regarding future cash flows.

5.2.3 Resulting Accounting Differences

According to § 253 (1) sentence 1 HGB, at initial recognition all assets have to be measured at their purchase or production costs. Likewise, in most cases purchase and production costs also constitute the applicable value of assets at initial recognition under IFRS. Despite some minor differences regarding the determination of production costs, conceptually initial measurement with purchase or production costs is similar in both accounting systems. However, there is a significant difference with regard to subsequent measurement of assets. As a consequence of the strict interpretation of the realization principle in the GCC, amortized purchase and production costs generally constitute the maximum value in subsequent measurement of assets, which may not be exceeded until the assets take the "leap" to the sales market as described in Sect. 5.2.1 above. Subsequent appreciations after initial recognition may only be disclosed if the associated profit contributions are objectified by real market transactions. In comparison, in the IFRS system the fair value also constitutes an important measurement concept. For example, when the revaluation method for subsequent measurement of property, plant and equipment or of intangible assets is being applied, asset values can exceed the threshold of amortized cost, leading to a disclosure of unrealized gains (Küting et al. 2013: 85). However, for most of all asset types these fair value changes above amortized cost are recognized in the other comprehensive income, so that users of IFRS financial statements can at least differentiate between realized and not yet realized gains.

However, for certain asset classes positive profit contributions through sole fair value changes are recognized directly in profit or loss. For example, after initial recognition IAS 40 allows to choose a full fair value model for the subsequent measurement of investment property.[6] In this case, all changes in fair value are being treated as gains and losses and are reported in the income statement as profit or loss of the period (IAS 40.35), which stands in sharp contrast to the distinctive realization principle as codified and interpreted in the GCC system.

It can be summarized that the IFRS in general favor a more transparent presentation of current values of investment property in order to serve the purpose of

[6] However, even if the cost model is chosen, IAS 40.79(e) requires the disclosure of the fair value of investment property in the notes.

providing decision useful information to investors and other creditors, whereas the strict realization principle in the GCC limits the maximum value of those assets—like of all other property, plant and equipment—to the amortized purchase or production costs. Generally, the different meaning of the realization principle in the IFRS leads to a more future-oriented but less objective profit determination compared to GCC rules.

5.3 Imparity Principle

5.3.1 The Imparity Principle of the German Commercial Code

The imparity principle can be classified, alongside with the principle of prudence, as one of the two principles of capital maintenance in the GCC. These principles consider economic events which lead to negative profit contributions that are already incurred but not yet materialized at the balance sheet date (Baetge et al. 2012: 137). The imparity principle, which is also codified in § 252 (1) no. 4 HGB, requires that all foreseeable risks and losses that are incurred up to the balance sheet date must be recognized in the current period. Therefore, unrealized prospective negative profit contributions have to be anticipated in the period in which they are economically incurred. The main idea behind the imparity principle is that anticipated negative profit contributions should be secured from distribution to investors in order to be able to absorb those negative profit contributions when they actually materialize in future periods (Baetge et al. 2012: 137). The name of this principle is derived from the unequal treatment of foreseeable but yet unrealized gains and losses (Winkeljohann and Büssow 2012: note 34). Though the disparate treatment of positive and negative profit contributions with regard to the realization date serves the purpose of capital maintenance, it conflicts with the purpose of stewardship because it constrains the determination of a comparable annual profit. The anticipation of negative profit contributions of subsequent years in the financial statements of the current year does not lead to a presentation of income according to the accrual basis of accounting. Instead, a lower—but hence distributable—income is disclosed (Baetge and Hendler 2000: 21). Therefore, in order not to fully conflict with the purpose of stewardship, the imparity principle has to be limited to cases where an anticipation of risks and losses is compulsory, that is, when the risks already have emerged up to the balance sheet date (Baetge et al. 2012: 137–138). In order for risks to be considered as having already been emerged up to the balance sheet date, they have to be associated with a clearly definable and already initiated transaction (Baetge and Knüppe 1986: 397). Furthermore, at least one of the causes leading to the adverse event after the balance sheet date has to be already occurred before the balance sheet date (Leffson 1987: 394–395). However, the imparity principle permits accountability with regard to future risks (Leffson 1987: 105). The imparity principle is supplemented and concretized in the GCC by the provisions in § 253 (3) and (4) HGB, which determine different depreciation rules regarding loss anticipation for current and non-current assets. A further concretization of this capital maintenance principle lies in the possibility to recognize provisions for contingent losses from pending transactions pursuant to § 249 (1) HGB (Baetge et al. 2012: 139).

5.3.2 Meaning and Interpretation of the Imparity Principle in the IFRS

In contrast to the GCC, there is no imparity principle codified in the IFRS or in the Conceptual Framework. Pursuant to the main objective of IFRS to provide decision useful information to existing and potential users, generally all sufficiently concretized gains and losses have to be considered in the financial statements—even if they are not yet realized. However, there exist a number of provisions in different standards which—similar to the imparity principle in the GCC—implicitly lead to an unequal treatment of foreseeable but yet unrealized positive and negative profit contributions in the financial statements prepared under IFRS (Ballwieser 2008: note 75; Coenenberg et al. 2009: 65). These provisions, however, are characterized by a varying degree of stringency regarding the unequal treatment of gains and losses (Winnefeld 2006: note 220). Furthermore, this unequal treatment is restricted only to some individual regulations and therefore cannot be considered as having the same importance as the codified imparity principle in the GCC.

5.3.3 Resulting Accounting Differences

A major difference due to the differing meaning of the imparity principle in GCC and IFRS exists in the accounting treatment of derivatives.[7] The GCC does not include any specific provisions regarding accounting for derivatives. Therefore, the general recognition, valuation and disclosure rules as well as the GoB have to be resorted to. As far as derivative financial instruments fulfill the general recognition criteria of assets in the GCC, they have to be initially valued at purchase costs according to § 255 (1) HGB. Those purchase costs generally comprise the premiums paid for the derivative instrument. According to the realization principle explained above, positive value changes above purchase costs may not be recognized until the derivative instruments are either sold or—in case of options—exercised.[8] In contrast, the imparity principle requires that negative profit

[7] The following description refers to stand-alone derivatives and not to derivatives that are designated in effective hedge relationships, because in case of hedge accounting the imparity principle is not applicable to the single derivative instrument as hedged item or hedging instrument but to the hedge itself.

[8] There is an exception for derivative instruments, which are designated to the trading portfolio of credit institutions. According to § 340e (1) HGB, all financial instruments designated to the trading portfolio of banks have to be measured at fair value through profit or loss. See: Brüggemann 2010: 127.

contributions mandatorily have to be anticipated, as soon as they are foreseeable. In case of options which are capitalized with their option premium, negative changes of value first have to be recognized by adjustments to the carrying amounts by conducting extraordinary depreciations according to § 253 (3) and (4) HGB. In all other cases, for example when accounting for futures or forwards, derivatives have the character of so-called pending transactions, which may not be recognized in the balance sheet until they are closed out or exercised. Even in such cases, foreseeable negative profit contributions from those derivatives have to be recognized by setting up a provision for contingent losses on pending transactions according to § 249 (1) sentence 1 HGB. This unequal treatment, where positive value changes may not be recognized in the current period and foreseeable negative profit contributions have to be realized immediately in the current period leads to a strictly prudent disclosure of profits, which is a consequence of the purpose of capital maintenance in the GCC.

In contrast, according to IAS 39.9 all derivatives are recorded in IFRS financial statements on the balance sheet at fair value, with any positive or negative changes in value being equally and immediately reported in profit or loss. Due to the lack of the purpose of capital maintenance in the IFRS there is no need and no cause for a prudent or conservative disparate treatment of foreseeable gains and losses.

5.4 Principle of Prudence

5.4.1 The Principle of Prudence of the German Commercial Code

The principle of prudence, which is also codified in § 252 (1) no. 4 HGB, demands that assets and liabilities have to be valued prudently. There is no further concretization of this principle in the GCC. The conceptual classification of this principle in the GoB system is controversially discussed in the literature. Most of the authors interpret the principle of prudence as being a superior principle, with the realization and imparity principles being just two specifications of this superior principle (Moxter 1986: 37–39; Adler et al. 2001: § 252, note 60–63 and 73; Selchert 2002: note 85; Winkeljohann and Büssow 2012: note 29). However, this interpretation is problematic because according to the realization principle—as explained in Sect. 5.2 above—not the most prudent realization date but with the "leap" to the sales market a compromise between the two purposes of financial statements, capital maintenance and stewardship, is chosen (Leffson 1987: 467–468; Baetge and Kirsch 2002: note 86). Therefore, the principle of prudence has to be considered as an equally-ranked principle with the other GoB (Baetge and Zülch 1984: note 94). The principle of prudence does not demand to build up hidden reserves by arbitrarily undervaluing assets and overvaluing liabilities, as this would conflict with the purpose of stewardship and prepare the ground for subsequent accounting policy measures in the form of a silent dissolution of hidden reserves. The principle of prudence is therefore restricted to uncertain future events in cases where, despite legal norms and other GoB, certain valuation discretions remain (Leffson 1987: 466–467). Valuation discretions are limited both upwards and downwards by the most and least favorable value, which have to be determined without any arbitrariness. The principle of prudence has the function to help determining a single value lying within a range of possible values. This value has to be compliant with the purpose of capital maintenance as well as the purpose of stewardship. According to our interpretation, in case of a continuous range of possible values, the most probable value should be chosen, and in case of a symmetric distribution of possible values—e.g. normally distributed values—the arithmetic mean should be chosen (Baetge 1968: 141–166; and based on him: Leffson 1987: 465–492). In order to fully account for the principle of prudence, an idea would be to simultaneously create a special provision (so called “bandwidth-provision”) in the amount of the difference of the mean value and the most pessimistic value in order to make resulting hidden reserves transparent. However, the creation of such a provision is not allowed under GCC rules. Therefore, in cases of uncertain expectations a more pessimistic value has to be chosen (Adler et al. 2001: § 252, note 68; Selchert 2002: note 87), whereas unrealistic values or outliers may not be considered (Ballwieser 2008: note 57; Baetge et al. 2002: note 144).

5.4.2 Meaning and Interpretation of the Principle of Prudence in the IFRS

The principle of prudence in the GCC mainly serves the purpose of capital maintenance and thus the aim of creditor protection, which has much greater significance in the German accounting system than in the IFRS. Consequently, by releasing the new Conceptual Framework in 2010 the IASB decided to eliminate the previously codified principle of prudence from its Framework. According to the view of the IASB, the principle of prudence or conservatism is inconsistent with the requirement of neutrality of information, which constitutes an essential characteristic of faithfully presented information (CF.BC.3.27-28). Furthermore, the previously codified principle of prudence in IFRS did not have the character of a fundamental principle as in GCC but rather was interpreted as a provision to exercise sufficient diligence in the exercise of judgments needed in making estimates under conditions of uncertainty (Winkeljohann and Büssow 2012: note 84). However, in some standards there are still tendencies towards a prudent determination of profit contributions (Wawrzinek 2013: note 94). For example, IAS 2.9 requires that inventories have to be valued at the lower of cost and net realizable value. A further example is the revaluation model for intangible assets is only applicable if the fair value can be determined by reference to an active market for the intangible asset (IAS 38.81). However, those provisions do not have the same importance and are by far not as prevalent as the principle of prudence in the GCC. The avoidance of the codification of a principle of prudence in the IFRS is a consequence of the fact that creditor protection—in contrast to the GCC—does not represent a primary goal of financial statements prepared under IFRS.

5.4.3 Resulting Accounting Differences

The absence of a principle of prudence in the IFRS leads to significant differences between GCC and IFRS with regard to the measurement of provisions when there is a bandwidth of possible values. According to § 253 (1) sentence 2 HGB, provisions have to be measured at the amount required on settlement date, determined "with reasonable commercial assessment". The term settlement value implies that provisions have to be measured on a forward-looking basis, so that future price increases have to be considered. The expression "in accordance with reasonable commercial assessment" claims that only intersubjectively verifiable assumptions about future developments may be regarded in the determination of the adequate amount of the provision (Baetge et al. 2002: 425). This also constrains the creation of undue hidden reserves by deliberately overstating future expenses (Baetge et al. 2012: 426). However, when a whole range of possible settlement values exists, the principle of prudence according to § 252 (1) no. 4 HGB is applicable in determining the adequate amount. Generally, it seems commercially reasonable to choose the most probable value. However, the strict interpretation of the principle of prudence in the GCC requires that at least in case of a symmetrical distribution of possible values the most probable value has to be supplemented by a prudence-component. As de lege lata a separate bandwidth-provision is not allowed according to § 249 (2) HGB, in the literature there is consensus to take a more pessimistic value within the previously identified bandwidth instead (Baetge et al. 2002: note 144; Kozikowski and Schubert 2012: note 155). This pessimistic value, however, has to be plausible and objectively justifiable (Selchert 2002: note 88).

In the IFRS, IAS 37.36 requires that the amount recognized as a provision should be the "best estimate" of the expenditure required to settle the present obligation at the end of the reporting period. When the provision being measured involves not only a single obligation but a large population of items (e.g. provision for warranty claims), IAS 37.39 requires the use of expected values as a best estimate. In case of a single obligation, the individual most likely outcome is considered the best estimate (IAS 37.40). Therefore, the use of expected values or most probable values for measuring provisions in the IFRS implicitly assumes risk neutrality (Baetge et al. 2002: note 78). This decisive difference compared to GCC tends to result in less conservative provisioning in financial statements prepared under IFRS.

6 Summary and Outlook

Although the Bilanzrechtsmodernisierungsgesetz (BilMoG) led to a moderate and partial alignment of GCC accounting rules with IFRS rules, there still remain some significant—hence deliberate—differences. These differences mainly result from the different purposes of financial statements in the two accounting systems. GCC financial statements have to serve three equally ranked purposes (documentation, stewardship, capital maintenance), whereas IFRS financial statements are solely intended to fulfill the purpose of providing decision useful information. The characteristic purpose of capital maintenance of GCC financial statements leads to a much greater role of the concept of creditor protection compared to IFRS. This guiding concept is manifested in a row of characteristic principles regarding the determination of a prudent but comparable and objective profit, which in turn are codified in numerous valuation and measurement provisions in the GCC. Moreover, the purpose of capital maintenance also forms the basis of the close link between GCC financial statements and tax accounts by permitting only the realization of sufficiently objectified profits. In Sect. 5 we explained the three most important principles of the GCC regarding the prudent determination of annual profits and showed how these principles lead to considerably different accounting treatments compared to IFRS rules.

In our opinion, there is a strong need to a further development of the IFRS towards a high quality, reliable, understandable, auditable, enforceable and globally accepted accounting system. However, we also agree with the German legislator that a mandatory application of IFRS should continue to be restricted to capital market oriented companies, who regularly make use of international capital markets and are intensely engaged in cross-border activities, whereas German SMEs should continue to prepare their financial statements in accordance with the GCC. Despite the efforts of the IASB to promote the application of IFRS for SMEs for small and medium-sized and non-capital market oriented companies, GCC financial statements will not be replaced by IFRS financial statements in the foreseeable future, because the latter cannot fulfill the purposes the German legislator has assigned to financial statements in general. The principles underlying the GCC evolved and have proven suitable over a long period of time. They can be traced back to the world's first accounting regulations, in particular, the French Ordinance (1673) and the comments on it by Jacques Savary in his famous book *Le Parfait Négociant* (1675) and, building on that, the Napoleonic Code of Commerce (1807).[9] Those regulations, in turn, laid the foundation of the ADHGB (Allgemeines Deutsches Handeslgesetzbuch) of 1861, the predecessor of today's GCC.

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