Financial Reporting from the Perspective of Banks as a major User Group of Financial Statements

Empirical Results and Implications for the further Development of an International Financial Reporting Standard for Private Entities

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Content

List of Abbreviations

ASCG	Accounting Standards Committee of Germany (DRSC e.V.)
BC	Basis for Conclusions on ED-IFRS for SMEs
BDI	Bundesverband deutscher Industrie (Federation of German Industries)
bnEUR	billion Euro
DIHK	Deutscher Industrie- und Handelskammertag (Association of German Chambers of Industry and Commerce)
EAA FRSC	European Accounting Association - Financial Reporting Standards Committee
ED	Exposure Draft
ED-IFRS for SMEs	Exposure Draft of International Financial Reporting Standard for Small and Medium Sized Entities
EUR	Euro
F	Framework for the Preparation and Presentation of Financial Statements related to the application of IFRS and IAS
FASB	Financial Accounting Standards Board
HGB	Handelsgesetzbuch (German Commercial Code)
IAS(s)	International Accounting Standard(s)
IASB	International Accounting Standards Board
IFRS(s)	International Financial Reporting Standard(s)
IFRS for PEs	International Financial Reporting Standard for Private Entities
KfW	Kreditanstalt für Wiederaufbau (KfW Bankengruppe)
KWG	Gesetz über das Kreditwesen (German Banking Act)
lit.	litera
mEUR	million Euro
n	Number of observations
p.	page
PE(s)	Private Entity(ies)
PwC	PricewaterhouseCoopers
SMEs	Small and Medium-sized Entities
Vol.	Volume

1 Introduction and Research Objectives

Introduction

This report presents the major findings of an empirical study on the role and usefulness of the general purpose financial statements of Small and Medium Sized Entities (SMEs, or more recently Private Entities (PEs)) in relation to banks.[1] The study is part of the research agenda of the Accounting Standards Committee of Germany (ASCG) regarding the International Accounting Standards Board's (IASB) Exposure Draft of the IFRS for Small and Medium-sized Entities (ED-IFRS for SMEs)[2]. The agenda was the ASCG's response to IASB's world-wide invitation to comment on the ED-IFRS for SMEs. In answering to the IASB the ASCG tried to first analyse the role of the general purpose financial statements of PEs, and then the appropriateness and practical acceptability of the proposed rules in the ED-IFRS for SMEs. The ASCG initiated three different, but related, research projects. Firstly, the "Survey on the ED-IFRS for SMEs among German SMEs" ("the SME survey") was carried out in 2007 in cooperation with the Federation of German Industries (BDI), and the Association of German Chambers of Industry and Commerce (DIHK) under the leadership of the Chair of Financial Accounting and Auditing of the University of Regensburg (Prof. Dr. Axel Haller and Dr. Brigitte Eierle).[3] This survey provided a broad insight into the role of financial reporting and the accounting needs of PEs as well as the attitudes and assessments of usefulness in relation to particular accounting issues covered in the ED-IFRS for SMEs. Secondly, the ASCG in cooperation with the Federation of German Industries (BDI) and PricewaterhouseCoopers AG (PwC Germany) initiated field tests with 15 German SMEs preparing "trial financial statements" in accordance with the ED-IFRS for SMEs.[4] Both papers were presented to the IASB. Finally, the ASCG in cooperation with the Chair of Financial Accounting and Auditing of the University of Regensburg (Prof. Dr. Axel Haller and Dipl.-Kfm. Johann V. Löffelmann) carried out the study presented below. While the first two research projects aimed at the preparers of financial statements the third and most recent research project focused on German banks as particular users of financial statements of PEs.

Research Objectives

According to the beliefs of the IASB[5], empirical evidence (see next chapter), and also practical experience, banks are one of the major groups of users of the general purpose financial statements of PEs. This is in particular the case in Germany, which has a traditionally very high proportion of bank loans as part of corporate capital.[6] However, there is very little knowledge and evidence as to what information is used and how this information is processed by banks. Also the expectations and needs with regard to financial reporting issues as well as the assessment of particular accounting methods has so far not been thoroughly investigated. Therefore, based on the proposals of the ED-IFRS for SMEs, the objective of this study was to find out:

- the banks' assessment of particular accounting methods as well as presentation and disclosure issues proposed in the ED-IFRS for SMEs;

[1] If it is not annotated otherwise, financial statements are understood as general purpose financial statements. Financial statements according to German GAAP are prepared to fulfil a general purpose.

[2] See IASB (2007a). In its May meeting of 2008, the IASB decided to change the title of the IFRS for SMEs into IFRS for PEs, see IASB (2008b). Pursuant to this decision in the following the standard will be referred to as IFRS for Private Entities (IFRS for PEs) unless the reference is to a specific section of the ED.

[3] EIERLE/HALLER/BEIERSDORF (2007). To download the SME survey, see: www.drsc.de ➔ News-Archive ➔ 2007 ➔ 2007-11-29.

[4] ASCG/BDI/PWC (2008). To download the report on the SME Field Tests in Germany, see: www.drsc.de ➔ News-Archive ➔ 2008 ➔ 2008-04-08.

[5] ED-IFRS for SMEs BC55 lit. a.

[6] See KfW (2008), p. 12.

- the use and importance of corporate general purpose financial statements with regard to banks' evaluations of PE-clients;
- banks' specific information needs for evaluating PE-clients;
- the characteristics that influence the role of financial reporting information for banks and
- the attitudes of banks to international financial reporting harmonisation and standardisation.

Cost-Benefit

Related to the results of ASCG's SME survey the findings of the bank study were intended to provide empirical evidence for the IASB to allow for a substantial "cost-benefit"-consideration with regard to specific financial reporting issues, so as to improve the assessment of whether the expected costs of a specific accounting treatment outweigh the expected benefits.[7]

2 Banks as Major Users of Financial Statements

2.1 Normative and empirical background

User of Financial Statements

As financial statements and other financial reporting instruments should provide information that assists users in making economic decisions, the investigation of user needs is an essential prerequisite to developing and establishing financial reporting standards.[8] Although there are differences in their importance according to country specific traditions and practices in financing enterprises, standard setters (including the IASB) have always seen banks as one of the major user groups of general purpose financial statements, not the least with regard to PEs.[9] This view is supported by the findings of many empirical studies from different countries[10] and also by the recent SME survey carried out by the ASCG. 63% of the responding German PEs stated that the objective of informing their banks through their financial statements was of high or very high relevance.[11] Another recent study among European PEs obtained similar results. Being asked who are the three main users of financial statements, 80% answered banks, 71% tax authorities and 52% shareholder.[12]

National particularities

As mentioned above, the role of banks and their importance as users of financial statements depends to a large extent on the structure, traditions and practices of national capital markets. In Germany, for example, banks have traditionally been the major supplier of capital for all types of enterprises, and in particular for PEs. Although the debt ratio for German PEs decreased from 81,3% in 2002 to 76,1% in 2005, this figure shows that the share of debt capital in the finance structure is still very important.[13]

Function of financial statements

This traditional credit-based finance structure of German enterprises has had a major influence on the financial reporting principles and is the reason for the predominant objective of "creditor protection", which defines creditors, such as banks and suppliers, as

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[7] Regarding the balance of cost and benefit see as well ED-IFRS for SMEs 2.11.

[8] ED-IFRS for SME P2 lit. a and ED-IFRS for SME BC23.

[9] F. 9 and ED-IFRS for SME BC55. In the joint project of FASB and IASB on the conceptual framework the standard setters state that they conceive banks as equally important as investors as users of financial statements , see IASB (2008c), paragraph OB5.

[10] See for an overview of those studies EVANS et al. (2005) as well as GÖBEL/KORMAIER (2007).

[11] For most of the respondents the objective to generate the "basis for taxation" (86%) and to inform the owners (78%) was of a high respectively very high relevance.

[12] MAZARS (2008), p. 9.

[13] KfW (2008), p. 12.

the most important users of financial statements and which has governed German accounting until today. Based on this objective financial statements under German GAAP focus on nominal capital maintenance, because creditors are mainly interested in the capital remaining in the company to build up and strengthen the capacity to repay debt when due.

2.2 Role of financial statements in credit decisions

Credit decision

Banks, identified as major users of financial statements, use a lot of different information during the credit decision process to assess the ability of the borrower to pay debt service and the capacity to repay debts when due. Examples of information considered are qualitative data, such as products, market circumstances, management etc., but more important are quantitative data such as cash flows, asset values, overdrafts, or company size. To assess the ability of the borrower to pay debt service and the capacity to repay debts when due, banks are mainly interested in future cash flows, asset values and the liability structure; cash flows and liability structure with regard to debt service payments and asset values with regard to the potential default of the borrower.[14] As financial statements include relevant information about all those criteria and measures, they may be regarded as one of the most important sources of these types of information. In addition to that, there is – at least in Germany – also a legal reason for the material role of financial statements in credit decisions. Banks are required by law to consider financial statements in their decisions, if the credit amount is higher than 750.000 Euro.[15]

3 Design of the Study

3.1 Concept

Research concept

This study was conducted by way of semi-structured personal interviews. The interviewee person was guided through the interview by a list of several questions with predefined answers as well as with open questions. The open questions were used to gather further explanations relating to the standardised questions and some insights on the information needs of banks. In order to test the practicability of the interview guideline some interviews were conducted with bankers during the conception phase of the research project. The number, structure, form and content of the questions were optimised on the basis of the results of those pretests. The final timing of the interviews was two hours.

3.2 Sample selection

German market for corporate banking

The sample selection reflects the current banking market in Germany. The structure of this market is primarily threefold, and it is therefore referred to as the “three pillar system”. One pillar includes private banks with few big players, some smaller private banks with in part specialised business models and foreign banks. In the second pillar are the Sparkassen that represent a big share of the PE-credit market. The Sparkassen sector contains regional savings banks and Landesbanken (federal state banks). The third pillar consists of the Volks- and Raiffeisenbanken which – in addition to the Sparkassen – also play a material role with regard to the financing of smaller and medium sized PEs and that are – like Sparkassen – regionally based and focused, but are however organised as co-operatives. In addition to the three pillars the German banking market includes also real estate banks and banks with special functions.

Sample Selection

In order to represent the German corporate credit market, the number of interviews within each bank type was calculated by reference to the distribution of market shares

14 OEHLER (2005), p. 145 and 151.
15 Article 18 KWG.

among the different types of banks.[16] However, the sample selection was not only derived from the banking market, but was also influenced by the internal structure of the banks, because usually three different organisational units are involved in the credit decision process. First, the "front-office", which is in contact with the customer directly, sells the "credit" product to the customers. Secondly the "back-office", which is independent from any selling incentives, approves credits in view of risk management issues. Finally, many banks have a unit to develop rating tools to support the front- as well as the back-office in evaluating the borrowers' ability to meet the debt service.[17] Due to this organisational and procedural separation into three units, in general three interviews were considered for each bank. However, already during the conception and pretest phase of the project it became obvious, that bankers of the back-office bankers are the main user of financial statements and for that reason the main focus of the interviews was on leading representatives of this organisational unit.[18]

3.3 Common definition of private entities

PE definition

In order to meet the PE focus of the study, it was necessary to find a workable PE-definition, because each bank uses a different internal definition of what PEs are. In line with ED-IFRS for SMEs we defined PEs as non-publicly traded enterprises and introduced this definition to the interviewees at the beginning of each interview, to safeguard a common perception of the entities the interviews were focused on and thus to get therefore comparable answers from the bankers interviewed. This also provided the basis for a comparative analysis of the bankers' answers with the results of ASCG's SME survey.

3.4 Interview partner characteristics

Interview partner characteristics

As explained in section 3.2, the sample selection was based on the market share of each bank type. Figure 1 shows the number of banks per bank type category which were included in the study. The number of the interviews per bank type and the organisational unit of the interviewed persons are shown in Figure 2 and Figure 3.

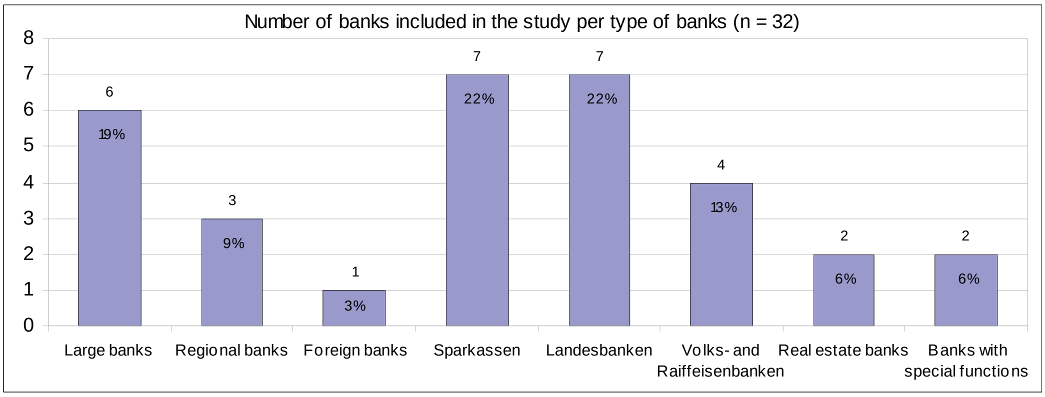

Figure 1: Banks included in the study per type of banks

[16] For the types of banks included in this study see Figure 1, section 3.4.

[17] If a bank wants to use a rating tool for Basel II purposes, the rating tool must fulfil strong requirements and normally each bank must develop its own tool.

[18] For the organisational units included in this study see Figure 3, section 3.4.

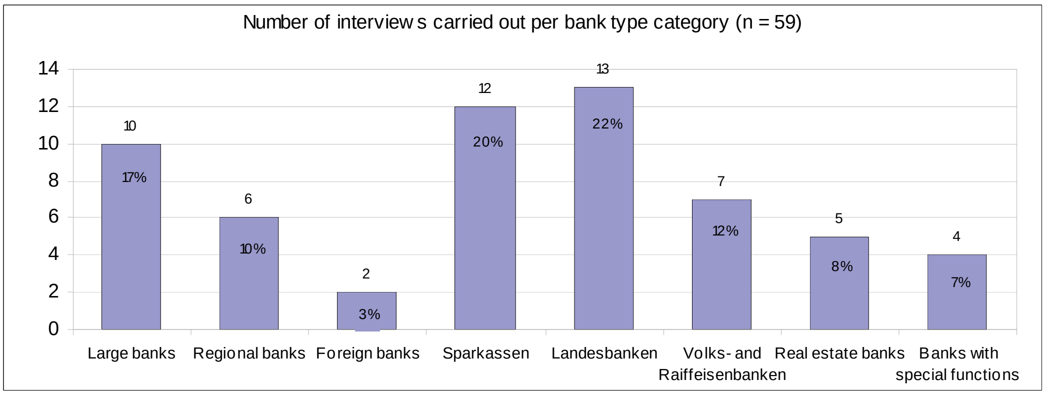

Figure 2: Interviews carried out per bank type category

Sample structure according to organisational units

As mentioned above, the main objective of the study was, to have in each bank in the sample one interview at least with a leading representative of the "back-office" and in addition to that also – if possible and appropriate – an interview with leading persons from the "front-office" or the rating development department in addition to that. This ranking of interviewees has led to the following distribution of interview participants (see Figure 3).

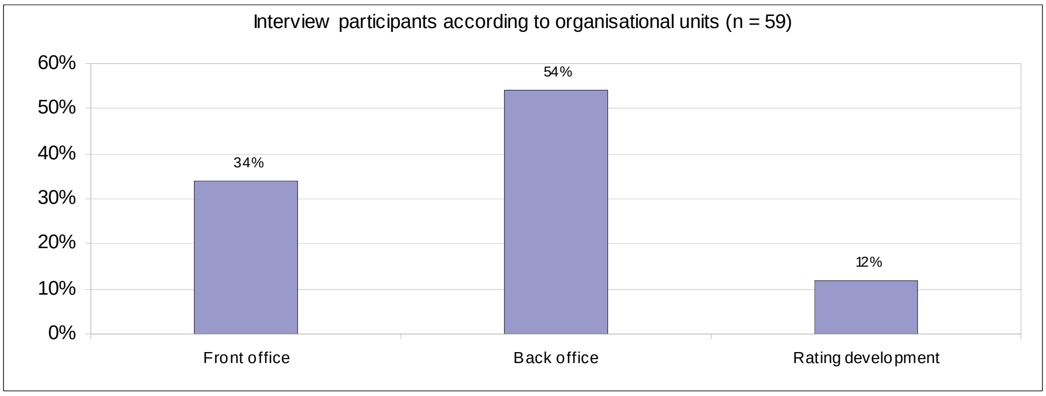

Figure 3: Interview participants according to organisational units

Sample characteristics

In order to characterise the structure of the sample properly the following Figures 4 to 6 categorise the banks in the sample according to their size, to the size of the majority of their customers as well as to their shares of foreign customers.

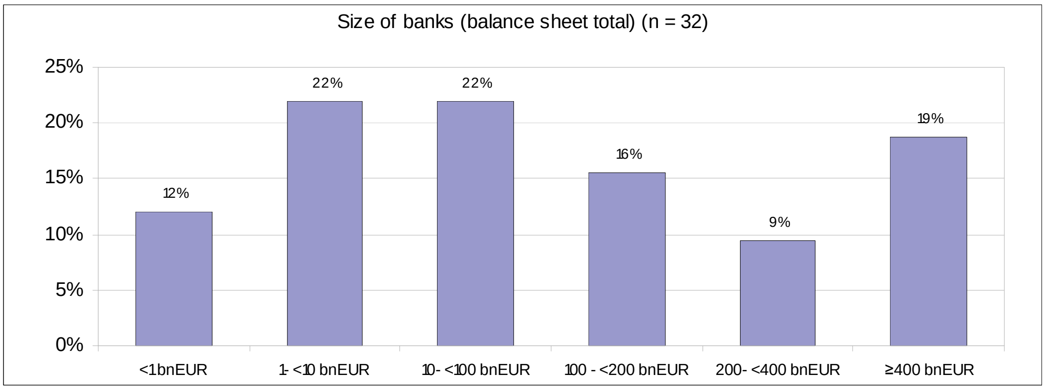

Figure 4: Size of banks (balance sheet total)

Size of banks

Figure 4 depicts that the majority of the participating banks has a balance sheet total of less than 100 billion Euro and may therefore be categorised as small and medium sized banks. This is due to the proportionally high number of Sparkassen and Volks- and Raiffeisenbanken in the sample. For example, the balance sheet total of Sparkassen included in our sample is on average approximately 3 billion Euro, for Volks- and Raiffeisenbanken 1 billion Euro.

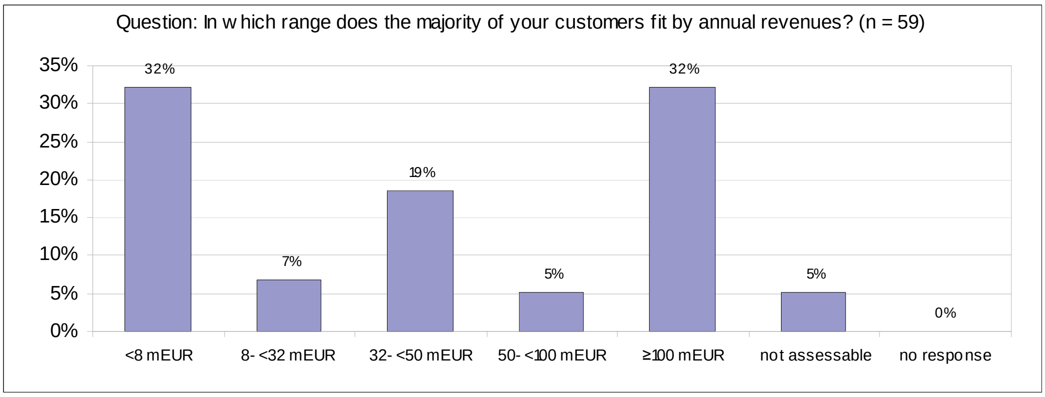

Figure 5: Structure of customers (revenues)

Size of customers

The structure of customers is measured by the customers' total revenues. Figure 5 shows that a high proportion of banks have a majority of customers with revenues of less then 8 million Euro and more than 100 million Euro. The reason for this is that of the banks with customers in the first category most are Sparkassen and Volks- and Raiffeisenbanken, which focus on that customer clientele and that in the category of revenues higher than 100 million Euro are mostly large banks, Landesbanken or real estate banks.

Share of foreign customers

Because this might be an influential factor in the answers of the interviewees, the banks were also grouped according to their share of foreign customers.

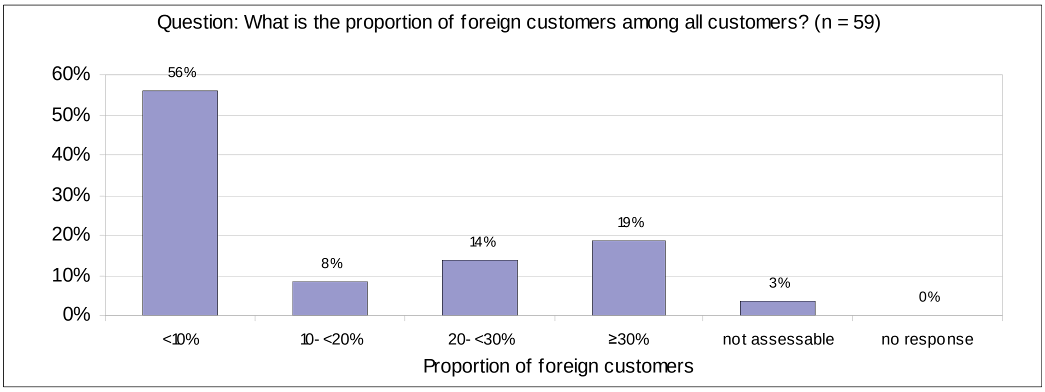

Figure 6: Proportion of foreign customers

Figure 6 shows that more than half of the banks asked have less than 10% foreign customers. Within this group the share is mostly at 5% or even below.

4 Results of the study

Research results

The following sections describe the results of the study. The first part covers general issues including the role of financial statements in granting credits, as well as the attitudes and views of bankers with regard to the international harmonisation of financial reporting standards. The second part includes the bankers' assessment of particular accounting issues and methods proposed and discussed in the ED-IFRS for SMEs and their expectations of potential impacts on their information base. The third part is focused on the information needs of banks and their assessment of the usefulness of IFRS compliant financial statements.

4.1 Use of financial statements by banks

4.1.1 Importance of financial statements for granting credits

Importance of financial statements

As mentioned in section 2, banks are generally regarded as one of the major user groups of financial statements. By analysing financial reporting issues from the point of view of this user group, the question arises of what weight they attach to financial statements data. Therefore, the participating bankers were asked to define the weight (and thus the importance) of financial statements data in general as compared with the total amount of information used by banks for credit decisions.[19] 84% of the interviewees rated the share of financial statements data within the total sum of information at over 50%. This result reflects the significant role of financial statements in the credit decision process. Hence, banks are not only one of the major user groups of financial statements, but they also rely to a large extent on them as a source of information.

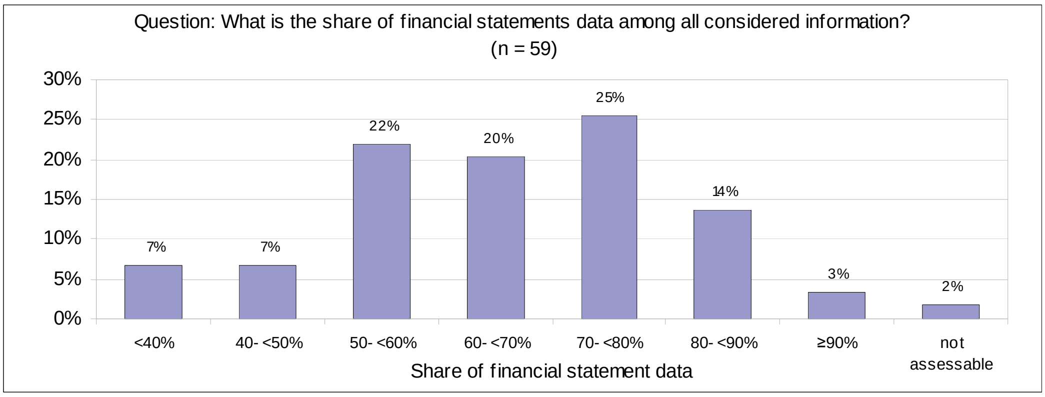

Figure 7: Share of financial statements data among all considered information

Group entity

If the customer is part of a group bankers ascribe greater usefulness to the consolidated financial statements than to the separate financial statements (see Figure 8). According to their experience an entity with strong relations and interdependencies within a group cannot be reasonably analysed without consideration of the group context that determines its financial situation. For the same reason banks regard combined financial statements (as mentioned in ED-IFRS for SMEs 9.21 et seq.) as important; 68% interviewees gave a high or very high level of importance to this type of statements (see Figure 8). Therefore banks often force their customers to present them, or else try to draw up such statements themselves where consolidated statements are not provided by a group entity.[20] The bankers stated clearly that they require combined financial statements in order to get a clear picture of a group entity's commitments with effects on its cash flows. In detail, points of interest are financial and delivery dependencies, complex group structures, intragroup rental payments or assumptions of liability. Bankers, who assessed combined financial statements as being of no or little importance, stated that such statements cannot replace consolidated financial statements and that they therefore urge their customers to provide full consolidated financial statements if applicable.

19 See Figure 7.
20 There is no regulation or guideline for the preparation of combined financial statements under German GAAP.

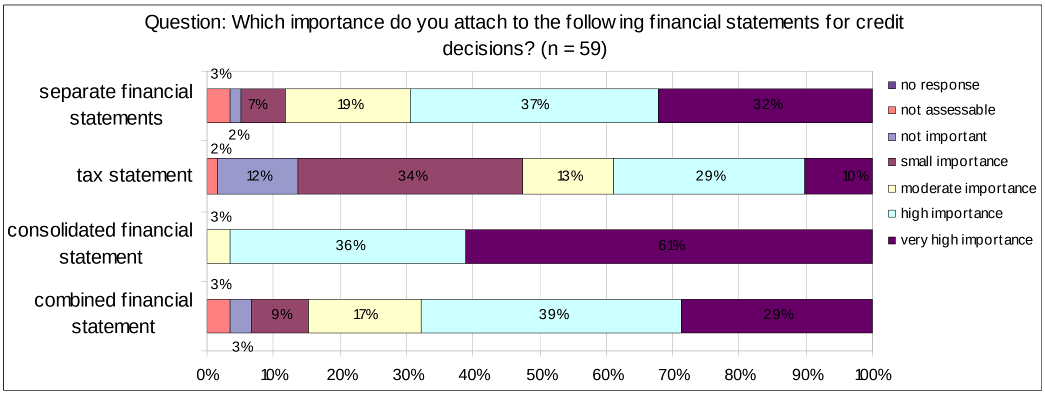

Figure 8: Importance of separate financial statements, importance of tax statements, importance of consolidated financial statements and importance of combined financial statements

4.1.2 Attitudes towards the internationalisation of financial reporting

Need to provide internationally comparable financial information

While banks are referred to as being one of the major beneficiaries of international financial reporting standards[21], the interviewees were asked to assess the need for their customers to provide internationally comparable financial information. About half of the respondents saw a (very) high or at least a partial need, 41% saw at least little need, only 5% saw no need (see Figure 9). This assessment is different from the responses to the same question of the entities which participated in the above mentioned SME survey. They expressed much lower levels of the need to provide internationally comparable financial information. Only 31% said there was a (very) high or partial need, and 48% stated that they do not see any need.[22] The bankers interviewed saw an increasing need especially for larger entities. Banks that see little need (41%) are mostly those with small-sized customers with no or little international activities.

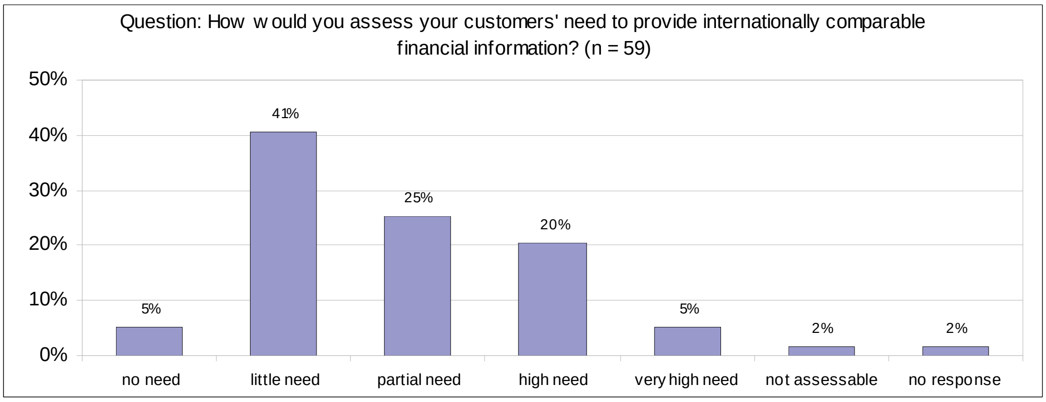

Figure 9: Need to provide internationally comparable financial information

Although this result demonstrates a rather low need for the banks' customers to provide international comparable financial information, it becomes obvious that the assessed need for such information is influenced by the size of the customers as well as by the share of foreign customers (see chapter 3.4). For example, 63% of the banks with customers with annual revenues under 8 million Euro stated there was little need, whereas in the category over 100 million Euro the same was stated by only 16%. An evaluation of a high need increases with regard to those two categories from 5% to 47%. Similar effects can be detected by analysing the influence of the share of foreign customers. The answers within the category "little need" decreases from 55% (given by bankers from banks with a

21 See also ED-IFRS for SMEs BC16(a).
22 See EIERLE/HALLER/BEIERSDORF (2007), p. 15.

share of foreign customers of less than 10%) to 36% (given by bankers from banks with a share of foreign customers of more than 30%).

Asking the interviewees about the pros and cons of internationally comparable financial information, the opinions expressed were mostly identical. Banks identified as a major advantage better comparability of entities from different countries as well as an enhanced transparency.[23] All in all, banks see potential to ease their analysis process. However, they perceive the quality and the content of the international standards applied as being major challenges and preconditions for their advantageous assessment.

Opinion about a special IFRS for PEs

As the IFRS for PEs has the objective of meeting in particular the needs of the users of PEs financial statement[24], the bankers were asked, whether they saw a benefit for their credit analyses in such a specialized standard for PEs. Nearly a quarter of them expressed the opinion that a special standard can be advantageous. Another quarter was not sure whether the advantages outweigh the disadvantages or vice versa. 41% assessed a special PE-standard as disadvantageous. These assessments do not seem to be influenced by the size of the major customer group of a bank, but rather by the share of foreign customers. 42% of the bankers from banks with a share of foreign customers under 10% assessed an IFRS for PEs as disadvantageous whereas this assessment was only expressed by 9% of interviewees from banks with a share of more than 30%. 36% of the latter are even in favour of it.

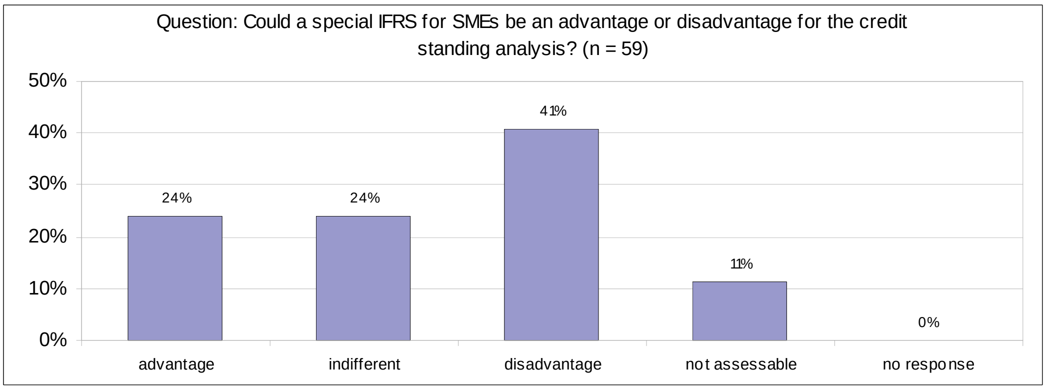

Figure 10: A special IFRS for SMEs - advantage or disadvantage for the credit standing analysis

The assessments were explained as follows. Many bankers see international comparability and increased transparency also for PEs as necessary and as a beneficial outcome of an international common standard. A few said that a simplified standard makes sense especially for PEs with international activities. However, several concerns were raised as well. Many interviewees wondered whether the benefits really would justify the (potential) efforts such a standard would require from their internal analysis system and processes. Moreover, some bankers reject an additional financial reporting standard as unnecessary. Others criticized the ED-IFRS for SMEs for containing too many implicit options and being too complex. Not least, some bankers are critical because of the lower importance of the principle of prudence in the IASB's framework compared to the one applied under German GAAP.

4.2 Assessment of specific accounting issues included in the ED-IFRS for SMEs

This section includes the bankers' assessments of specific accounting issues that are included in the IFRS for PEs. The selection of issues is driven by the importance of

[23] Like stated in ED-IFRS for SMEs BC16 lit. a - c.
[24] See ED-IFRS for SMEs BC23.

particular issues for credit decisions as well as by the sample of issues that were also investigated in ASCG's SME survey mentioned above. The issues are property plant and equipment, intangibles, inventories, financial instruments, income taxes, financial statement presentation and specific disclosure issues. This linkage to the SME survey is necessary because this survey provides insight into the cost assessments relating to particular accounting issues and methods of PEs and reveals their expectations with regard to the benefits to the users of their financial statements. The interviews with the bankers should provide comparable insight into the benefit assessment of one of the major user groups and should therefore allow a direct cost/benefit comparison.

4.2.1 Assessment of specific balance sheet items

Component approach of property, plant and equipment

Regarding property, plant and equipment the ED-IFRS for SMEs 16.14 stipulates that an "entity shall allocate the amount initially recognized in respect of an item of property, plant and equipment to its significant parts and depreciate separately each such part". The interviewees were asked to assess the information benefit flowing from this component approach of depreciation compared with just one depreciation charge for the entire item. 54% of them noted that the component approach is advantageous compared to the single depreciation charge, however, they also considered that the comparable and consistent application of the materiality concept is a major challenge in this approach. More than a quarter said that there are really neither advantages nor disadvantages in the information base provided. Another 15% saw disadvantages due to an expected information overload and the risk that the preparers spend too much time to setting out that (according to their opinion not really useful) information instead of concentrating on the important reporting issues.

With regard to the question of whether the implementation of the component approach in financial statements would have an effect on their analysis process in the course of a credit decision the distribution of the answers is nearly equal. 49% of the interviewees said that they wouldn't expect a change in their process due to the additional information; another 48% would consider this additional information.

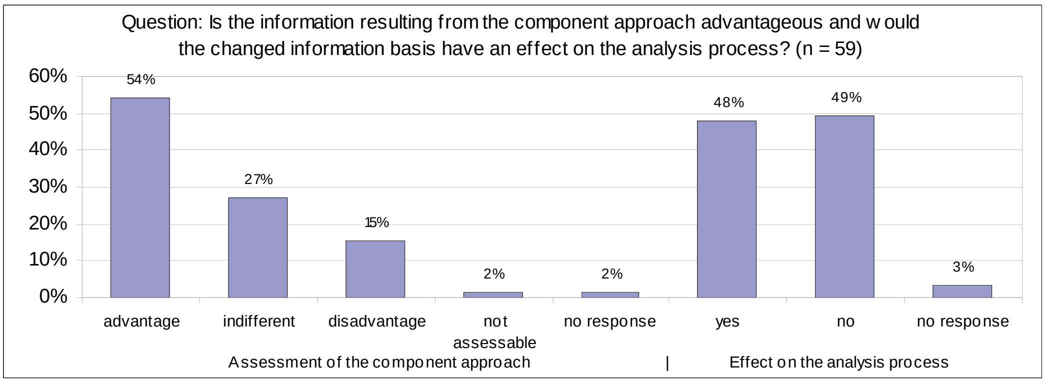

Figure 11: Advantageousness of the component approach and effect on the analysis process

Matching this result with the cost estimation of PEs the costs seem to outweigh the benefits, because a relatively high portion of 74% of the responding PEs see higher costs involved in the preparation. The PEs assessed the benefits for the users quite in conformity with the assessments of the interviewed bankers, because 38% of the PEs expressed the opinion that the components approach does not provide additional benefit compared to a general application of depreciation charges.[25]

[25] See EIERLE/HALLER/BEIERSDORF (2007), p. 37.

Revaluation model for property, plant and equipment

With regard to the optional revaluation model for property, plant and equipment items proposed in ED-IFRS for SMEs 16.11 the bankers clearly stated that their assessment of this model compared to the cost model depends on the question of whether market prices exist for the item ("mark to market"), or whether the revalued amount has to be estimated by using appropriate valuation models ("mark to model"). While 66% of the interview partners evaluated the revaluation model as advantageous compared to the cost model, if market prices exist, 56% expressed the opinion that the revaluation model is disadvantageous if no market prices exist and the revalued amount has to be estimated.

In addition to that, a vast majority of 78% of the bankers stated that the application of the revaluation model would have effects on their analysis approach. With reference to the expected additional efforts involved in analysing the revalued amounts, statements varied. Some said the effort might decrease, because they already do revaluations of parts of the property, plant and equipment by themselves, and some others anticipated an increased effort, because they would not rely on the presented amounts, and would therefore have to verify the amounts presented by the entities. In total the "mark to model" approach is regarded quite sceptically by most of the interviewed bankers, because the outcomes are perceived as not very reliable. As this type of revaluation is seen as being the regular case for property, plant and equipment items, the revaluation method is not assessed as being advantageous for this type of assets due to market prices being lacking.

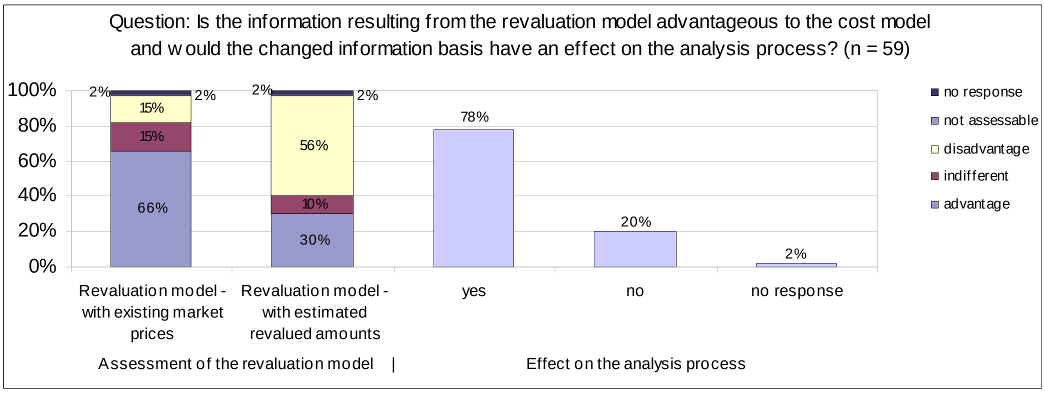

Figure 12: Advantageousness of revaluation model and effect on the analysis process

Analysing the answers that rejected the mark to model approach in more detail a bank's share of foreign customers seems to be an influential factor (not so the major size of the customers). Among the banks with a share of foreign customers under 10% a plain reluctance on the part of 67% is observable (24% see an advantage). Only 9% of bankers from banks with more than 30% of foreign customers expected a disadvantage, whereas 64% expected an advantage.

The combination of the higher benefit assessments of the revaluation model if market prices exist together with the estimation of higher cost by 48% of the PEs which participated in the SME survey[26] might be interpreted as an excess of the benefit over the costs. A different picture can be drawn with regard to the mark to model approach, where 58% of the PEs expected higher costs[27] and 56% of the bankers interviewed classified it as disadvantageous.

Revaluation option

The bankers were also asked about their preference with regard to an optional or compulsory application of the revaluation model. As Figure 13 illustrates, just 15% of the bankers interviewed prefer an option, 41% prefer a compulsory application of the cost

[26] See EIERLE/HALLER/BEIERSDORF (2007), p. 28.
[27] See EIERLE/HALLER/BEIERSDORF (2007), p. 29.

model (because of the concerns mentioned above), and another 37% prefer a compulsory requirement of the revaluation model only. A small number of 2% that should not be ignored suggest making the application of the revaluation model dependent on the existence of market prices.[28]

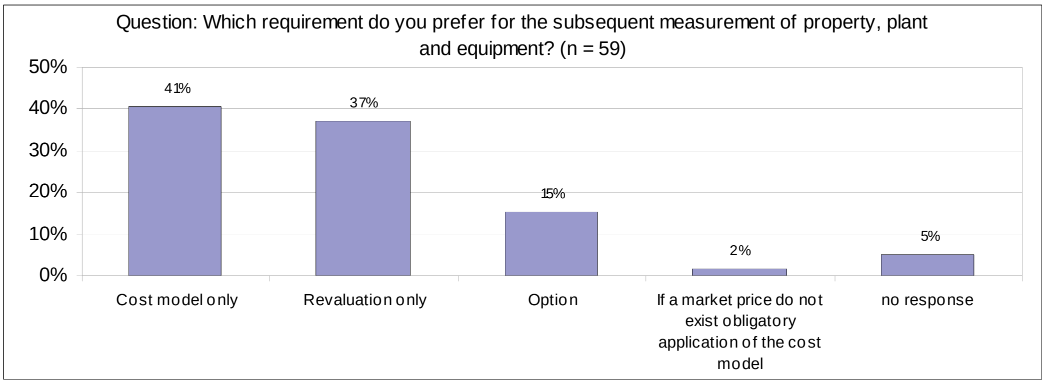

Figure 13: Type of requirement of subsequent measurement of property, plant and equipment

Treatment of non-current assets held for sale

The separate presentation and the specific measurement rules of non-current assets held for sale on the face of the balance sheet, as proposed in ED-IFRS for SMEs Sec. 36, is perceived by a vast majority of 73% of interviewees as being advantageous compared to the situation where this information is not provided by financial statements. Concerning the effects on the credit analysis process most of the bankers stated that it would not result in a material additional effort, but would provide additional useful information.

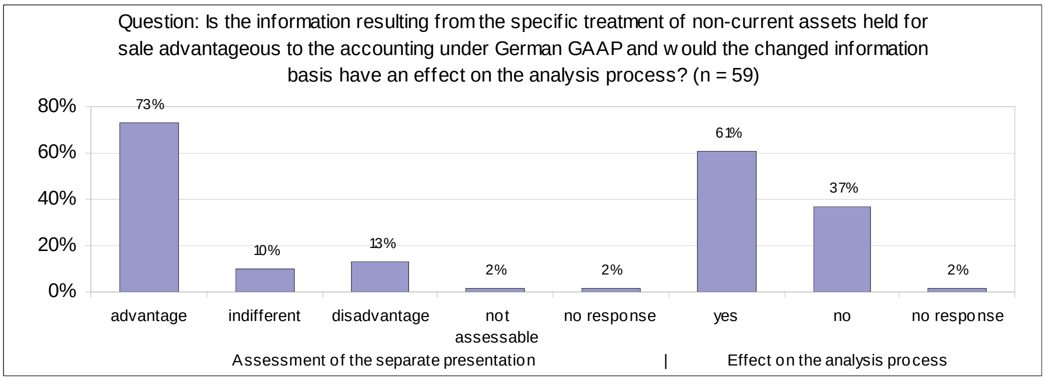

Figure 14: Advantageousness of separate presentation of non-current assets held for sale and effect on the analysis process

Compared with the responses from the SME survey, it is clear that the greater expected benefit from using this information again comes with higher expected costs of the preparers.[29]

Investments in associates

Besides the measurement of property, plant and equipment we also asked the participants about their assessment of subsequent measurement methods for investments in associates. Looking at the results shown in Figure 15, it becomes clear, that bankers are in favour of the equity method. 61% evaluated this approach as being advantageous as

[28] Although not totally comparable due to differently formulated questions, it is interesting to note that in the SME survey 28% of the respondents viewed the option between the cost model and the revaluation model as advantageous, 25% as disadvantageous and 40% were indifferent; see EIERLE/HALLER/BEIERSDORF (2007), p. 27.

[29] Although only 52% of the PEs expect greater benefits to the users of their financial statements, 56% of the PEs expect higher costs from applying this method (see EIERLE/HALLER/BEIERSDORF (2007), p. 37).

compared to the cost model. Regarding the effects of the measurement at equity on the credit analysis process, 49% of the interviewees said that it would most likely have an effect on this process. In detail, they anticipate a decreased effort to be involved in analysing investments in associates. A few mentioned that the cost model amounts do usually not reflect the true value of the investment and the consideration of profits and losses at the recognised value using the revaluation model seems reasonable to them. Furthermore, some supported this approach, because they perceive it as the best alternative to the mark to model approach when calculating the fair value of the investment.

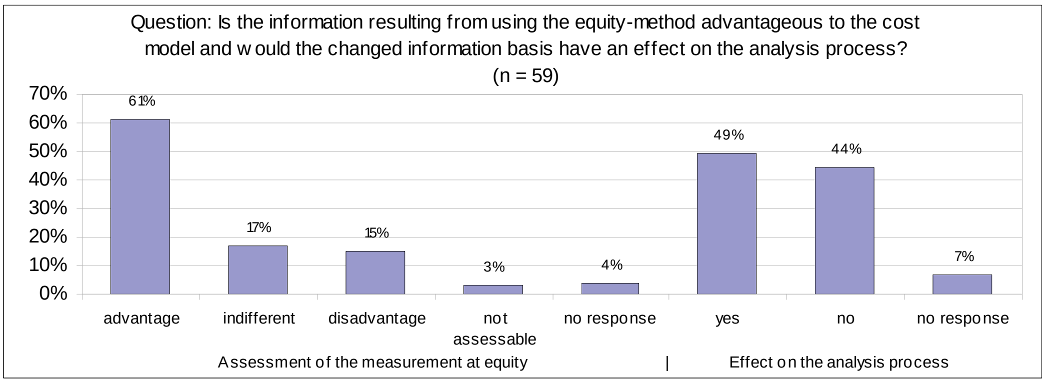

Figure 15: Advantageousness of the measurement of investments in associates at equity and effect on the analysis process

The results concerning the measurement of investments in associates at fair value shown in Figure 16 are quite unambiguous. 58% of the asked bankers prefer the measurement at fair value, on condition that the revalued amount is based on market prices, whereas 58% of the bankers see an outweighing disadvantage in the fair value method, if the mark to model approach is applied.

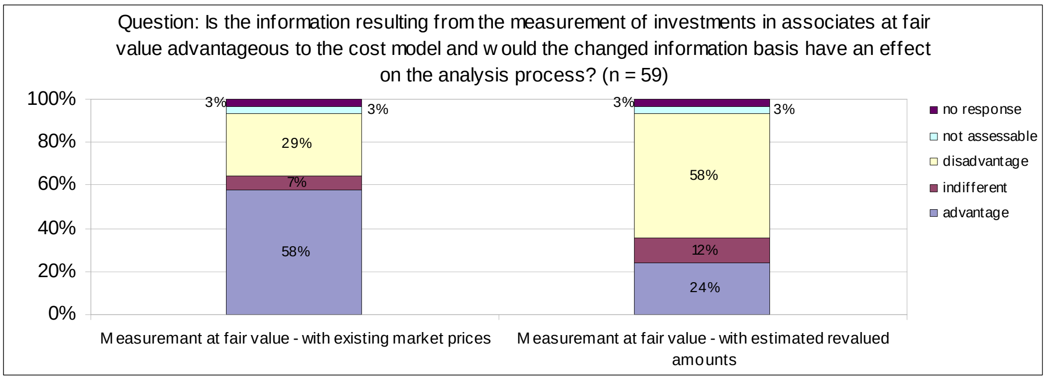

Figure 16: Advantageousness of the measurement of investments in associates at fair value

The option between the cost model, equity method and fair value method proposed in ED-IFRS for SMEs 13.3 is not perceived as favourable. Only 8% of the interviewees assessed it as advantageous, whereas 49% of the participating bankers see the requirement of the equity method as the most preferable type of regulation and 17% said the same with regard to the cost model and the fair value model (see Figure 17). The high vote for the equity method was explained by the fact that the application of the equity method avoids the problems resulting from the mark to model approach and is perceived to be easier to handle for the preparer. Some others mentioned that a reduced option could be considered as well, that is, to provide a fair value option in cases where market price exists.

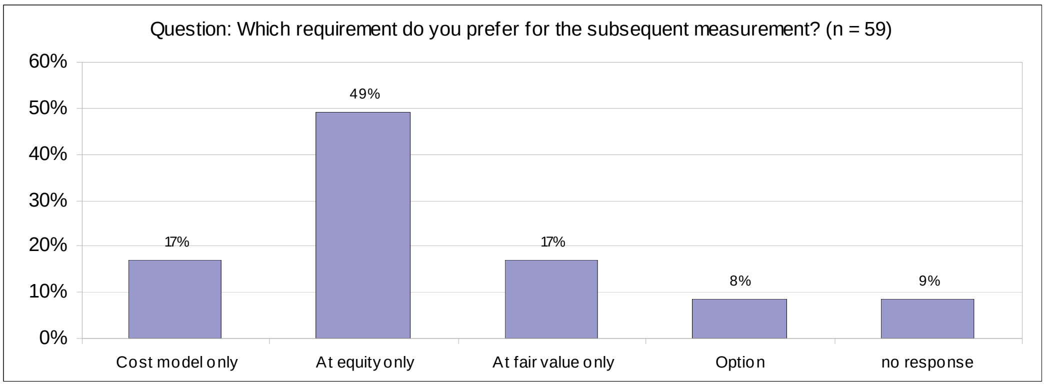

Figure 17: Types of requirement of subsequent measurement of investments in associates

Financial instruments

As for the assets listed above the fair value method proposed in ED-IRFS for SMEs 11.8[30] is also assessed very positively for financial instruments, but only if market prices exist for the particular instrument. In this case 71% of the interviewees assessed the mark to market approach as being advantageous compared to the cost method for financial assets, and 66% viewed it advantageous for financial liabilities or equity instruments (see Figure 18). Among this majority the opinion was expressed that where there are existing market prices it is reasonable to use them. However, in order to capture the volatility of the market prices it was proposed to apply risk deductions.[31] Otherwise, the mark to model approach was viewed with considerable concern, because the bankers expect there to be a lot of subjectivity and discretion involved in setting the model assumptions.

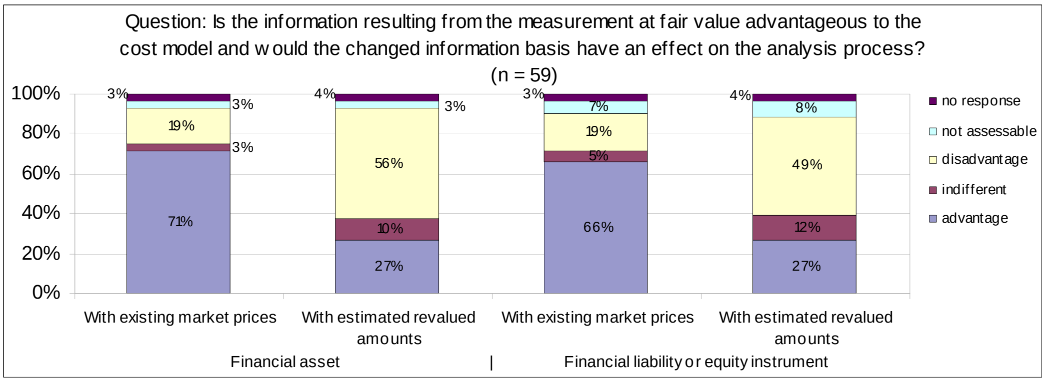

Figure 18: Advantageousness of the measurement of financial instruments at fair value

Analysing the expressed opinions on the mark to model approach for financial instruments in more detail, it turns out that the major size of customers of a bank has only a slight positive influence. However, the share of foreign customers of a bank has a stronger influence. Between the group of banks with a share of less than 10% of foreign customers and the one with a share of more than 30% the advantage assessments rise from 18% to 45%.

Capitalisation of development costs

The interviews reaffirm the experience the IASB mentioned in ED-IFRS for SMEs BC81, namely that banks rate information about development costs as being of little benefit and therefore would disregard it for credit decisions. As Figure 19 shows 49% of the interviewees assessed the capitalisation of development costs as being

30 ED-IFRS for SMEs 11.8 requires measurement at fair value for all financial instruments. For certain financial instruments the ED-IFRS for SMEs 11.7 and 11.9 include exceptions; e.g. for committed loans, for financial instruments for which the fair value could not be measured reliably, bonds, etc; for further examples see ED-IFRS for SMEs 11.10.

31 According to the banks a risk deduction sounds reasonable especially in view of the delay between the end of the reporting period and the date when the financial statements are issued.

disadvantageous compared to their treatment as an expense. This assessment was explained by bankers by reference to the effects on their analysis process. 58% said that the capitalisation model has a negative effect on the analysis process because of the additional effort involved in verifying the recognised amounts on the balance sheet. In the end, the most interviewees said that they would set the capitalised amount off against equity. This is because the value is strongly subjective and usually not recoverable in the case of a liquidation of a customer's business.

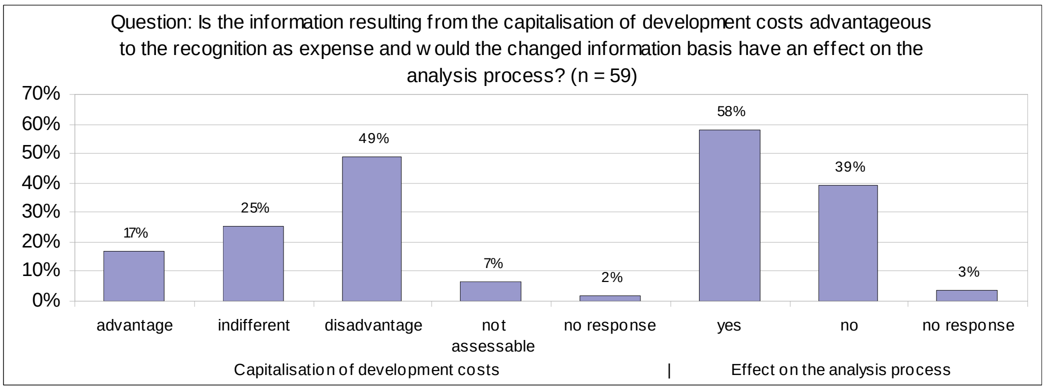

Figure 19: Advantageousness of the capitalisation of development costs and effect on the analysis process

Taking into account the cost evaluations of the PEs that participated in the SME survey, where 58% of the respondents reported higher costs through the capitalisation of development expenses[32], the bankers' assessments question the justification of the capitalisation of such expenses.[33]

When analysing influences on the statements made regarding the capitalisation of development costs the result is different to the mark to model approach. With increasing customer size of a bank the concerns increase as well. Whereas among the banks with the smaller customers (annual revenues under 8 million Euro) 32% see disadvantages, this is so for 63% of the banks with primarily larger customers (revenues of more than 100 million Euro). With regard to the influence of the share of foreign customers of a bank the result is just the contrary; with an increasing proportion of foreign customers, the share of positive opinions increases as well (from 19% in the case of bankers from banks with a share of foreign customers under 10% to 27% in the case of bankers with more than 30% of foreign customers).

Revaluation of intangibles

With regard to the optional use of the revaluation method for intangible assets[34], the bankers' assessments vary considerably. Whereas 39% see an advantage, 32% assessed the revaluation as being disadvantageous and 24% said it makes no difference for them. Most of the respondents who said it is a disadvantage or it makes no difference for them mentioned that it would have an effect on the analysis process, because the analysis effort would increase and they would set the revalued amount off against equity.

[32] See EIERLE/HALLER/BEIERSDORF (2007), p. 34.

[33] However, 42% of the PEs expected higher benefits to the users of their financial statements from the capitalisation of development costs, and 36% expressed benefits for internal management and control purposes, see EIERLE/HALLER/BEIERSDORF (2007), p. 34.

[34] See ED-IFRS for SMEs 17.21. For the application of the revaluation option, ED-IFRS for SMEs 17.23 refers to IAS 38.75 – .87 and .124 et seq.

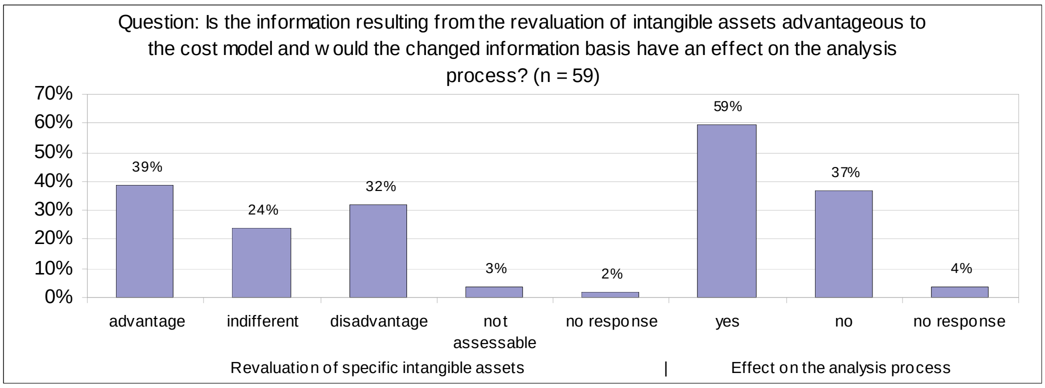

Figure 20: Advantageousness of the revaluation of intangible assets and effect on the analysis process

As with the findings with regard to the capitalisation of development costs the size of customers seems to influence the assessments. Bankers from banks with smaller major customers (revenues of less than 8 million Euro) evaluate the advantageousness higher (58% see an advantage, 16% see a disadvantage) than those from banks with larger customers (revenues of more than 100 million Eur) (5% see an advantage, 53% see a disadvantage).

Taking the higher cost evaluation of the PEs in the SME survey into account (64% of the responding PEs expected higher costs of preparation)[35], the slight benefit bankers expect from the revaluation method for intangibles may call into question the reasons for this method.

Goodwill

Concerning the treatment of goodwill (see ED-IFRS for SMEs 18.20-.21) the bankers appeared to be quite indifferent. Only 17% saw an advantage in the impairment-only-approach compared with the amortisation approach to goodwill, whereas 25% saw a disadvantage, and 53 % said they were indifferent (see Figure 21). When asking for the reason behind these assessments, the most frequent explanation given was that it is common to set the goodwill amount off against equity anyway for the credit analysis, and that they do not think that this practice would change, because goodwill is not regarded as a recoverable asset in case of the liquidation of a customer's business.

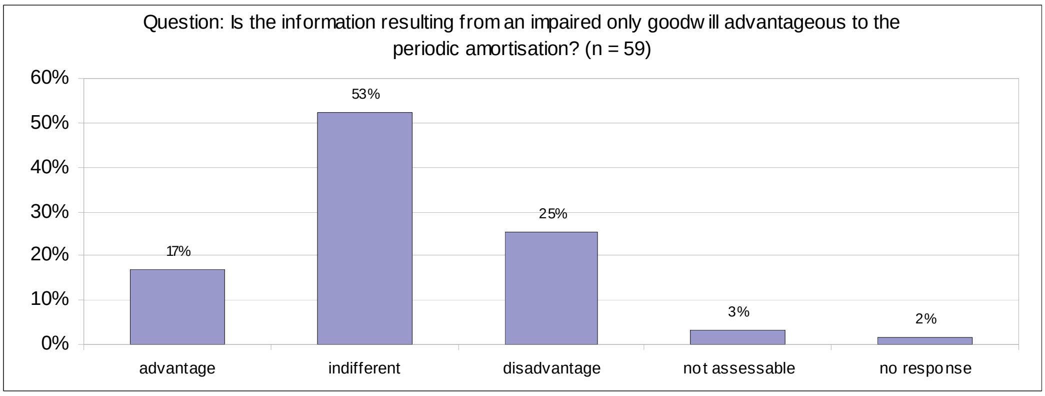

Figure 21: Advantageousness of the impairment-only-approach

It is clear that bankers are quite indifferent in relation to the results from the goodwill impairment due to the practice of setting it off against equity. No influence can be identified with respect to the size of the banks' customers. It is different in regard to the share of foreign customers, where 39% of the bankers from banks with less than 10% of foreign customers see a disadvantage in the application of the impairment only

35 See EIERLE/HALLER/BEIERSDORF (2007), p. 31.

approach; this rate is at 9% for banks with more than 30% of foreign customers and 36% of this group even see an advantage.

Deferred tax assets

Almost the same picture can be drawn with regard to deferred tax assets which are required to be recognised according to ED-IFRS for SMEs 28.2. 36% of the bankers assessed the required recognition of deferred tax assets as an advantage (mostly because of increased comparability), and nearly the same proportion of 37% was indifferent. 72% of the interviewees were convinced that the capitalisation wouldn't change their analysis process, because they would continue to set the tax assets amount off against equity on the basis of the same reasoning as explained above, namely that the recoverability of a deferred tax asset is considered to be too uncertain.

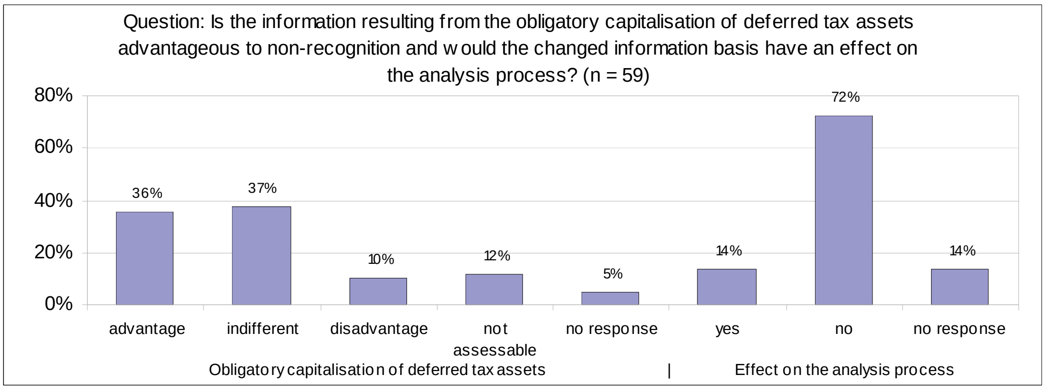

Figure 22: Advantageousness of the obligatory capitalisation of deferred tax assets and effect on the analysis process

With regard to deferred tax assets the influence of the customer size on the answers is obvious. 53% of the bankers from banks with large customers (more than 100 million Euro revenues) see an advantage whereas only 26% do so from banks with major customers of less than 8 million Euro revenues.

Combining this assessment by the users of financial statements with the evaluations of the PEs in the SME survey (54% of the respondents expected higher costs and (only) 30% higher benefits for the users of their financial statements)[36] the reasoning underlying the recognition of deferred assets may be questioned.

4.2.2 Assessment of financial statement presentation

Balance sheet presentation

As the ED-IFRS for SMEs does not prescribe any particular balance sheet structure (besides the general principle of classifying the items according to whether they are current or non-current; see ED-IFRS for SMEs 4.5) the interviewees were asked about their expectations for a balance sheet presentation that would fulfil their needs in order to carry out an effective solvency analysis. Many of them supported the idea to distinguish between current and non-current and therefore a structure based on the maturity of the items. In addition to this many expressed their wish for one uniform presentation format that is transparent and clear as most important for their needs, and safeguards so that identical economic issues are presented under the same balance sheet item by all entities. This would increase the efficiency of performing the analysis as further research regarding specific items could be significantly reduced. Additionally, displacing information into the notes should be avoided due to the fact that the analysis of the notes involves greater efforts than using the standardised information on the face of the balance sheet.

[36] See EIERLE/HALLER/BEIERSDORF (2007), p. 39.

Income statement structure

Asked about their preferences with regard to the classification of the expenses in the income statement according to the nature of expense (nature of expense method) or the function of expense (cost of sales method) the majority of 64% of the interviewees rated the nature of expense method as more useful than the cost of sales method (Figure 23). In interpreting this result, it must be considered that the classification based on the nature of expense is the traditional and still most practiced one when presenting income statements in Germany. However, as the bankers interviewed explained, their assessment is not primarily triggered by this fact but by their conviction that information about the nature of expenses is more useful for their analysis than information about the function of expenses, and it is more practical for them to have this information on the face of the income statement than set out somewhere in the notes.

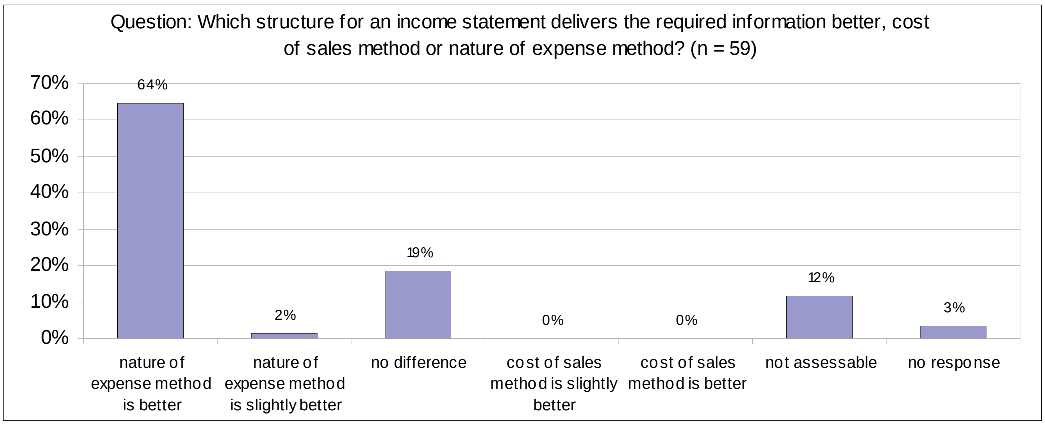

Figure 23: Income statement presentation – cost of sales method versus nature of expense method

Extraordinary items

We also asked the bankers about their views on two particular income statement issues. One was the non-presentation of "extraordinary items" (as expressed in ED-IFRS for SMEs 5.6)[37] and the other was the separate presentation of write-downs and reversal of such write-downs on the face of the income statement (as required in ED-IFRS for SMEs 5.7 lit. b). With regard to the non-presentation of "extraordinary items" the reaction was very negative as demonstrated in Figure 24. A vast majority of 82% expressed their strong opinion that the information about extraordinary items is absolutely indispensable. Bankers explained that they need this information to calculate a prediction of sustainable future cash flows, which is not influenced by extraordinary and (it may be) short term effects. The background is that banks are deeply interested in the future debt service coverage and for that purpose the cash flows from ordinary activities are decisive. Regarding the separate presentation of extraordinary items in the income statement the interviewees stated unequivocally (75%) that a prohibition would involve a lot of additional costs in identifying the extraordinary effects. On the one hand they would have to disaggregate the provided information and on the other they would have to consult the customer in order to prepare additional data. Furthermore, most of the interviewees requested a more specific regulation for extraordinary items and very detailed guidelines on classifying them.

[37] Under German GAAP a separate line item extraordinary income or expense is required.

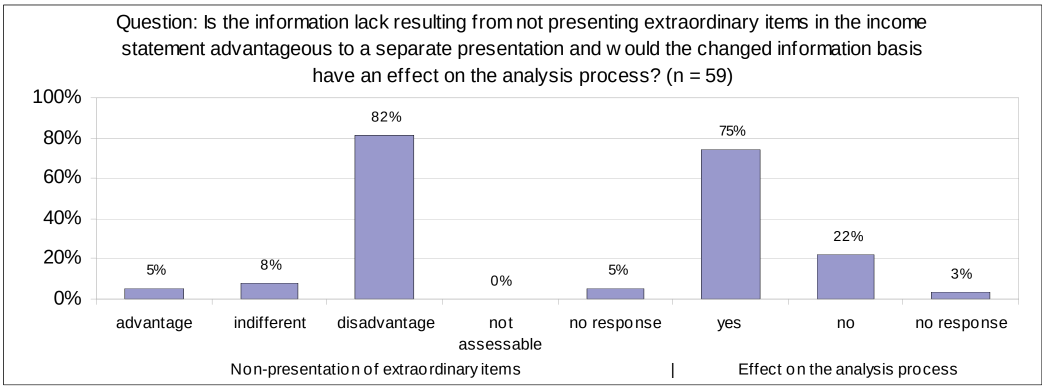

Figure 24: **Advantageousness of not presenting extraordinary items separately and effect on the analysis process**

The same clear statement was received concerning the separate presentation of write-ups and -downs for property, plant and equipment. As Figure 25 illustrates, 78% of interviewees considered the separate presentation to be advantageous, mainly because this would help them to reduce their analytical efforts, because up to now they try to calculate these figures by themselves in their analysis process. Another 53% mentioned that the separate presentation delivers additional information; however, they would not change their analysis process in detail.

Separate presentation of revaluation differences

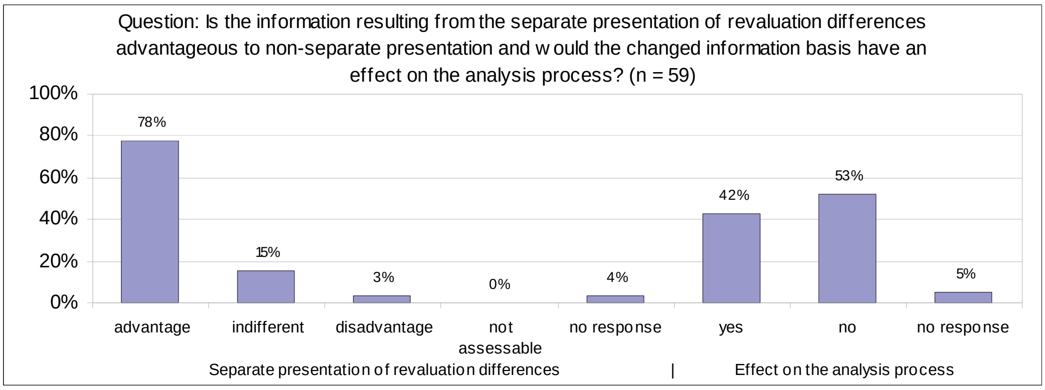

Figure 25: **Advantageousness of the separate presentation of revaluation differences and effect on the analysis process**

4.2.3 Assessment of specific disclosures

As banks need to know details about the cash flows which influence the solvency in order to effectively analyse the creditworthiness of their customers, and payables and receivables are a major cash flow source, the interviewees were asked to assess the importance of disclosed information about maturities of these balance sheet items. More than half of the bankers (58%) said this information is needed to analyse the borrowers' solvency and/or future cash flow situation. In this connection bankers remarked that for them it is not only necessary to know some maturities, it would be even better to have more detailed information about the timing of individual payments. The final maturity itself provides no information about any repayments during the contracted credit period.

Maturities of accounts payable and receivable

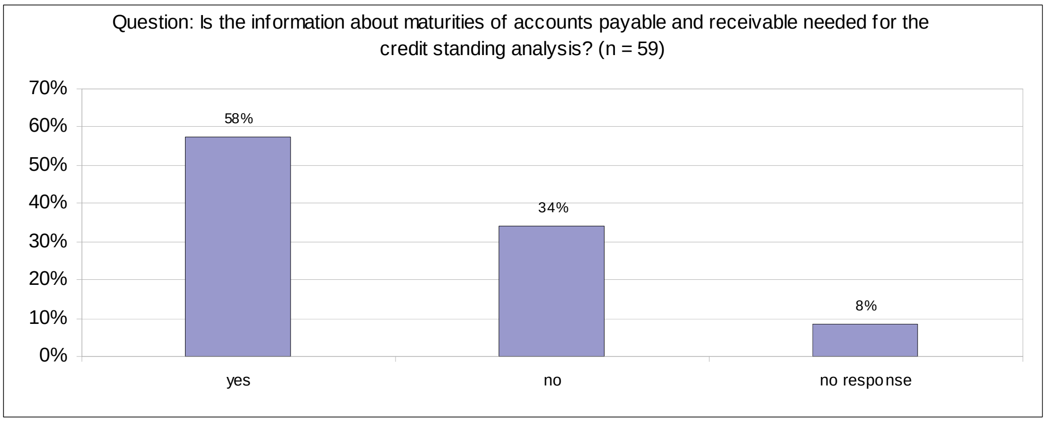

Figure 26: Information about maturities of account payable and receivable

General disclosures

The reduced amount of disclosures compared to the full IFRS is considered to be one of the major particularities of the ED-IFRS for SMEs, and it attempts to cope with the special characteristics of the cost/benefit relation of PEs. Nevertheless, the remaining amount is still perceived to be too burdensome and is questioned with regard to its appropriateness by lots of commentators to the ED.[38] Against this background the bankers, as users of financial statements, where asked to evaluate some selected disclosures.[39] Figure 27 shows the evaluations provided by the interviewees. The results demonstrate that banks are in favour of the disclosed information, because they – as the interviewees explained – mostly support the basing of their decision very well. One exception can be identified. Disclosure of the reconciliation between recognised and expected tax expense (income) seems not to be very interesting to banks. A possible explanation might be that banks – as already noted above[40] – do not really consider deferred taxes in their analysis. Furthermore, although bankers assessed the provided information as supportive and decisive, regarding the category "breaches of loan agreements" some expressed extreme concerns about the sensitivity of this disclosure. On the one hand, it could lead to the final break because if some breaches were reported, the suppliers most likely would stop their deliveries. Furthermore, when the breach is reported it is too late anyway; it would be more important to know it immediately.

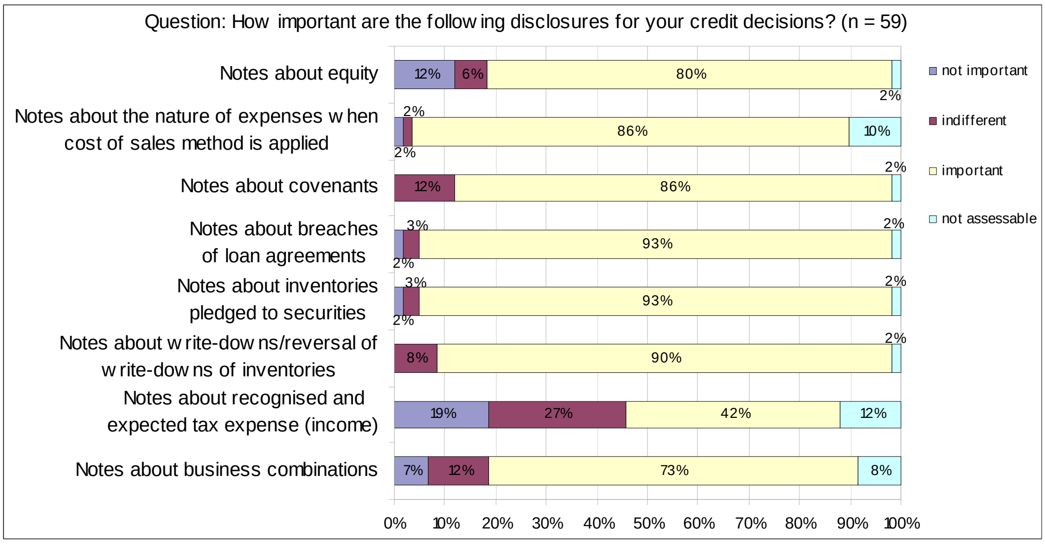

Figure 27: Importance of specific disclosures

38 See summary of the comments letters on the ED in IASB (2008a), paragraph 32.
39 For further details of disclosures, see IASB (2007c), disclosure checklist.
40 See remarks to deferred tax assets in section 4.2.1 as well.

Related parties disclosures

Due to the fact that disclosures about related parties' issues are usually perceived as sensitive by preparers of financial statements (where up to 58% of the respondents perceived these kinds of disclosures as very sensitive)[41] it was important to find out about the perceived benefits to banks. Figure 28 shows a clear interest by banks in related party disclosures. Information about transactions with owners (96%) and with other group entities (93%) is seen as the most important. With the former the bank can see (potentially) unfavourable property and liquidity transfers from the entity's sphere to the owners' sphere. The latter assessment is also quite comprehensible, having the assessment of the importance of consolidated financial statements (see above 4.1.1) in mind. For banks it is essential to analyse the whole group and therefore the intragroup relations also. Disclosures about the management were seen as a little bit less important, with the remarks that transactions with the management are usually not material. Although assessed as less important, the transactions with other related parties are still assessed as important by 58% of the interviewees.

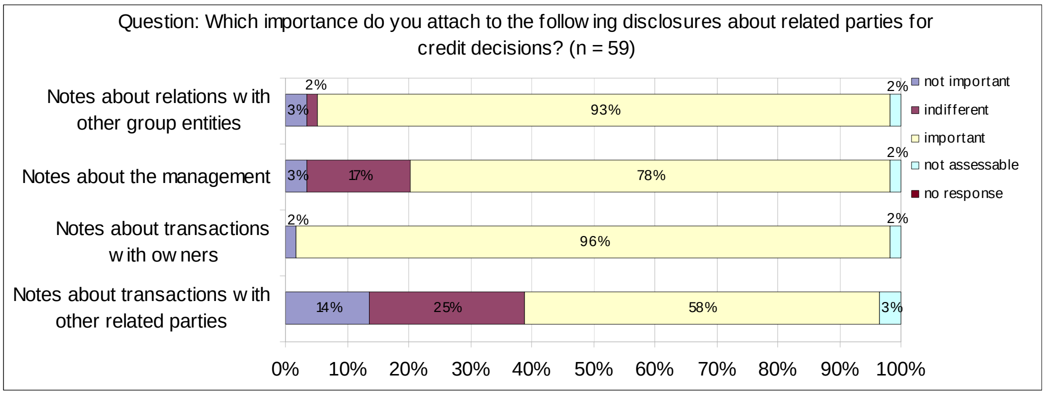

Figure 28: Importance of disclosures about related parties

Additional disclosures

With reference to disclosures, some of the participants suggested including additional disclosures in the notes to the financial statements of PEs. Major suggestions were:

- report about the main risks of the entity; in this context the suggestion was made to require a SWOT-analysis and a statement concerning the business plans of the PE;
- detailed information about any extraordinary events and items (see also 4.2.2);
- disclosures about standing credit lines, payments and subordinations with regard to liabilities;
- a standardised disclosure scheme of the information provided with regard to post-employment benefits; for example a table with all important facts about the amounts of defined benefit liabilities, plan assets and discount rates, and
- more detailed information about the staff, such as education, age, development over time and availability of adequate employees.

These suggestions were made in consideration of the general assessments of the usefulness of note disclosures. The bankers interviewed often remarked that they prefer a standardised form of information instead of extended verbal descriptions that often involve material effort to analyse them. Therefore it is not so much the quantity of information that challenges banks, but rather the quality in terms of comparability, comprehensibility and length of note disclosures.

41 See EIERLE/HALLER/BEIERSDORF (2007), p. 45.

4.3 Further insights into the information needs of banks and the usefulness of IFRS compliant financial statements

4.3.1 Information needs of credit institutions for granting credits

Information needs

Banks use several sources of information to assess the ability of a borrower to pay debt service and to repay debts when due. In order to find out which information sources are commonly used and how important they are, banks where asked to identify the three most important information sources. As it is common to differentiate between "hard facts" (quantitative information) and "soft facts" (qualitative information) the question was separated into these two categories.

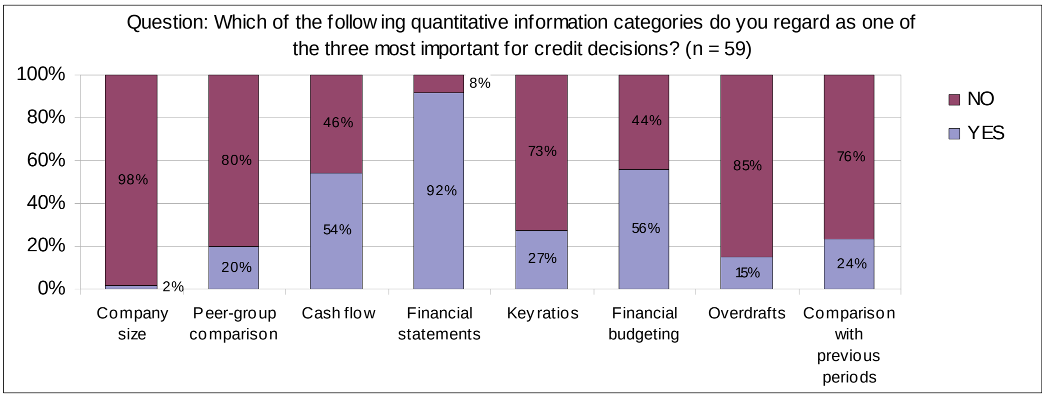

Figure 29: Most important type of quantitative information for credit decisions of banks

Quantitative information basis

Looking at the quantitative information primarily used by creditors, the importance of financial statements is very obvious. Absolutely every interview partner included financial statements among the three most important sources of information. This result is evidenced by the answers given to the question on the weight (importance) of financial statements information compared to the total of the information used for creditors' decision making (see below chapter 4.1.1). Besides the financial statements, banks use information about cash flows, key ratios, financial budgeting and comparisons with previous periods. That kind of information can be separated into a backward and a forward looking perspective. From the backward orientated information such as period comparisons or past cash flows banks want to analyse a company's development and extrapolate some future scenarios about capital demand and risks. To support these estimations, banks are keen on financial budget planning as well as on comparisons with previous periods.

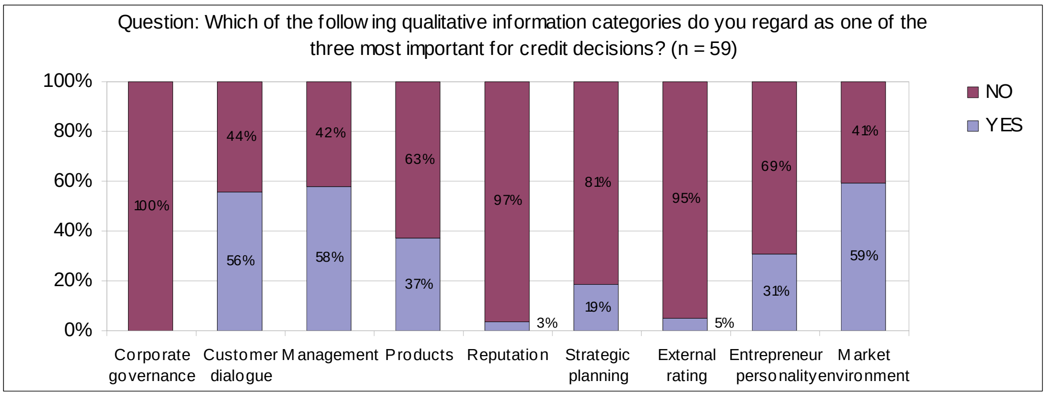

Figure 30: Most important type of qualitative information for credit decision of banks

Qualitative information basis

Concerning the three most important qualitative type of information the interviewees mentioned market environment, management and customer dialogue as the most important matters for the assessment of the borrower's solvency. It is obvious that a company's solvency depends strongly on the management and the market environment. The customer dialogue is very important not the least to verify some contents of the financial statements, where the information presented is insufficient to provide a sound basis for the bank's decision.

4.3.2 Usefulness of IFRS compliant financial statements

Frequency of financial statements in compliance with IFRS

The interviews revealed that for most of the banks IFRS still do not play an important role in their daily business. Figure 31 shows that for 66% of the interviewed bankers the share of financial statements presented according to IFRS is under 10% of all the financial statements they analyse per year. However, for more than 12% of the interviewees the share is already 20% and higher. The bankers were also asked whether they intend to see this share growing and therefore force their customers to present IFRS financial statements. The answers were identical; all interviewees denied putting any such pressure on their customers. The simple reason is that especially for customers in the PE segment, a bank usually does not have enough market power to demand it due to the tough competition on the credit market. Generally banks are in a position to demand a lot of additional information but only if it is not too burdensome for the borrower to prepare such information.

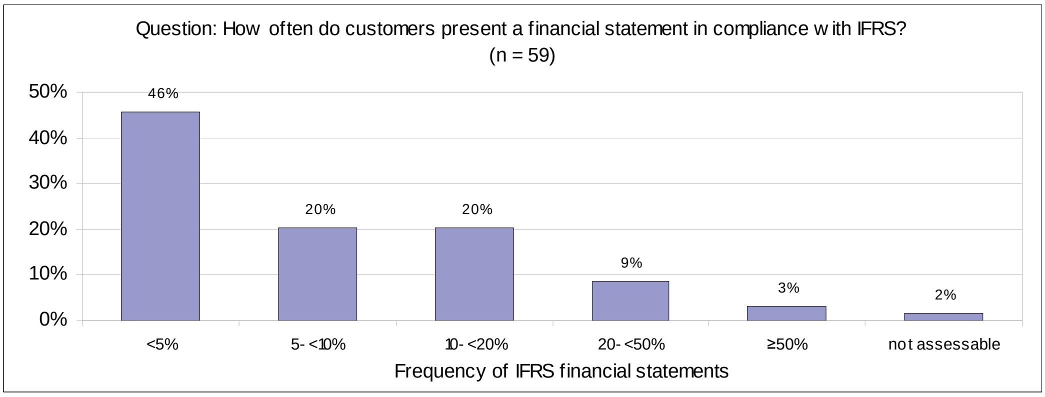

Figure 31: Frequency of IFRS financial statements

On analysing the results shown in Figure 32 and Figure 33 it becomes obvious that the number of IFRS financial statements banks have to deal with, is related to the size of their customers on the one hand and the amount of foreign customers on the other. Figure 32 reveals the raising frequency of IFRS financial statements with increasing size of the customers.[42] In the smallest size category 68% of the interviewees stated that they get IFRS financial statements from less than 5% and 32% of the bankers estimated the rate of such statements between 5% and 10%. In the next size category 50% of the respondents already give a rate between 5% and 10%. In the largest category 53% of the interviewees mention a rate of IFRS statements in the range between 10% and 50%, and even 11% of the interview partners encountered already a rate of over 50%.

[42] However, due to the small number of companies represented in the customer size categories "8- <32 mEUR" and "50- <100 mEUR" the significance and therefore the reliability of the findings has to be evaluated cautiously.

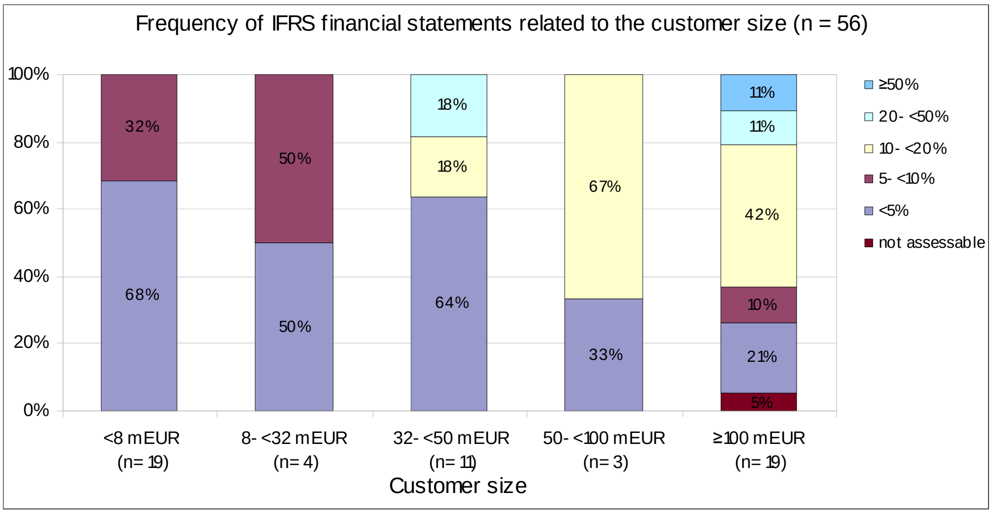

Figure 32: Frequency of IFRS financial statements related to the customer size

With regard to the share of foreign customers of a bank the results are comparable (see Figure 33). 64% of banks with a share of foreign customers under 10%, receive a maximum 5% IFRS financial statements. At the opposite end, banks with more than 30% foreign customers receive many more financial statements compliant with IFRS (28% of the interviewees reported rates between 10% and 50% and even 18% of the bankers even mentioned rates of over 50% for such statements).

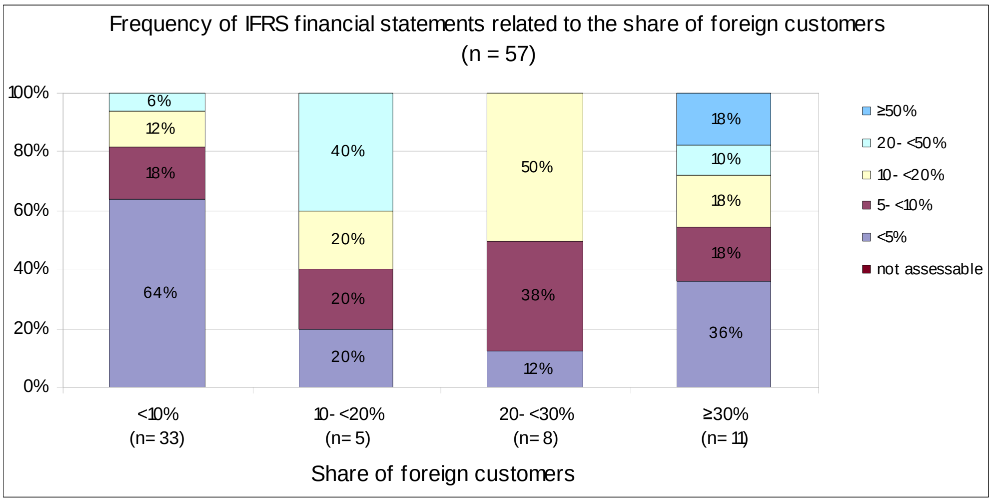

Figure 33: Frequency of IFRS financial statements related to the share of foreign customers

Information benefit and analysis effort

To evaluate their experiences with IFRS financial statements and their views on the advantageousness of using them compared to German GAAP financial statements, the bankers were asked to assess the information benefit resulting from the use of financial statements for credit decisions and to assess the efforts required to analyse them. The majority assesses the information benefit of German GAAP financial statements as being high and the efforts to analyse those as being moderate. Therefore the information benefit outweighs the analysis effort. Compared to this, the result with regard to IFRS financial statements are quite ambiguous. As Figure 34 shows, 24% and 20% of the interviewees see high information benefits and high analysis efforts respectively. But in contrast to German GAAP, many more of the interviewees report a very high information benefit. While for German GAAP the number is just 10%, for IFRS it is 25%. Otherwise, nearly a half of the interviewees (47%) see a very high effort required to analyse IFRS financial statements, whereas only 3% do so for German GAAP. The quite high number of “not assessable" responses indicates that German bankers which deal with PEs still have lower levels of knowledge of IFRS (see also below Figure 35).

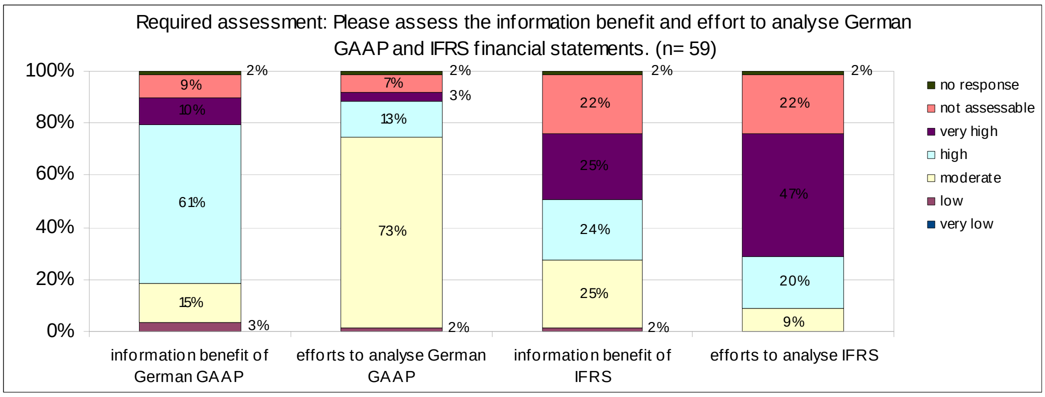

Figure 34: Information benefit of German GAAP and IFRS financial statements versus the effort to analyse them

Figure 35 shows the bankers' evaluation of their own IFRS-knowledge and that of their colleagues. Approximately a third assess their own IFRS-knowledge as very low or low. 44% say that their IFRS knowledge is moderate, and 15% assess their knowledge as high. Asked about the situation among their colleagues in the same organisational unit the results are similar. The slight difference can be explained by the persons who were interviewed. Most of the interviewees are leading representatives of the banks and therefore much more in touch with IFRS issues than their staff members.

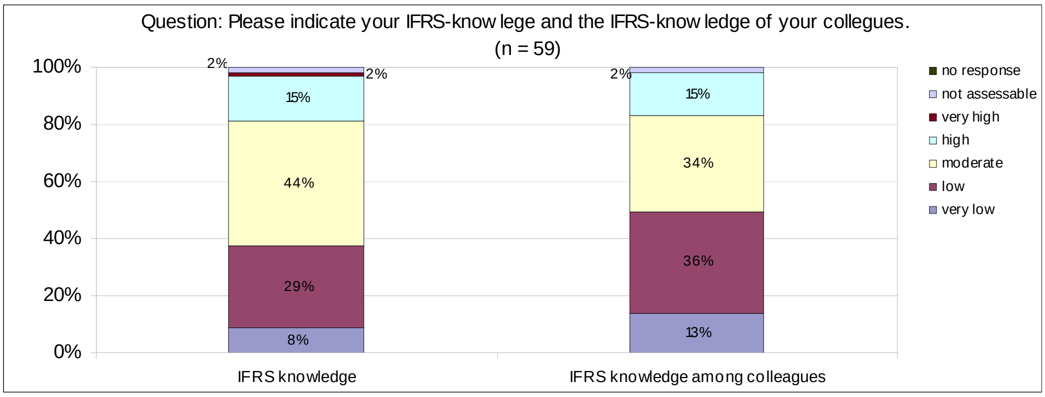

Figure 35: Own IFRS-knowledge and estimated knowledge of the colleagues of the same organisational unit

Since the introduction of Basel II, internal rating systems have become very important for banks. Thus, we asked the interviewees whether their rating system differentiate between German GAAP and IFRS. A majority of 47% of the banks[43] use just one rating system which does not differentiate between the two financial reporting standards (see Figure 36). 25% of the applied systems differentiate between German GAAP and IFRS. That means the bank has developed separate rating systems which have regard to the differences in the accounting methods for each financial reporting standard.[44] Another 12% use a rating system which considers the differences between German GAAP and IFRS by first reconciling the statements from IFRS to German GAAP and then applying the German GAAP based rating system.

[43] The answers of the interviewees were related to their banks to avoid double counting. Therefore the "n" in Figure 36 is only 32, which is the amount of banks included in the study.

[44] It has to be noted, that it is not always possible to develop a separate rating system, because for that purpose it is necessary to have enough bankrupted entities which prepared an IFRS compliant financial statement before the default.

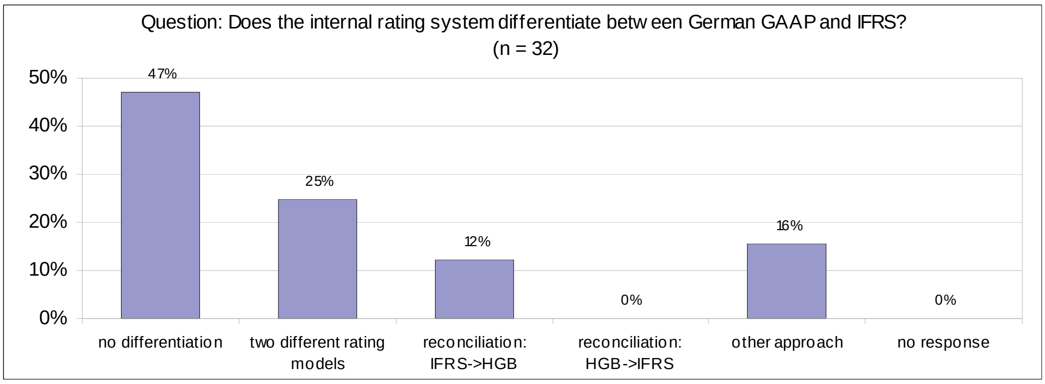

Figure 36: Differentiation between German GAAP and IFRS in the rating system

The fact of whether a bank differentiates in its rating system between the two normative systems (German GAAP versus IFRS), is obviously related to the share of IFRS financial statements the bank receives from its customers. Within the group of banks with two rating models 50% receive between 5% and 10% IFRS financial statements. Even 26% have a rate of IFRS financial statements of between 10% and 50%. Those rates are much smaller within the group of banks that do not differentiate in their rating system. Only 13% receive between 5% and 10% IFRS financial statements and 14% receive between 10% and 50% IFRS financial statements.

5 Summary

As part of the ASCG's research agenda regarding the IASB's ED-IFRS for SMEs this study aimed at assessing the attitude of German banks towards the usefulness of PE's financial statements in general and the proposed requirements and methods of the ED-IFRS for SMEs in particular. Together with the results of the ASCG's SME survey the findings of this study are intended to provide empirical evidence of the potential cost/benefit effects of the content of the ED-IFRS for SMEs and thus help the IASB better to decide on specific controversial financial reporting issues included in the ED.

Importance of financial statements

The study proves that financial statements are a major source of information for banks that is taken into consideration with regard to credit decisions. A vast majority of the interviewed bankers (84%) rate the importance of financial statement data in relation to all other considered information at over 50%. The financial statements received from their PE-customers are still to a large extent based on German GAAP. 46 % of the banks of the sample receive financial statements in compliance with IFRS from less than 5% of their customers, and approximately 40% stated the rate of "incoming" IFRS statements to be between 5% and 20% (Figure 31). According to the findings this frequency is positively related to banks' average customer size. In general, banks see the necessity for their customers to present internationally comparable financial statements quite equivocally; 29% see a (very) high need whereas 46% see no or only little need (Figure 9). Related with this finding, the interviewees also assessed the development of special IFRS for PEs equivocally. 41% rated it as being disadvantageous and 24% as being advantageous, and another 24% were indifferent (Figure 10). However, the interviews disclosed unanimously that banks do not force or encourage their customers to apply IFRS or do have a clear preference for IFRS (see 4.3.2).

With regard to the assessment of the usefulness of specific financial reporting issues of the ED-IFRS for SMEs the major findings are (see also Table 1and Table 2):

Positive assessments

Primarily positive assessments were made with regard to

- the components approach of the depreciation of property, plant and equipment (see Figure 11),
- the revaluation of property, plant and equipment if a market price exists (see Figure 12),
- the separate disclosure of non-current assets held for sale (see Figure 14),
- the measurement of investments in associates at equity or at fair value (the latter only if a market price exists) (see Figure 15 and Figure 16) and
- the measurement of financial instruments at fair value if a market price exists (see Figure 18).

Neutral assessments

The subsequent measurement of goodwill according to the impairment-only-approach (see Figure 21) and the recognition of deferred tax assets (see Figure 22) were assessed mainly as indifferent, because the recoverability of these items is conceived as being too unlikely. Thus, it is a common practice of banks to set intangible assets and deferred tax assets off against equity. Also quite unequivocal was the assessment of the revaluation option of intangible assets, because the bankers often do not rely on the amounts presented, as a market value is usually missing.

Criticism

What the bankers criticised the most was the “mark to model” approach to assessing fair values (see Figure 12, Figure 16 and Figure 18). The amount calculated depends considerably on the model assumptions and it is seen as too burdensome to acquire an understanding of the valuation process. An almost comparable negative assessment was made with regard to the recognition of development costs (see Figure 19). Additionally the interviewees were not in favour of accounting options such as the measurement choice between the cost and revaluation model for property, plant, equipment, and the choice between the equity and fair value method for investments in associates (see Figure 13 and Figure 17). Another critical issue was the presentation format of balance sheet and income statement. On the one hand banks need an explicit format with a detailed structure and specifications of the items in order to find the necessary information quickly and to compare it between the entities. On the other hand, they evaluated the prohibition on disclosing extraordinary items on the face of the income statement as a real problem (see Figure 24), because it hinders their purpose of detecting the ordinary and sustainable income of the period.

Disclosures

With regard to disclosures the bankers in our study assessed the following information as being of considerable importance: transactions with related parties, amount and structure of equity, nature of expenses, existence and content of covenants, pledged inventories, write-downs and reversals of write-downs of inventories and business combinations (see Figure 27 and Figure 28). Furthermore they are in favour of a disclosure of maturities of accounts payable and receivable (see Figure 26) and of revaluation gains and losses of a period (see Figure 25).

Assessment of the advantageousness of accounting methods in view of information benefits in credit decisions	*advantageous*	*indifferent*	*disadvantageous*
Component approach compared to a uniform depreciation charge (n = 59)	54%	27%	15%
Revaluation model for property, plant and equipment compared to the cost model – with existing market prices (n = 59)	66%	15%	15%

Assessment of the advantageousness of accounting methods in view of information benefits in credit decisions	*advantageous*	*indifferent*	*disadvantageous*
Revaluation model for property, plant and equipment compared to the cost model – with estimated revalued amounts (n = 59)	30%	10%	56%
Separate presentation of non-current assets held for sale (n = 59)	73%	10%	13%
Measurement of investments in associates at equity compared to the cost model (n = 59)	61%	17%	15%
Measurement of investments in associates at fair value compared to the cost model – with existing market prices (n = 59)	58%	7%	29%
Measurement of investments in associates at fair value compared to the cost model – with estimated revalued amounts (n = 59)	24%	12%	58%
Measurement of financial instruments at fair value compared to the cost model – with existing market prices (n = 59)	71%	3%	19%
Measurement of financial instruments at fair value compared to the cost model – with estimated revalued amounts (n = 59)	27%	10%	56%
Measurement of financial instruments at fair value compared to the cost model – with estimated revalued amounts (n = 59)	66%	5%	19%
Measurement of financial instruments at fair value compared to the cost model – with estimated revalued amounts (n = 59)	27%	12%	49%
Capitalisation of development costs compared to the recognition as expense (n = 59)	17%	25%	49%
Revaluation model for intangible assets compared to the cost model (n = 59)	39%	24%	32%
Impaired only goodwill compared to the periodic amortisation (n = 59)	17%	53%	25%
Obligatory capitalisation of deferred tax assets compared to the non-recognition (n = 59)	36%	37%	10%
Not presenting extraordinary items in the income statement separately compared to a separate presentation (n = 59)	5%	8%	82%
Separated presentation of revaluation differences in the income statement compared to a non-separate presentation (n = 59)	78%	15%	3%

Table 1: Assessment of the advantageousness of accounting methods in view of information benefits for credit decisions

Importance of disclosures in view of information benefits for the credit decision	*important*	*indifferent*	*not important*
Notes about equity (n = 59)	80%	6%	12%
Notes about the nature of expenses when cost of sales method is applied (n = 59)	86%	2%	2%
Notes about covenants (n = 59)	86%	12%	0%
Notes about breaches of loan agreements (n = 59)	93%	3%	2%
Notes about inventories pledged to securities (n = 59)	93%	3%	2%
Notes about write-downs/reversals of write-downs of inventories (n = 59)	90%	8%	0%
Notes about recognised and expected tax expense (income) (n = 59)	42%	27%	19%
Notes about business combinations (n = 59)	73%	12%	7%
Notes about relations with other group entities (n = 59)	93%	2%	3%
Notes about the management (n = 59)	78%	17%	3%
Notes about transactions with owners (n = 59)	96%	0%	2%
Notes about transactions with other related parties (n = 59)	58%	25%	14%

Table 2: Importance of specific disclosures in view of information benefits for credit decisions

Conclusion

Combined with the results of ASCG's SME survey the interviews reveal issues relating to the ED-IFRS for SMEs where the cost/benefit balance might be questioned. Those issues are: mark-to-model approach to assess fair values, impairment-only approach of goodwill, recognition of development costs and deferred tax assets, non-presentation of extraordinary items.

Generally, the participating bankers stated that a single set of international financial reporting standards would be beneficial for comparison and analysis purposes, however, only if the content of the standards meet their expectations of decision usefulness. One characteristic of these expectations is an appropriate level of standardisation that allows the banks to process and compare presented data easily.

In interpreting the results of this study the following reservations must be considered: they reflect only the assessments of bankers that were part of our sample, based in Germany, and willing to participate in the study. Therefore the study's results may not be extrapolated so as to evaluate the appropriateness of the ED-IFRS for SMEs to serving the needs of banks adequately on a worldwide base. However, the findings may be regarded as a valuable and up to date record of the attitudes and assessments of a considerable number of bankers which is able to provide fruitful empirical input to the national and international discussions about the bankers' expectations and evaluations with regard to financial statements in general and accounting methods in particular.

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