Deutsches Rechnungslegungs Standards
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Questionnaire on Possible Recognition and Measurement Modifications for Small and Medium-sized Entities (SMEs)

Dear Mr Pacter

As indicated in our response to the Questionnaire on Possible Recognition and Measurement Modifications for Small and Medium-sized Entities (SMEs) of June 7th 2005, we would like to comment on IAS 39 in more detail.

Overall we do not suggest major modifications of IAS 39 for SMEs. IAS 39 regulates derivative and hedge accounting to ensure appropriate accounting and presentation of the risk involved in these transactions. As outlined in our previous response we assume a type of SME which tends to be a smaller entity (yearly turnover of around 50 Mio. €). Accordingly, we assume that in this type of SME the economic risk managed by use of derivatives arises from more regular and simple transactions. Consequently these entities would typically use derivatives, if any, of a less sophisticated nature such as FX forwards or interest rate swaps. Accordingly, the financial instruments used would tend to be simple and not complex. Moreover SMEs are less likely to have to hedge certain risks. Foreign currency risks for instance, might occur less as an SME is less involved in cross border transactions and operates primarily locally.

Furthermore, the kind of operations and resulting hedging-contracts need to be taken into account. Due to the exemption laid out in IAS 39.5 (“own use exemption”), these contracts might be excluded from the scope of IAS 39 as SMEs tend to enter contracts for the purpose of the receipt or delivery of a non-financial item in accordance with the entity’s expected purchase, sale or usage requirements.

Our suggestions are as follows:

Derivative Accounting

As to the methods of accounting for derivatives in general we do not suggest any modifications for standards for SMEs.

Usually, we consider the determination of fair values by means of complex valuation techniques as overly burdensome for SMEs. However, based on our assumption expressed above, we do not think that complex financial instruments requiring complex valuation techniques are common to SMEs.

Hedge Accounting for SMEs

Hedging transactions should generally be accounted for according to IAS 39. We have come to the conclusion that in the light of the risks involved in derivative transactions fundamental changes in accounting for hedge transactions for SMEs are not justifiable. Existing IAS 39 reflects the complexity and the risks of derivative transactions designated as hedges. If our assumption mentioned above is valid, there should be no need for complex derivatives. Consequently, we see no reason why the underlying principles of IAS 39 should not be retained within the standards for SMEs.

Furthermore, with the introduction of the fair value option hedge accounting is subject to simplified practises. We believe that the fair value option covers various possible hedging transactions of SMEs. These transactions can be designated as at fair value through profit or loss, because they will usually eliminate or significantly reduce a measurement or recognition inconsistency. If applicable, both the hedging instrument and the hedged item will have to be accounted for at fair value with documentation and effectiveness requirements becoming obsolete. This option is available to all entities, SMEs should not be excluded.

However, if the entity chooses not to apply the fair value option the hedging accounting rules of IAS 39 apply. For these cases we believe some kind of simplification is advisable. It is possible for instance to modify the requirements with respect to documentation and measurement of effectiveness. For example less detailed documentation in accordance to the fair value option (see IAS 39 BC 75B) might be acceptable for hedge accounting in general. Thus an entity would describe its hedging strategy in general rather than follow the detailed guidelines in IAS 39.

Moreover, the shortcut method could be reconsidered for SMEs. As laid out in SFAS 133, accounting for certain hedge transactions is based on the assumption of no ineffectiveness. According to this standard no measurement of effectiveness of hedges for interest rate risk (fair value hedge and cash flow hedge) is needed when defined conditions are met. In the Basis for Conclusion (IAS 39 BC 134) the IASB gave reasons for its decision to not make an exception. It decided that ineffectiveness always has to be measured and recognised in profit or loss. Nevertheless this might provide a sensible approach to simplified hedge accounting for SMEs. It might also be reasonable to consider the application of the shortcut method for other risks as well (e.g. FX forward contracts).

Furthermore, it could also be feasible to link effectiveness measurement requirements to certain indicators. This could prolong the assessment intervals and hence ease the burden of measuring effectiveness throughout the year. For example the effectiveness of an interest rate hedge depends on the compensation in fair values when changes in interest rates occur, therefore a considerable change in interest rates could be the indicator that triggers measurement of effectiveness. However, we are aware of the difficulties connected with defining both, indicators and thresholds for relative changes.

Embedded Derivatives

Regarding embedded derivatives GASB suggests modifying the requirements. SMEs should not need to account for embedded derivatives separately, but only disclose the information within the notes. The combined instrument should be accounted for following the measurement of the host contract. However, this modification of the current requirements of IAS 39 should not allow evasion of derivative accounting.

This simplification should therefore be restricted to contracts which were closed under usual terms between knowledgeable, willing parties in an arm's length transaction within a usual business transaction. Also, most importantly, the embedded derivative should possess a simpler feature which is commonly embedded in such contracts and which reflects typical risks according to the nature of the contract, e.g. a price escalation clause which reasonably reflects the market's view on probable risks. We believe that these requirements also safeguard that the information disclosed provides a meaningful insight into the risks involved. All these conditions need to be established in order to prevent including derivatives which are of an unreasonable nature and speculative. For those derivatives the provisions of IAS 39 with regard to embedded derivatives should apply in full.

If you would like any clarification of these comments please contact me.

Yours sincerely,

Prof. Dr. Klaus Pohle
President