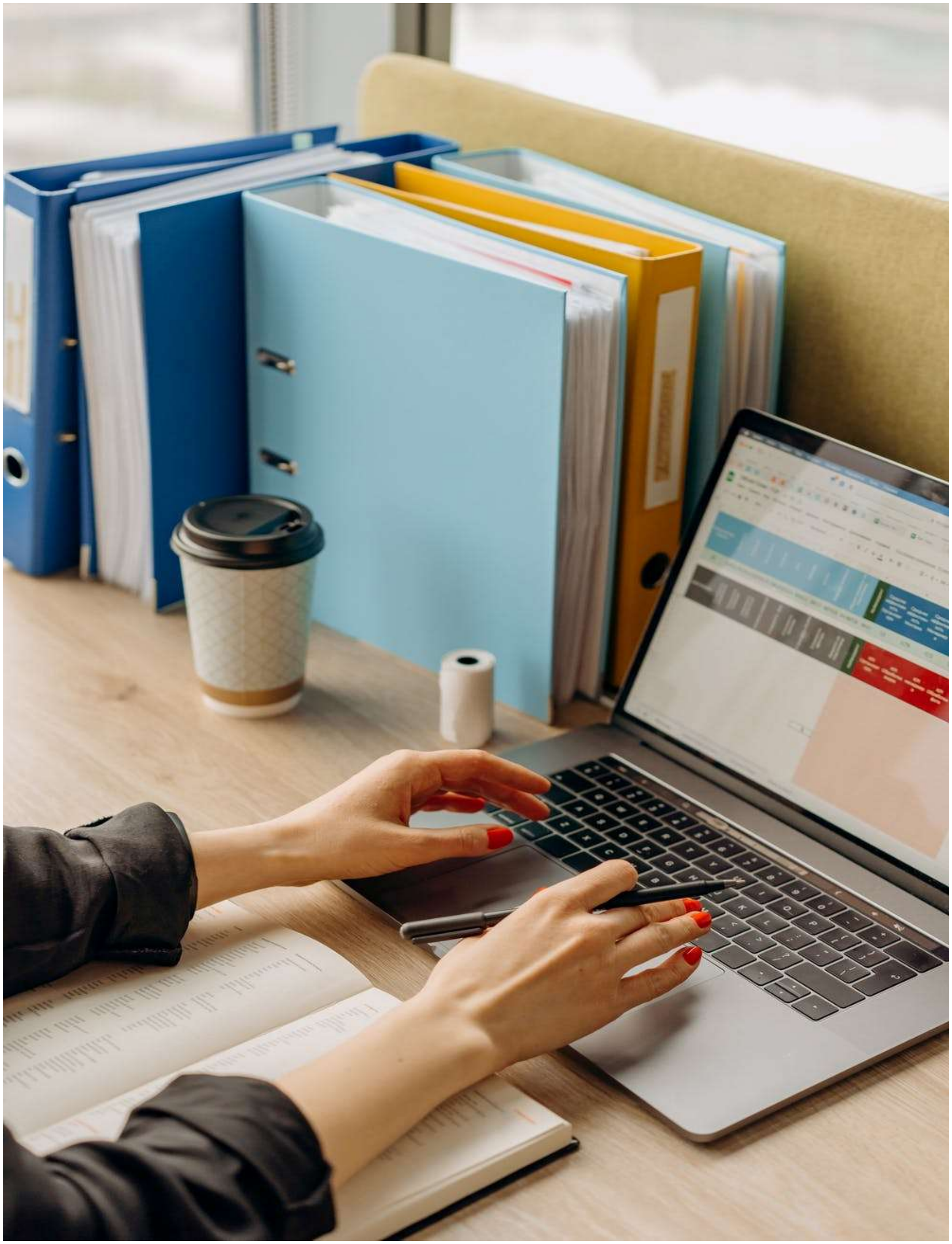
# BASICS OF GERMAN GAAP



# Introduction and framework

**German Commercial Code (Handelsgesetzbuch, HGB)** requires all corporations to prepare annual financial statements which present a true and fair view of the net assets, financial position and results of operation in accordance with German generally accepted accounting principles (German GAAP). **German GAAP is mainly derived from legal provisions of the German Commercial Code.**

Further, the Accounting Standards Committee of the Germany (ASCG) may issue so-called German Accounting Standards (GAS) for the purpose of closing legal loopholes, specifying and interpreting legal provisions and further development of German GAAP.

The German Commercial code are designed for use by both Profit-oriented entities and certain not-for-profit organizations. For claiming Compliance with German GAAP, an entity must comply with all standards and interpretations, including disclosure requirements.

Transactions are accounted for with their substance, rather than only their legal form. Financial Statements are prepared on a going concern basis, unless management intends or has no realistic alternative other than to liquidate the entity or stop trading.

There is no written conceptual framework in German GAAP. The primary purpose of separate German GAAP Financial Statements is the determination of distributable Profits. All listed entities are required to prepare accounts under IFRS hence German GAAP group accounts are not relevant in a capital market context.

# Form of Financial Statements

An entity with one or more subsidiaries must present consolidated financial statements unless specific criteria are met for example-entity's immediate parent prepares consolidated financial statements in which the entity is consolidated, subject to further conditions.

German GAAP grants **several exemptions for Companies to draw up consolidated accounts**:

-Small groups (refer next page)
-Intermediate holding companies

Further, the requirement to consolidate does not apply for companies to be consolidated:

- for which the combined significance is not material to the whole;
- for which significant or ongoing restrictions affect the exercise of the Parent Company's rights in relation to its assets or management;
- for which the interest was only held for disposal from the beginning; or
- for which the required information can only be obtained or estimated at disproportionate expense or with great delay.

A legal entity for which, amongst other conditions, a declaration to guarantee for commitments was issued, may exempt from preparing, auditing and publishing financial statements.

A parent entity is also required to prepare its separate financial statements in accordance with German GAAP and to make them available for public use.

# Categorization of entities into Small/Medium/Large

German GAAP defines size categories to specify accounting and disclosure requirements for separate financial statements and groups. Size of Entity can be classified into Micro/Small/Medium/large. This classification depends on three criteria:

-Balance Sheet total
-Sales revenue
-Average no. of employees

**Section 267 of HGB define the three thresholds** (as summarized in Table A) and a Company needs to meet two of the three criteria on two executive balance sheet dates to be classified into one specific group.

***Table A***

| **Size** | **Balance Sheet Total** | **Sales revenue** | **Average no. of employees** |
|---|---|---|---|
| Micro | <=Eur 0.35 m | <=Eur 0.7 m | <=10 |
| Small | > Eur 0.35 m and <=Eur 6 m | > Eur 0.7 m and <=Eur 12 m | >10 and <=50 |
| Medium | > Eur 6 m and <=Eur 20 m | > Eur 12 m and <=Eur 40 m | >50 and <=250 |
| Large | > Eur 20 m | > Eur 40 m | >250 |

Further, Section 293 of HGB define the three thresholds (as summarized in Table B) and a group needs to meet two of the three criteria on two executive balance sheet dates to be classified as a small group.

***Table B***

| **Basis** | **Balance Sheet Total** | **Sales revenue** | **Average no. of employees** |
|---|---|---|---|
| Without consolidation | <Eur 23.1 m | < Eur 46.2 m | <250 |
| Consolidated balance | <Eur 19.25 m | < Eur 38.5 m | <250 |

# Components of Financial Statements

A set of Consolidated financial statements consists of:

i. A Statement of Financial Position;
ii. An Income Statement;
iii. A Statement of Cash Flows;
iv. A Statement of Changes in Equity; and
v. Notes to the Financial Statements

A Statement of Cash Flows and a Statement of Changes in Equity is not required for Separate Financial Statements, except for publicly traded Companies.

The line items to be presented in both the statement of financial position and the statement of profit and loss are largely regulated by HGB. Concept of materiality is followed and line item can be aggregated in the primary financial statements with disclosure in the notes when certain criteria are met.

Notes shall be presented in the order of the line items of the primary financial statements. Restatement of Prior year's figures is generally not allowed. Further, the preparation of opening balance sheet for the beginning of the earliest period presented is not required in any case.

## Statement of Financial Position

- The statement of financial position is presented in a horizontal layout.
- Line items are differentiated into main items and sub line items. There is flexibility to aggregate sub line items.
- A current/non-current classification is required for non-financial institutions.
- Non-current assets are those that are intended for long term use in the business. Current assets are those that are neither classified as non-current assets nor as deferred expense.

- A Financial asset and financial liability are offset and reported net when the entity has a legally enforceable right to offset, i.e., the intention to settle is not relevant.

## Income Statement

- There is a single statement approach as there is no concept of Other Comprehensive Income (OCI)
- Revenue comprises income arising in the course of an entity's ordinary activities and is presented as a separate line item in the Income statement.
- An analysis of expenses is required (either by nature or by function) on the face of the Income Statement.
- Concept of materiality is followed and line item can be aggregated in the primary financial statements with disclosure in the notes when certain criteria are met.
- Presenting extra ordinary items is not permitted, but they are to be disclosed in the notes.
- Items of income and expenses are not offset unless required or permitted.

## Statement of cash flows

- The statement of cash flows is a primary statement; however, it is required only in consolidated financial statements and in the financial statements of publicly traded companies.
- Cash flows are classified as relating to operating, investing of financing activities. If cash flow is attributable to several activities, then the components of that cash flow shall either be allocated appropriately to the activities concerned or shall be allocated in full to the activity that is predominantly affected.
- Net cash flow from all three activities are totalled to show the changes in cash and cash equivalents.

- Cash and cash equivalents include certain short-term highly liquid investments, which are readily convertible to known amounts of cash and subject to only minor changes in value. Their maturity is restricted to less than three months from the date of acquisition.
- Cash flow from operating activities may be presented using the direct or indirect method.
- Interest and dividends received are classified as investing activities and interest and dividends paid are classified as financing activities.

## Statement of changes in equity

- A Statement of changes in equity is a part of Complete set of financial statements, however, only for consolidated financial statements.
- It presents line items distinguishing between profit or loss and transactions with owners in their capacity as owners, showing separate contributions, distributions and changes in ownership interests in subsidiaries that do not result in a loss of control.
- It results in a reconciliation for each component of equity between the carrying amount at the beginning and the end of the period.

# Basis of Accounting

- Financial statements are prepared on a strict historical basis.
- Fair value measurement is less widespread, used in very limited circumstances and often optional, such as in case of non-monetary barter transactions, impairment of inventory if quoted prices or market prices are available and for the purchase price allocation in a business combination. The revaluation model is generally not admitted for subsequent measurement. Further, there is no detailed guidance on how a fair value is determined.
- Fair value may be defined as the amount for which an asset could be exchanged, or a liability settled between knowledgeable, willing merchants in an arm's length transaction. Fair value is the stock price or asset price in an active market.
- When an entity's functional currency is hyperinflationary, According to GAS 25, the inclusion of subsidiary in hyper inflationary economies in the Consolidation financial statements requires the elimination of the effects of inflation on assets, Liabilities, income and expenses at latest in the financial statements adjusted to conform to uniform group accounting policies. The same shall apply to the financial statements of joint ventures and associates.
- It is mandatory to disclose information about key sources of estimation uncertainty and judgements made in applying the entity's accounting policies. The Valuation and recognition principles chosen by the Management are to be disclosed in the notes to the financial statements.

## SUBMIT A REQUEST FOR PROPOSAL (RFP)

**Find out how FFR's expertise can help you and your Company.**

**FAIR FINANCIAL REPORTING ADVISORS PRIVATE LIMITED**

**NISHA SUYAL AGGARWAL**

**HEAD CONSULTANT**

**+ 91 9868 752 007  + 91 (11) 455 100 73**

**nsa@fairfinancialreporting.com**

**www.fairfinancialreporting.com**