PKF
Accountants &
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Editorial

Dear Readers,

The Accounting Standards Committee of Germany (ASCG) commissioned a study to determine how companies had implemented the German accounting standard GAS 20, requirements for management reports, which had to be applied for the first time last year. In the Focus section, we consider the findings on ‚reporting of expected developments' and, based on these, we provide some practical advice as to how you can create your 2014 management report so that it will satisfy the requirements – and, in the case of larger companies, thus also make it "FREP-resilient".

At the turn of the year, the German government, the courts and the tax authorities were very busy. Shortly before Christmas, the ‚Act to align the German Tax Code to the Customs Code of the Union' was passed and, in it, the scope for tax exemptions for company events was changed. This also included a number of clarifications in practical terms. By contrast, it is questionable whether there will be greater clarity as a result of a Federal Fiscal Court ruling on child benefits during a course of study abroad and a Federal Ministry of Finance circular on the issue of which tax rate should apply to interest on shareholder loans and loans made by relatives. Both of these issues are also discussed in the Tax section.

In the "Legal" section we report on how the Federal Court of Justice abandoned its previous interpretation of the law on majority-voting clauses and replaced it with a two-fold test. Then again, there is now some more legal certainty for controlling shareholders in a profit transfer agreement, as a time limit has been imposed on their extended liability.

However, there should be no easing off when valuing owner-managed businesses. In our "Corporate Finance" series, we present the common opinion of the professional associations of both public auditors as well as tax advisors.

We hope that you find this newsletter stimulating reading.

Yours sincerely,
Your PKF Team

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In focus: Management reports that satisfy requirements

FOCUS

Preparing management reports that satisfy requirements – Reporting, in practice, on expected developments in accordance with GAS 20

Businesses that are required to compile a management report, or a group management report had to comply with new guidelines already for the 2013 financial year. These guidelines stem from the revised German accounting standard GAS 20 and, in particular, affect the reporting on expected developments.

I. Overview

In the accounting standard GAS 20, the Accounting Standards Committee of Germany (ASCG) specified the group management reporting requirements pursuant to Section 315 HGB (German Commercial Code). GAS 20 was applicable for the first time for the 2013 financial year and, in principle, also to the management reports of individual enterprises (Section 289 HGB). Compared with the previous standard, GAS 15, there are new rules in particular for reporting on expected developments. The **forecast horizon** has been shortened from two years to at least one year. In return, there are stricter requirements as regards the accuracy of the forecasts; moreover, the forecasts that were provided in the previous period will now have to be compared with the actual business development.

I. II. FREP is monitoring the application of the standard

Germany's Financial Reporting Enforcement Panel (FREP) regularly scrutinises the implementation of new standards. For 2015, FREP has in particular listed the following points as the main focus for its examination of capital market oriented companies:

- Consistent and transparent reporting, in the management report, on key financial and non-financial performance indicators
- Presentation of the calculation of company-specific performance indicators and – where reasonably feasible – reconciliation to the amounts reported in the financial statements
- Presentation of significant changes in performance indicators compared with actual prior year results and prior year forecast as part of the analysis of business development and the situation of the group
- Presentation of the expected change in forecast performance indicators compared with the actual results for the year under review and disclosure of the main underlying assumptions in the report on expected developments

III. Key points for satisfying the requirements for reporting on expected developments

The ASCG, in turn, commissioned a study from the University of Münster to determine how capital market oriented companies had implemented the guidelines in the

first reporting season of the 2013 financial year. We have summarised the most important findings from this study below. These constitute a guide to reporting in practice within the scope of the first time application of GAS 20. From this it is possible to derive the following nine key points for satisfying the requirements for reporting expected developments, in 2014, and especially, in a way that will also be "FREP-resilient".

(1) GAS 20 already prescribes disclosure of the **main assumptions** that underlie the forecasts, as a basis for understanding the forecasts that are made. In practice, three-quarters of companies based their assumptions on the business environment (e.g. the economy) and a quarter of them on the company itself (e.g. sales volumes and/or prices). Here, it was usual to refer to the forecasts of other organisations.

(2) A **forecast horizon** of one year after the last reporting date is sufficient.

(3) The disclosure of at least six forecasts for **financial performance indicators**. According to the study, the most frequently forecast indicators are: sales, investment volume, payout, net income, EBIT, ratios for cash flow, financing, capital structure as well as liquidity.

(4) The disclosure of two forecasts for **non-financial performance indicators**. Generally, in practice, these indicators are less frequently disclosed, so that providing such information constitutes a positive distinction. If disclosed then, frequently, it is the following indicators: number of employees, employee and customer satisfaction levels as well as the number of sites/branches.

(5) Forecast accuracy – Qualified comparative forecasts ("for the current year we expect a slight increase in energy costs") should at least be provided, as qualitative and comparative forecasts do not satisfy the requirements of GAS 20. Point forecasts or interval forecasts are even better.

(6) Consolidating the statements on the separate forecasts into an **overall assessment as a concluding summary**.

(7) Comparison of all the forecasts reported in the **previous period** with actual business development: 87 % of the companies provide this information in the economic report. In practice, comparisons were only provided for half of all previous year forecasts. It remains to be seen, whether this divergence is due to the first time application of the standard, or whether this will continue to be a feature. To be on the safe side, a comparison should be provided for all forecasts.

(8) Any divergences in the comparison between the forecast and actual results have to be **explained**, whereby it is usual to make reference to external and internal influencing factors.

(9) By **using tables** for juxtaposing figures (esp. for comparisons between the previous year's forecasts and the actual values) a company can differentiate itself positively.

TAX

Corporate Taxes

Broader scope for tax exemptions on benefits to employees at company events

» **Who for:** Employers and employees.

» **Issue:** Benefits granted to employees by the employer within the context of company events constitute a non-cash benefit and, as they are considered to be remuneration, the employees have to pay tax on them. Revisions to the relevant tax provisions came into effect on 1.1.2015 as follows:

- By legal definition, the term 'company event' now includes all events at the company level of a social nature (e.g. Christmas party/company outing/anniversary celebration).
- The previous tax exemption limit for benefits of € 110 per employee and company event has been replaced by a tax-free allowance in the same amount. If this threshold is breached then only that part that exceeds € 110 is taxable.
- Eligible benefits are all the employer's expenses for a company event (incl. VAT). Thus, in contrast to the previous ruling from the Federal Fiscal Court (*Bundesfinanzhof*, BFH), the costs per participating employee represent not only individually attributable costs (e.g the food served) but also a notional share of the employer's costs vis à vis third parties for the external setting of the

event (e. g. room hire, fees for musicians / event managers). Furthermore, the costs incurred for an accompanying guest should be attributed to the employee.

The tax-free allowance may be deducted for a maximum of two events per year and only applies if participation is open to all members of the company, or a part of the company.

» **More Information:** As the above-mentioned changes are part of the "Act to align the German Tax Code to the Customs Code of the Union and to amend other tax provisions" they can be viewed online at all times under: www.bundesfinanzministerium.de. (German version only).

Personal Taxes

Can child benefit (Kindergeld) also be paid during a course of study abroad?

» **Who for:** Parents whose children are studying abroad.

» **Issue:** In principle, parents are entitled to receive child benefit even during the education period of their children (until they reach 25 years of age). The precondition for this is, however, that the respective child has to be domiciled, or ordinarily resident in Germany, or in a EU / EEA member state.

Studying abroad - when does the state share the costs?

Recently, the Federal Fiscal Court (*Bundesfinanzhof*, BFH) dealt with a case where the daughter initially completed an au pair programme in the USA and then, immediately afterwards, took up a course of study, in New York, lasting several years. The child's room in the parental home continued to be available to the daughter. The Family Benefits Office (Familienkasse) stopped the child benefit payments because the daughter was no longer domiciled in Germany.

The BFH established that, on its own, continuing to have the parental home at your disposal was not sufficient to be deemed to be domiciled in Germany. In fact, a place of residence in Germany at the parental home can only be retained if the periods outside of term time are spent, at least mostly, in Germany. In the case of stays abroad lasting several years, it is not sufficient if the visits are short and of the usual type that can be explained by the child-parent relationship. This can be assumed to be the case if the visits are only of a short duration – two to three weeks per year.

Based on these principles, the case was referred back to the tax court because of a lack of findings of fact. Within the scope of the overall assessment, the tax court now has to rectify this situation and make an evaluation of all the circumstances with respect to the duration and frequency of the stays in Germany.

» **More Information:** Unlike child benefit, when it comes to granting tax-free allowances within the scope of the Family Tax-Relief Package (*Familienleistungsausgleich*) (child allowance, the allowance for the care and educational or professional training needs of a child), these do not depend on the child being resident in Germany. The ruling from 25.9.2014 (case reference: III R 10/14) is available online at www.bundesfinanzhof.de (German version only).

Withholding tax in the case of shareholder loans and loans made by relatives – The tax authorities have changed their opinion

» **Who for:** Private individuals who grant loans to their relatives, or to companies in which their relatives hold shares

» **Issue:** First of all, with regard to the topic, we would like to remind you of the recent Federal Fiscal Court (*Bundesfinanzhof*, BFH) ruling on the application of the withholding tax rate on interest income from share-

holder loans and loans made by relatives, which we reported on already in the October 2014 issue of the PKF newsletter. In the decisions taken at that time, the BFH opposed the view of the tax authorities that relatives within the meaning of Section 15 of the (German) Fiscal Code are always closely related persons. Up to now, in such cases, this had resulted in the application of the standard rate of income tax (up to 45 %) instead of the withholding tax rate (25 %).

In a Federal Ministry of Finance (*Bundesministerium der Finanzen*, BMF) circular, from 9.12.2014, the tax authorities abandoned their previous view on the definition of closely related persons and now unreservedly apply the BFH ruling from 2014. Thus, the withholding tax rate shall generally apply to the interest income from loans granted by relatives, insofar as the loan agreement fulfils the arm's length principles. Therefore, the withholding tax rate shall be inapplicable only in cases where

(1) the creditor and the debtor are **closely related** and the debtor is able to deduct interest payments as business expenses or professional expenses;

(2) the loan interest is paid to a shareholder with a shareholding of **at least 10 %** in a corporation. This also applies if the lender is closely related to the shareholder.

A close relationship is now deemed to exist between two persons if a controlling influence can be exerted over one of them by the other. Control is understood to mean personal or economic dependence. The "person who is being controlled" may not be given any scope to exercise discretion in decision-making. For example, parents control their under-age children and, consequently, in these cases the standard rate of income tax shall be used as a basis. This shall apply even if two people grant loans to each other and both are dependent on the same person.

» **Recommendation:** Insofar as the local tax office refuses to apply the withholding tax rate to loans granted by relatives, even though the loan agreement fulfils the above-mentioned criteria, then a complaint should be lodged against this (with reference to the BMF circular from 9.12.2014). If there are disputes with the local tax office as to whether a controlling or a dependent relationship exists between the contractual parties and if you have any general questions with respect to the (new) definition of closely related persons, please do not hesitate to contact your PKF consultant, who would be delighted to help.

LEGAL

Scope of majority-voting clauses in partnership agreements – BGH has specified a new review system

» **Who for:** Shareholders of partnership companies.

» **Issue:** In many articles of association/partnership agreements, the transfer of shares is made subject to a resolution approving the transfer being adopted by the shareholders' meeting, frequently without providing for a particular majority. This was also the situation in a case, from 21.10.2014, ruled on by the Federal Court of Justice (*Bundesgerichtshof*, BGH). With a simple majority, pursuant to a general majority-voting clause, a company had approved the transfer of shares. The claimant, who had been out-voted, believed that the resolution approving the transfer was invalid. He made reference to the so-called principle of clarity and definiteness, according to which a general majority-voting clause does not apply to subjects of resolutions that affect the basis of the company, or exceptional transactions. These types of resolutions can only be approved by unanimous shareholder resolution.

However, the BGH has now rejected this view and, in place of the principle of clarity and definiteness, has prescribed a two-phase review system.

- In the first phase, initially, the formal legitimacy of a majority decision has to be checked by interpreting the articles of association/partnership agreement, as to whether or not the majority-voting clause should cover the subject of the resolution. Here, the importance of the subject of the resolution does not play a role.
- After that, in the second phase, a check is carried out to determine whether or not the formally legitimate resolution would withstand a substantive review. Here, it is particularly important whether or not a major-

ity decision could be viewed as a breach of fiduciary duty towards the minority shareholders. This in turn depends on the individual circumstances and, in the case in question, was rejected.

» **Recommendation:** In order to avoid possible interpretation difficulties, the desired majority requirements for certain resolutions should be regulated as precisely as possible in the articles of association / partnership agreement. We would be pleased to provide support in this regard.

» **More Information:** The full text of the BGH ruling of 21.10.2014 (case reference: II ZR 84/13) is available at www.bundesgerichtshof.de (German version only).

Profit transfers – Time limits for the extended liability of a controlling company with respect to the provision of security

» **Who for:** Companies with control and profit transfer agreements.

» **Issue:** The Federal Court of Justice (*Bundesgerichtshof*, BGH) recently ruled on a case where the defendant ("D") was a controlling company within the scope of a control and profit transfer agreement ("PTA") with S GmbH ("S"), a German limited company. After the termination of the "PTA", claimant (C), who had leased a commercial property for a period of 15 years to "S", the dependent company, asked "D" to provide security for the lease payments for a period of six years from the date when the termination of the "PTA" is recorded in the commercial register. However, "B" merely provided a collateral undertaking (personal guarantee) for a period of five years after the date when the cancellation was recorded.

In this respect, the BGH decided that the claim of the dependent company's ("S") creditor for the provision of security for obligations, which had been established before the publication of the entry about the termination of the "PTA" but which were only due thereafter, was limited in accordance with the (general) rules on the extended liability for claims that become due after a period of five years subsequent to the registration. This legal concept for providing security stems from the German Stock Corporation Act (*Aktiengesetz*, "AktG") and is also applicable to a GmbH when it is a dependent company. However, the provision in Section 303 of the "AktG" has a regulatory loophole with respect to continuous obligations, whereby there is a risk of continuous liability for the controlling company after the termination of the "PTA". The unintentional regulatory loophole should be closed up by means of interpretation. A period of time that is in accordance with the security needs of the creditor is less appropriate in view of the indeterminancy and the risk of continuous liability, which is why the loophole has to be closed in accordance with the general liability rules (Sections 26,160 of the German Commercial Code, Section 327(4) of the "AktG").

» **Recommendation:** The termination of a "PTA" should be recorded in the commercial register immediately, if possible, in order to limit liability for continuous obligations that have already been established but are not yet due (e. g. rent, pension obligations, etc.).

» **More Information:** The full text of the BGH ruling of 7.10.2014 (case reference: II ZR 361/13) is available at http://juris.bundesgerichtshof.de.

CORPORATE FINANCE

Company valuations for SMEs – Waving goodbye to transferable earnings potential?

» **Who for:** Companies or business owners needing a business valuation.

» **Issue:** When valuing small and medium-sized companies (SMEs), usually, you have to pay attention to some particularities. The characteristic features of SMEs are, in particular, the following:

- management is, to a large extent, dependent on the shareholders;
- the business and private spheres overlap;
- contracts with family members not drawn up on an arm's length basis;
- financing options are restricted on account of a lack of access to capital markets;

- the information value of the financial statements is limited (e.g. frequently there are no audited accounts, or cash flow statements);
- there is no business planning, or it is poorly documented.

In this respect, the Institute of Public Auditors in Germany (Institut der Wirtschaftsprüfer, IDW) and the German Federal Chamber of Tax Consultants (*Bundessteuerberaterkammer*, BStBK) have expressed their views, in identical publications (hereafter referred to as "the Guide"), on the possible ways of dealing with the particularities of SMEs within the scope of a company valuation. This is examined in the publications, after a description of the baseline situation, with particular regard to the core aspect of transferable earnings potential and is followed by a discussion of earnings power determined by the purchaser as well as a brief overview of other important points.

(1) Baseline situation – According to the IDW standard S1, a company valuation that is based on an expert opinion is, in practice, usually derived from the present value of future financial surpluses. The IDW and the BStBK are of the opinion that IDW S1 should be used for the valuation of SMEs. The Guide is not supposed to introduce any additional requirements, or exemptions from valuation.

(2) Transferable earnings power – A key point in the guide is the calculation of transferable earnings power and the potential requisite "erosion" of future earnings potential. This involves making an assessment of whether or not a new owner would also be able to generate the financial surpluses that the company had generated in the past and whether or not the surpluses are dependent, to a significant degree, on the personal knowledge, capabilities and relationships of the current owner. Transferable earnings power is largely affected by factors that determine value, such as technical knowledge, innovative capacity or the relationships with customers and suppliers. In SMEs, it is not uncommon for these factors to be influenced by the personality of the business owner. Over the course of time, this influence and its impact on the earnings power wanes. That is why it is necessary to eliminate all personal influence on the financial surpluses, or to erode those financial surpluses that could be transferred only temporarily (possibly by extending the detailed planning phase).

(3) Earnings power determined by the purchaser – Insofar as the purchaser, on the basis of his/her knowledge, manpower and contacts, would be responsible for the realisation of future surpluses then s/he would not pay for this within the scope of the acquisition of the business.

(4) Other important points in the Guide are:

- An analysis of the past should not be for the purpose of providing projections of future developments by extrapolating from past results.
- If documentation for an integrated financial projection is missing, or is inadequate then this could not only give rise to gaps in the projection but also contradictions.
- When determining the discount rate for taking into account specific SME risks, general premiums (e.g. insufficient investor diversification, lack of fungibility of the shares) would not be acceptable.
- When delimiting the boundaries of the object to be valued, it is necessary to determine if and to what extent the company's expenses and income are business related and have been included in the calculation of the financial surpluses (i.e. no business-related expenses have been shifted to the private level). For example, such expenses could be incurred by the business owner or his/her family (e.g. salary expenses for family members who are employees). It is important to pay attention to assets and debts that are solely, or also partially for private use (e.g. a company car, shareholder loan).
- Clarification of the use of simplified valuation methods, such as e.g. models based on multiples. These provide a basis for performing plausibility checks on the results of the valuation, however, they cannot be used as a substitute for an overall valuation of a company.

» **Recommendation:** For the valuation of SMEs, it is advisable to perform the company valuation in accordance with IDW S1 and also to take into consideration the Guide, at least, as a supplement to simplified methods. For support in this area please do not hesitate to contact your PKF team.

IN BRIEF

No more provisional assessments for childcare costs

As the Federal Constitutional Court did not accept, for adjudication, an appeal on a constitutional issue against a Federal Fiscal Court ruling on restrictions to the deductibility of childcare costs, the Federal Ministry of Finance, in a circular from 11.12.2014, cancelled the notices of provisional status for this issue. Therefore, income tax assessment notices pertaining to this issue are no longer provisional.

Liability for damages for a shareholder in a GbR (company / partnership under German civil law) in the case of anti-competitive statements

The Frankfurt / Main court of appeals (*Oberlandesgericht*, OLG) in a (partial) ruling from 11.9.2014 (case reference 6 U 107/13) decided that a claim for damages against a GbR shareholder on account of statements made that were anti-competitive for the company does not require an own action by the shareholder. A shareholder is liable with his private assets for contractual as well as (in this case) statutory obligations of the company. Moreover, the court affirmed the right of access to information against the shareholder.

Reactions to the ruling on inheritance tax by the Federal Constitutional Court ("BVerfG")

Specialist essays, published since the "BVerfG" ruling from 17.12.2014, highlight the fact that now a degree of legal certainty has been achieved as not the entire Inheritance Tax Act is inconsistent with the constitution but only parts of it. However, it appears that the economic needs test that was stipulated by the "BVerfG" for exemptions for large companies will become a key problem for the reform and a type of inheritance tax legislation with two classes could develop.

AND FINALLY…

"You cannot teach a man anything. You can only help him to discover it within himself."

Galileo Galilei (1564 – 1642)

Impressum

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