

## Editorial

Dear Readers,

The notion of **Corporate Social Responsibility (CSR)** and sustainability – buzzwords that have increasingly been the focus of attention in recent times – addresses the issue that companies have a commitment not just to themselves but they also bear a responsibility to society. The new statutory requirements in this respect, at first glance, oblige only large capital market-oriented companies to provide sustainability reports. However, these companies will only be able to produce reports if they demand CSR-compliant conduct from the upstream and downstream enterprises in their value chain. In the ‚Focus‘ section you can read about which reporting requirements will therefore indirectly also lie ahead for medium-sized companies in the near term.

The Federal Ministry of Finance has, at last, dealt with the new ruling from the ECJ and from the Federal Fiscal Court on the **VAT groups of partnerships and input tax deduction by holding companies**. In the first report in the ‚Tax‘ section, you can find out whether or not there is now indeed greater clarity (or understanding) on the part of the tax authority. We know that currency fluctuations can have a significant effect on the **valuation of liabilities**; in this respect, the second article discusses the hurdles to the **tax recognition of an increase in value**. The third contribution could also be described as the curse of the good deed – many **gifts** breach the limit on tax deductibility because the flat-rate tax that has been paid on behalf of the recipients qualifies as a further gift and, consequently, a subsequent tax declaration is required.

Our ‚Accounting‘ section focuses on the recognition and measurement of **internally generated intangible assets** with a look at some of the basic issues. This is the first in a four-part series of articles. Other compelling topics will follow, such as, the treatment of customising costs, accounting for apps as well as the relaunch of brands. **Company valuations** that incorporate **extra financials** such as, e.g. CSR, are becoming more and more important. Under ‚Corporate Finance‘ you can read about which factors are included here, besides CSR, and what impact they could have within the framework of determining a company’s value.

Following this double issue, the next newsletter will appear at the beginning of September. Until then we hope you have a lovely summer and a relaxing holiday but – before you go – a stimulating read.

Your Team at  
PKF

## Contents

### » FOCUS



- » CSR reporting requirements will affect medium-sized companies, too

### » TAX

- » VAT groups – Strict conditions are the Federal Ministry of Finance’s response to the latest court ruling
- » The conditions for write-ups in the case of foreign currency loans
- » Caution with respect to corporate gifts – The deduction ceiling also includes the flat-rate tax that is paid on behalf of the customer

### » ACCOUNTING

- » Internally generated non-current intangible assets – Part 1 – Basic principles of recognition and measurement

### » CORPORATE FINANCE

- » Extra financials in company valuations - Which ones should be taken into account and how?

### » IN BRIEF

- » Increase in the limit for low-cost assets from € 410 to € 800 (net) as of 1.1.2018

## FOCUS

## CSR reporting requirements will affect medium-sized enterprises, too

**CSR stands for Corporate Social Responsibility, thus a corporation's initiatives to take responsibility for the company's effects on our society. From 2017 on, certain capital market-oriented companies will have to prepare a sustainability report. These reporting requirements will also have a ripple effect on considerably smaller medium-sized enterprises.**

### 1. Significance of sustainability reports

Under the new law, large capital market-oriented companies with more than 500 employees will have to include a non-financial statement in their management report in which they will have to give an account of the consequences of their commercial activities. The aim of this requirement is to respond to the fact that, these days, businesses are no longer assessed solely on the basis of their financial data. So-called non-financial information on topics such as respect for human rights, environmental or social matters form an increasingly important part of corporate communications.

Investors, enterprises and consumers have to decide whether or not they wish to invest, enter into a supplier relationship, or purchase products from an enterprise and so they expect more and better information about the business activities of companies. This development can also be attributed to the growing media coverage of the working and living conditions in third countries that has led to greater awareness of non-financial matters.

» **Please note:** As a consequence of the worldwide business relationships of German companies, products are frequently processed in many different countries where a wide range of legal, social and ecological specifications and standards are applicable.

### 2. Non-financial aspects in CSR reports

The reports should start with a short description of the company's business model. Furthermore, the following non-financial aspects, should at least be addressed (Section 289c of the German Commercial Code, as amended):

- environmental matters – e.g. greenhouse gas emissions,

water consumption, air pollution, use of renewable and non-renewable energies, or protection of biodiversity;

- employee matters – e.g. measures that have been taken to ensure gender equality, working conditions to respect the rights of employees as well as unions, health and safety at work;
- social matters – e.g. a dialogue at regional level, or measures to protect and to develop local communities;
- respect for human rights - e.g. preventing violations of human rights;
- combating corruption and bribery – e.g. the instruments that exist for combating corruption and bribery.

### 3. Mandatory disclosures of non-financial aspects

Information has to be disclosed that is required to understand business performance and results, the situation of the company as well as the impact of its business activities on the non-financial aspects. This includes the following information:

- a description of the strategies that the company pursues, the results of these and the due diligence processes that are applied;
- information on the main risks that are related to own business activities as well as to the business relationships and the company's products and services and that are very likely to have a severe negative impact on the non-financial aspects, as well as how these risks are handled;
- information on non-financial performance indicators that are important for business activities;
- information and explanations about the amounts disclosed in the annual financial statement if this is necessary to ensure understanding.

» **Please note:** If a company does not pursue any strategy with respect to ecological, social and ethical aspects then there has to be a clear and well-founded explanation (so-called principle of "comply or explain").

### 4. CSR reports starting from the 2017 financial year

CSR reporting requirements for companies with financial

years aligned with the calendar year will have to be taken into account for the first time for the 2017 financial year. The sustainability report can be presented as an addition to the management report. Alternatively, it is possible to prepare a separate non-financial report outside the framework of the management report. A separate non-financial report can be published either together with the management report in the German Federal Gazette (*Bundesanzeiger*), or on the company's website provided that a reference is made to it in the management report. The requirements shall similarly apply to group reports.

## 5. Ripple effect on medium-sized enterprises

Companies that are directly affected by the CSR reporting requirements also have to report on the situation of their suppliers in respect of sustainability. In practice, this will probably mean that, in the future, small and medium-sized enterprises that have been integrated into the supply chains of large companies will also be confronted with CSR demands without actually themselves being subject to CSR reporting requirements. For this reason, in future, all enterprises that maintain business relations, directly or indirectly, via supply chains with large capital market-oriented companies will de facto have to produce CSR reports. Furthermore, extending the management report in order to include sustainability aspects will have a ripple effect on the larger medium-sized companies. Very soon, for all companies, a good management report will probably also include sustainability aspects.



The new reporting requirements go far beyond environmental matters

## TAX

### VAT groups – Strict conditions as Federal Ministry of Finance's response to the new court ruling

» **Who for:** Holding companies and groups with partnerships.

» **Issue:** In 2015 and 2016, in all aspects of the proceedings of "Larentia + Minerva as well as Marenave", the ECJ and the Federal Fiscal Court (*Bundesfinanzhof, BFH*) ruled on various issues relating to VAT groups and input tax deduction at management holding companies (for the ECJ ruling cf. issue 9/2015 of the PKF Newsletter). In a circular from 26.5.2017, the Federal Ministry of Finance (*Bundesministerium der Finanzen, BMF*) made selective revisions to the VAT application decree (*Umsatzsteuer-Anwendungsersatz*). In the following section you will find an overview of the most important changes.

#### 1. Partnerships as subsidiary companies

The tax authority is indeed implementing the rulings and will permit partnerships to be subsidiary companies. However, by adding the wording "in exceptional cases" it is clear that a (too?) narrow framework has been established of what constitutes integration and, therefore, a VAT group.

**(1) Financial integration** – The prerequisite is "integration with rights of intervention". Financial integration is deemed to exist if the equity stake is above 50 % and if voting rights are proportionate with the size of the shareholding. It is the view of the BMF that no importance should be attached to voting trust agreements or proxy voting powers. These can only be taken into consideration if they ensue from the articles of association, for example, as in the case of granting multiple voting rights.

» **Please note:** In the case of partnerships, financial integration implies that all the shareholders (100 %) are financially integrated into the business of the group's parent company.

**(2) Organisational integration** – The parent company has to control the subsidiary company through the way it manages the subsidiary and it has to be able to enforce its will. If a domination agreement has been recorded in the commercial register then organisational integration will always be deemed to exist.

## 2. Insolvency during VAT grouping

A VAT group shall cease to exist upon the opening of insolvency proceedings pertaining to the assets of the parent company or the subsidiary company. This shall also apply to the appointment of a trustee within the scope of self-administration, or of a provisional insolvency administrator.

## 3. Input tax deduction at the holding company

The ECJ permits full input tax deduction in the case of a management holding company. A management holding is understood to be a holding company that engages in business activities because it provides administrative, financial, commercial or technical services in return for payment. In the case of so-called mixed holding companies, which partially only hold shares in other companies, the ECJ considers it to be necessary to apportion the input tax.

» **Please note:** In this respect, the BMF circular is unsatisfactory in terms of the rulings and does not provide greater clarity. Only one clause has been amended that explains when an input tax deduction is not possible but without adopting a view here on the criteria for allocating the input tax.

## 4. Application principles

The changes relating to VAT groups with partnerships will have to be applied for the first time to transactions executed after 31.12.2018. There will be no objection to an earlier application of the rules if the parties involved in a VAT group unanimously invoke the rules in this circular. The other changes should be applied to all open cases.

» **Recommendation:** Businesses for whom advantages ensue from the ECJ ruling as a consequence of the existence of a VAT group should keep notices of VAT assessment open. This is likewise advisable if the input tax deduction is not allowed at a holding company that does not clearly and exclusively carry out investment activity.

» **More Information:** The BMF circular from 26.5.2017 can be downloaded at [www.bundesfinanzministerium.de](http://www.bundesfinanzministerium.de). (German version only).

## The conditions for write-ups in the case of foreign currency loans

» **Who for:** Businesses with foreign currency loans whose rate of exchange has deteriorated (e.g. Swiss franc).

» **Issue:** According to Section 6 of the German Income Tax Act (*Einkommenssteuergesetz*, “EStG”), if a permanent impairment in value can be presumed for fixed and current assets then, for tax purposes, they can be written down to a lower fair value, at the balance sheet date, thus reducing the taxable profit. On the liability side, it is similarly possible to record a charge in the case of foreign currency liabilities if there has been a permanent deterioration in the exchange rate. In such cases this is referred to as a write-up to fair value.

Within respect to this issue, the Baden-Wuerttemberg tax court made an interesting decision in its ruling from 8.3.2016. According to this, a permanent change in value can be presumed for a foreign currency loan if the fluctuation in the exchange rate exceeds a limit of 20 % for the

specific balance sheet date, or 10 % for two consecutive balance sheet dates. By contrast, lower percentage thresholds are not sufficient given that the Federal Fiscal Court (*Bundesfinanzhof*, BFH) does not apply a 5 % limit for stock market-listed shares in the case of foreign currency liabilities.

However, according to the tax court, regular exchange rate fluctuations on the currency markets would not yet allow for a higher valuation of the liability. Moreover, changes to the exchange rate that go above

and beyond that should not be taken into account if the loan has a residual time to maturity of approx. 10 years because it could be presumed that, over this period, the currency fluctuations could basically balance each other out. However, if no specific loan term is agreed (as in the case in question) and, moreover, if an imminent cancellation of a loan of indefinite duration cannot seriously be expected then permanent changes in the exchange rate



Write-ups due to exchange rate fluctuations?

would have to have an impact on the valuation of the foreign currency loan.

» **More Information:** The ruling from 8.3.2016 (case reference: 2 V 2763/15) is available online [www.fg-baden-wuerttemberg.de](http://www.fg-baden-wuerttemberg.de) under “*Entscheidungen*“ (rulings) (German version only).

### Caution with respect to corporate gifts – Deduction ceiling also includes the flat-rate tax that is paid on behalf of the customer

» **Who for:** Businesses that give their business partners gifts.

» **Issue:** Gifts from companies to business partners and customers can only be taken into account as tax-deductible business costs if their value per each recipient



Gifts are often bigger than they appear to be

and financial year does not exceed € 35. In order for the gift not to be treated as taxable income for the recipients many companies assume the payment of the 30 % flat-rate tax. According to a recent Federal Fiscal Court (*Bundesfinanzhof*, BFH) ruling, from 30.3.2017, the value of the gift including the flat-rate tax that has been assumed is the relevant amount for the assessment of the € 35 limit.

In the case in question, the claimant, who was a concert organiser, had given out free tickets to business partners and had assumed the 30 % flat-rate tax. The local tax office and the tax court had refused to recognise the business expense deduction made by the claimant. The BFH ruled in favour of the local tax office and the tax court. In the opinion of the Munich judges, by assuming the tax payment the business makes a further gift to the recipient. According to section 4(5) clause 1 no.1 of the German Income Tax Act (*Einkommenssteuergesetz*,

“EStG”), the tax-exempt limit also includes the tax payment that has been assumed. A gift – in the case in question a free ticket – and tax are connected in such a way that they have to be considered together. The upshot is that this implies that companies will be disallowed from making a business expense deduction for a gift and the tax that has been on behalf of the recipient if the value of the gift alone or together with the value of the tax that has been assumed for each recipient and financial year exceeds € 35.

» **Recommendation:** In the context of this BFH ruling, in all cases that are not yet binding you should, once again, check the business expense deduction that has been made for gifts together with the flat-rate tax that was paid and, if necessary, correct the tax return in accordance with Section 153 of the (German) Fiscal Code. For future corporate gifts, a precise calculation of the value should be made in advance with regard to the € 35 limit.

» **More Information:** The BFH ruling from 30.3.2017 (case reference: IV R 13/14) is available at [www.bundesfinanzhof.de](http://www.bundesfinanzhof.de) (German version only).

## ACCOUNTING

### Internally generated non-current intangible assets – Part 1 – Basic principles of recognition and measurement

**For a long time now, intangible assets, when compared with tangible assets, have been increasingly gaining in importance. However, financial reporting is still traditionally oriented towards the classic production processes for material goods. That is why we are going to delve into selected aspects of accounting for internally generated non-current intangible assets in terms of the reason (recognition) and the amount (measurement). In the current newsletter, we discuss the basic principles according to the German Commercial Code (*Handelsgesetzbuch*, HGB). In the subsequent issues of the PKF newsletter, a discussion of the treatment of customising costs, accounting for apps and the relaunch of brands will follow.**

#### 1. Definition of terms

An asset is deemed to be “internally generated” not only when the entire value chain is within the enterprise that

prepares the accounts. What matters is that the enterprise bears the responsibility and the risk for the construction and completion. Under these conditions, a third party can also be commissioned with the construction within the scope of a service contract. Conversely, if a third party has produced an asset at its own risk (via a contract for work and services) then this is assumed to be an acquired intangible asset. This issue is not considered further in the following section.

## 2. Accounting for the reason (recognition)

While it is mandatory to include material assets and acquired intangible assets in the balance sheet, under Section 248(2) of the HGB, there is an option to recognise internally generated intangible assets. If this option is exercised and the assets are recognised then a non-distributable and non-transferable reserve has to be created in the amount that has been recognised. If, in the subsequent period, the intangible asset is amortised or sold then the reserve is reduced accordingly or becomes completely unnecessary. The option to recognise expressly excludes brands, mastheads, publishing rights, customer lists and similar assets. There is a statutory prohibition on the recognition of these internally generated intangible assets.

» **Please note:** Recognising internally generated non-current intangible assets in the tax accounts is prohibited. In the event of recognition under German commercial law there is a requirement to recognise deferred taxes.

## 3. Accounting for the amount (measurement)

Production costs also constitute the statutory measurement benchmark for internally generated non-current intangible assets. According to Section 255(2a) of the HGB, these include development costs but expressly not the non-specific research costs of development, which are usually incurred at an early stage.

Accordingly, the **initial measurement** is performed as per Section 253 of the HGB in proportion to these development costs. If it is not possible to separate research costs and development costs from each other in a reliable way then there is a prohibition on recognition for both. Nevertheless, in practice, a certain amount of discretionary leeway usually remains here.

With respect to the measurement in subsequent years (subsequent measurement), there is generally no distinction between internally generated intangible assets and other assets.

» **Recommendation:** When calculating the production costs for internally generated intangible assets you should try to ensure that there is good documentation of the boundaries between research and development.

» **More Information:** The accounting rules outlined above are not applicable to goodwill – there are special rules for that. With respect to the issue of unscheduled amortisation, frequently, the valuation for the recognition of intangible assets constitutes a particular challenge. Current assets classified as ‘held for sale’ will not be covered in the course of this four-part series (for the thematic focal points please see above on p. 5).

# CORPORATE FINANCE

## Extra financials in company valuations – Which ones should be taken into account and how?

**The term extra financials refers to the economic effects that, within the framework of a company valuation, have no direct impact on the data relevant to the valuation, nevertheless, they could have an immediate or delayed effect. Typically, it is difficult to accommodate these effects in commonly used valuation models and, frequently, they are underestimated even though they could strongly affect a company’s value. In practice, there is frequently a lack of a systematic approach that enables the depiction of the extra financials. In the following section we present the most important categories of extra financials and we describe how technical implementation could be possible despite the difficulties involved in accommodating these factors in valuation models.**

### 1. Categories of extra financials

**(1) Ecological sustainability** – Ecological activities are often associated with high costs that customers are not usually willing to bear. Nevertheless, a value enhancing effect results when a product then generates positive cash flows, or positive side effects occur e.g. in the case of investors, customers and suppliers.

**(2) Corporate governance** – The aim of good corporate governance is the management of a company in compliance with standards that are in the interests of all the shareholders. Taking these extra financials (especially

the aspects of management remuneration, succession planning and supervisory board independence) into consideration is particularly important if the ownership and management of the enterprise are closely linked. Poor corporate governance can have a very negative impact on the value of an enterprise.

**(3) Business culture** – Depending on the business model of a company, there are various perspectives that are meaningful, such as, e.g. innovation-driven, formalistic, or service-driven cultures. However, in all of these, high levels of employee satisfaction usually have a positive effect on enterprise value, at least if customer satisfaction also increases through this. An indicator here could be, e.g. the levels of spending on human resource development – the lower these are, the more likely it is that this could lead to lower levels of employee satisfaction.

**(4) Corporate Social Responsibility (CSR)** – The way that activities in the CSR area are organised is very important. This was demonstrated in a study by Barnett/Salomon, in 2012, where the return on capital and CSR ratings of companies were analysed in relation to each other. The result was that successful enterprises had either a high or a low CSR rating. Enterprises with a moderate CSR rating were less successful. With lower levels of CSR activity problems could arise with society or investors and, thus, with the (still) good returns.

» **Please note:** Within the framework of a company valuation, where appropriate, the costs for enhancing the CSR rating should be priced in.

**(5) Corporate reputation** – The impact of reputation on the value of a company arises, firstly, in the case of so-called credence goods (goods where you have to be able to be confident about the quality in advance through, for example, brand strength) as well as experience goods (goods where the quality can be ascertained only through the experience). Reputation has little significance, within the framework of a company valuation, in the case of so-called search goods where, for the most part, customers can check the quality in advance (e.g. clothing, shoes, etc.).

» **Please note:** A high proportion of recurring revenues from loyal customers underscores the reputation and, therefore, this can have an effect on corporate performance.

## 2. When valuing a company, you should take into account:

**(1) the expected values (amounts) for cash flows** – In some cases, it is easy to identify the effects on the payments side that arise from the presence or absence of extra financials and it is possible to derive a direct presentation of the expected values within the framework of

the cash flow plan. In more complicated cases, scenario techniques are the most frequently used means. Thus, for example, it would be possible to present the effects on the results side of a decreasing allocation of resources for CSR activities by comparing alternative scenarios with the original plan. Moreover, within the framework of the cash flow forecast, it would be possible to take the scenarios into account with weightings as to their probability of occurrence.

**(2) The risk to the cash flows** – Taking the effects into account in the cost of capital could entail enormous difficulties; even for stock market-listed companies with known market values the effects of extra financials on the cost of capital can scarcely be measured reliably. Frequently, the only option that remains is a general directional adjustment to the cost of capital, on a case-by-case basis, in

order to take into account the risk from extra financials.

**(3) Asymmetrical effects** – In some cases, it should be assumed that the effects would be asymmetrical. For example, reputational damage could be expected to have a major effect on a company's value, while no comparable value-enhancing effects result from a good reputation. Within the framework of a company valuation, the technically easiest way for this imbalance to be taken into account is within the scope of determining the cost of capital. In order to model the additional risk so-called "relevering" can be used to determine the increase in the cost of capital – this is comparable to the approach used for companies with different levels of debt.



Cash flow from extra financials such as, e.g., ecological sustainability

### 3. Summary

Properly taking into account extra financials within the framework of a company valuation poses a particular challenge for the evaluator. Generally, in the practice of valuation, various techniques are still being tested and continuously developed.

» **Recommendation:** In any event, prior to a company valuation, there should already be an analysis with respect to which of the categories described above could have an impact on the value of the company. If any effects are detected then they should be examined in detail.

## IN BRIEF

### Increase in the limit for low-cost assets from € 410 to € 800 (net) as of 1.1.2018

The threshold for the immediate write-off of low-cost assets will be raised from € 410 to € 800 (net value) as

of 1.1.2018. This will affect non-current movable assets that can be used on a stand-alone basis. In the year in which they are acquired, it will be possible to offset these in full against tax as expenses, or depreciate them over the normal period of their useful life. This option can be exercised individually for each asset.

» **Please note:** Besides the immediate write-off, assets with a cost of acquisition or production of between € 250 (increased value limit as of 1.1.2018) and € 1,000 can still be grouped into a compound item (pool) and evenly amortised/depreciated over a period of 5 years. The group amortisation/depreciation option has to be uniformly applied for each financial year.

## AND FINALLY...

„The *Mittelstand* [German medium-sized companies], in a special way, embodies the commitment to performance, diligence and social responsibility that goes beyond the present day.“

**Dr Helmut Kohl, 3.4.1930 – 16.6.2017, German politician and Federal Chancellor from 1982 – 1998**

### Impressum

**PKF Deutschland GmbH** Wirtschaftsprüfungsgesellschaft

Jungfernstieg 7 | 20354 Hamburg | Tel. +49 40 35552-0 | Fax +49 (0) 40 355 52-222 | [www.pkf.de](http://www.pkf.de)

Please send any enquiries and comments to: [pkf-nachrichten@pkf.de](mailto:pkf-nachrichten@pkf.de)

The contents of the PKF\* Newsletter do not purport to be a full statement on any given problem nor should they be relied upon as a substitute for seeking tax and other professional advice on the particularities of individual cases. Moreover, while every care is taken to ensure that the contents of the PKF Newsletter reflect the current legal status, please note, however, that changes to the law, to case law or administration opinions can always occur at short notice. Thus it is always recommended that you should seek personal advice before you undertake or refrain from any measures.

\* PKF Deutschland GmbH is a member firm of the PKF International Limited network and, in Germany, a member of a network of auditors in accordance with Section 319b HGB (German Commercial Code). The network consists of legally independent member firms. PKF Deutschland GmbH accepts no responsibility or liability for any action or inaction on the part of other individual member firms. For disclosure of information pursuant to regulations on information requirements for services see [www.pkf.de](http://www.pkf.de).