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# Working Group on External Financial Reporting of the Schmalenbach-Gesellschaft-Deutsche Gesellschaft für Betriebswirtschaft

Jörg Baetge, Helmut Berndt, Hans-Georg Bruns, Walter Busse von Colbe, Adolf Gerhard Coenenberg, Helmut Korst, Herbert Lederle, Albrecht Metze, Dieter Ordelheide, Hans-Dieter Pfingsten, Herbert Reinhard, Christian Schnicke, Jürgen Schwitters, Thomas Seeberg, Günther Siepe, Peter Urban, Hans Weber, Albert Weismüller, and Klaus v. Wysocki

# German Accounting Principles: An Institutionalized Framework

The Working Group on External Financial Reporting ("Externe Unternehmensrechnung") of the "Schmalenbach-Gesellschaft—Deutsche Gesellschaft für Betriebswirtschaft" developed the following position paper concerning German Accounting Principles which apply mainly to limited liability companies. The paper attempts to facilitate a better understanding of the meaning of German Accounting Principles in other countries and at the same time to contribute to the international harmonization of financial reporting.

Harmonization has to take the socio-economic conditions of the individual countries into account. The accounting principles have evolved in Germany over centuries and their meaning has changed according to the changing environment they operate in. The growing internationalisation of accounting, resulting from capital market developments, has induced necessary adaptations of the principles.

The "Schmalenbach-Gesellschaft" is the leading scientific society in the area of business administration in Germany. In numerous working groups an active discourse between theory and practice is cultivated in order to develop solutions for common problems. The Working group on External Financial Reporting was set up in 1978 and consists of practitioners, auditors and academics. It has published accounting recommendations, some of them together with other organizations. These recommendations have a significant influence on business practice.

The International Accounting Standards Committee (IASC) is pursuing the worldwide acceptance and introduction of its International Accounting Standards (IAS). These standards are largely based on Anglo-Saxon principles of accounting, which give priority to the matching of revenues and expenses, as compared to the continental European principle of conservatism.

The IASC and the International Organization of Securities Commissions (IOSCO) agreed, that IOSCO will use its influence to encourage the usage of the IAS. Discussion papers relating to accounting issues, such as

A comprehensive list of publications concerning German Accounting (in English) is available upon request from Prof. Dr. Dieter Ordelheide, J. W. Goethe-Universität, Postfach 111932, 60054 Frankfurt am Main, Germany.

foreign currency translation, accounting for leases and accounting for subsidies and grants, which have been presented by the Accounting Advisory Forum of the EU-Commission, are largely based on the IASC standards. There is concern in Germany and other member states of the EU that this apparent international trend to weaken the principle of conservatism in accounting will lead to a different interpretation, or a revision, of the 4th and 7th EC Directives.

The international criticism of German accounting principles usually not only misjudges their substance and their effect (e.g. on the capital market), but also gives little consideration to the framework under which these principles were developed, and have operated in practice for a long period of time. With this paper the Working Group on External Financial Reporting hopes to facilitate a better understanding of German accounting principles in the international accounting community.

## PRESENTATION OF FINANCIAL STATEMENTS AND THE SOCIO-ECONOMIC ENVIRONMENT

The guidelines used for determining the value and economic success of a corporation are a central element of every economic system and involve interdependencies with many other elements. A correct understanding of particular guidelines, and the underlying purpose of financial statements, is only possible if the socio-economic environment and its historical development are taken into consideration.

While the German accounting acts regulate the presentation of a large number of economic transactions in the financial statements, it is not intended, nor is it possible, to cover all theoretically conceivable situations through specific legal regulations. To the extent that there are no legal regulations in existence, the legislative body refers to the German version of accepted accounting principles (Grundsätze ordnungsmäßiger Buchführung or GoB). The GoB used in the presentation of accounts have been developed over time as a result of teachings, practice and administration of justice. While they may supplement written law, they do not replace it.

As far as legal considerations for the preparation of financial statements are concerned, the Commercial Code (Handelsgesetzbuch) plays an important role in Germany. In its current basic form, it has been in effect since January 1, 1900. However, it has been updated and adjusted several times. A major change resulted from the harmonization of accounting within the EU through the 4th and 7th EC Directives. In order to implement the EC directives, the Commercial Code was revised, effective from January 1, 1986. A major component of this reform concerned consolidated financial statements and required, among other changes, that consolidated financial statements on a worldwide basis be provided. Financial statements for German groups of companies have to be based on essentially the same accounting principles as the ones in effect for the individual companies on a stand-alone basis. This means that legal requirements in effect for individual companies are also applicable for consolidated financial statements. Specific issues with regard to consolidated financial statements are addressed later.

An important characteristic of German financial statements is the significance of the principle of creditor protection. This principle results in a complete presentation of all assets and liabilities and a conservative valuation that is cognizant of risks. This principle of protecting creditors appeared in the mid 19th century General German Commercial Code, as well as in the French Ordonnance de Commerce, from 1673, and in the Code de Commerce, dated 1807, which became the basis for the Commercial Code of many other nations. The principle of protecting creditors was included in the EC directives, as part of the compromise of the positions of individual nations. The German accounting regulations, which belong to the continental European accounting system, remain different from the Anglo-Saxon presentation of accounts in many aspects.

Another cornerstone of German Accounting is the longstanding principle that the treatment of transactions in the tax financial statements shall be consistent with that in the commercial balance sheet. Even though this principle is of primary importance for tax purposes, it also exerts influence on the commercial balance sheet. This occurs because an optimized tax strategy affects the commercial financial statements and the respective asset carrying values, thus emphasizing the principle of conservatism. One important reason for the close interrelationship between the commercial and tax statements is seen in the fact that most corporations required to prepare financial statements are small companies. The expenses involved in the preparation of financial statements are significantly reduced for those companies if they need to prepare only one set of financial statements.

The German financial statements—as stated above—serve the interests of the shareholders as well as those of the creditors and tax authorities. In addition, there is a responsibility to employees, government, society and the environment. Another peculiarity is that the regulations covering financial statements are not only valid for publicly traded and other corporations but also for companies operating under different legal forms and—as stated above—therefore even for small companies. With the introduction of the European accounting regulations, which are written for corporations (in Germany about 250,000), there are sometimes different regulations for corporations and for other companies, because for other companies the former German regulations prevail. The following comments address issues concerning incorporated companies, in Germany so called "AG's" or "GmbH's", since most large companies are established as corporations. It is important to recognize, that the majority of German corporations have only one or a few individuals as owners, who at the same time are involved in the management of the enterprise.

As for the importance of the various users of financial statements, and the background of their respective interests, specific national traits can be identified. When analyzing the make-up of shareholders and company structures of joint-stock corporations in Germany (about 2,700), it is noteworthy that individual small investors play only a minor role. This might be one of the main reasons why, for the majority of stockholders in German corporations, entrepreneurial issues are of major importance, and why there is a distinct appreciation for long-term strategies. A short-term profit orientation is not of major concern.

With regard to financing of German corporations it is significant that equity financing plays a relatively minor role. For instance, at the end of 1990 the equity element of the balance sheets of large corporations (excluding banks and insurance companies) accounted for only an average of 27 percent of total assets. It must be recognized, however, that this low level of equity is partially due to differing accounting standards and taxation practices, as well as differences in the presentation of accounts.

Of greater significance to German corporations than equity financing is the establishment of accrued and contingent liabilities and deferred credits. They represented in 1990 an average of 34 percent of the total of equity and liabilities. More than 40 percent thereof are for pensions, which being liabilities of the company have to be capitalized in the balance sheet. As a result, German companies have a direct responsibility for the retirement funds of their employees.

A third component is other liabilities, including long-term debt. They represented on average 35 percent of the balance sheet total in large corporations at the end of 1990. In addition to their significance for this kind of financing of corporations the importance of banks is based on the characteristics of the German banking system; that is to say the dominant role of the "universal" banks. In contrast to the speciality banks, which can be found in many countries, universal banks provide all banking services. Of the 4000 banks in Germany, more than 90 percent operate on a universal basis. A portion of the bank deposits are invested in extensive holdings in commercial and industrial corporations in various industries. As a result, bank representatives are members of the Supervisory Boards of large corporations. The role of the banks is further emphasized by proxy rights. As many individual investors have little interest in personally representing their interests at shareholders' meetings, they assign the proxies to one of the banks, which then represents them.

Summarizing these statements, two characteristics regarding the financing of German corporations should be noted:

1. The relative importance of accrued and contingent liabilities and deferred credits as financing instruments, as well as,
2. the importance of banks for the financing of corporations.

There are several consequences for the presentation of accounts based on the framework outlined above. Creditors are interested in ensuring that neither interest payments nor payments of principle are jeopardized by dividend payments. In Germany the distribution of profits is influenced by the conservative calculation of profits. The financial valuation regulations are written in such a way that unrealized income is neither recognized nor paid out as dividends. The idea of dividend payments only being made when this causes no risk to the company was established in the General German Commercial Code and specifically in the Corporate Supplementary Act of 1884. This should help to clarify why in Germany the computation of distributable income is perhaps more important than in other countries, where financing through creditors does not play such an important role, and where the banks' status is not as significant. In addition, the regulations only determine the maximum profit available for distribution. The actual distribution can vary based upon the usage and formation of reserves.

Another peculiarity of the German economic system is the comparatively large participation of employees and their representatives in the economic decision-making-process. This participation takes place at branch and corporate levels, as well as at the site and work-place level. As a result of large memberships, the influence of unions in politics, especially regarding economic and social policies, is noteworthy. In addition, employees participate in the decision-making process, particularly through representation on the Supervisory Board. Three laws (the Montan Participation Act of 1951, the Workers Participation Act of 1976 and the Labor Management Relations Act of 1952) form the basis for workers' participation in the corporations. For instance, up to 50 percent of Supervisory Board members are elected by the employees. This structure supports a conservative income calculation, in order to protect the financial viability of a company. So long as there are peculiarities in the socio-economic environment, national accounting standards will differ in order to better reflect these country-specific distinctions.

The socio-economic environment in Germany demands the preservation of capital. At the same time additional goals are pursued through financial statements, such as the protection of creditors, the protection of minority interests, taxation and information. Financial statements should balance the occasionally differing interests of the relevant parties. As a result, financial statements, from a German point of view, do not serve as a source of information for only one group, such as the shareholders. German financial statements are thus not presented with only the interests of this one group in mind.

## PRESERVATION OF CAPITAL IN GERMAN COMMERCIAL FINANCIAL STATEMENTS

As a basic principle it is assumed that a company exists for the long run. The idea of safeguarding the source of income generation (that is the company), on a long term basis, is reflected in the presentation of accounts. Preservation of capital is seen as primary for the safeguarding of a company.

In order to preserve the capital which is invested in a company only those profits which have been definitely realized can be distributed. If profits are distributed, which have been realized only due to temporary or uncertain increases in the value of assets, then the assets of a company will decline over time. The legal regulations covering the preservation of capital deal primarily with the valuation of assets and the determination of the annual result under consideration of the principle of conservative accounting. The principle of conservative accounting demands on the one hand, that liabilities are established for all risks and losses which can be anticipated, and on the other hand that income is recognized only when it can be determined as being sufficiently certain.

The principles used for determining profitability are based upon the assumption that it is sufficient if the nominal value of capital is preserved, since the issue of monetary stability has to be resolved by the economy as a whole. There are no specific regulations and computations in place for determining the preservation of the "real" (adjusted for the effects of inflation) capital. However, there are a number of regulations (e.g. inventory valuation based on last in, first out—LIFO) which are useful for safeguarding the real capital.

The principles used for the conservative valuation of assets and the determination of income can be illustrated using the following specific regulations:

- Historical acquisition/production costs represent the maximum value for capitalization. A revaluation to a higher value (e.g. based on higher replacement cost or market value) is not allowed for German companies.
- Intangible assets, which are generated by the company itself or acquired without payment, cannot be capitalized. This is designed to ensure that values, which are not objectively determinable (e.g. via purchase) or are generally uncertain, are not recorded in the balance sheet.
- Depreciable assets have to be amortized using a predetermined basis. The necessity to depreciate is valid even when the market value of the asset is higher than its acquisition cost (e.g. in the case of buildings).
- Current assets have to be valued using the lower of cost or market principle, determinable at year end, even if a diminution in value is only temporary.
- The possibility of using the LIFO-Valuation method in times of rising inventory prices. This prevents the realization and the taxation of non-existent profits.
- European and German Law include the mandate to establish accrued and contingent liabilities for uncertainties, for impending losses (e.g. from pending contracts), and for warranties (even where there is no legal obligation), and allow deferred credits for certain future expenses. The large portion of liabilities in German balance sheets is a result of the traditionally high sensitivity to the recognition of risks, and also because of the highly developed social and environmental regulations in Germany, which result in liabilities in those areas.
- The realization of sales and profits can only take place at the completion of a contract or for predetermined independent parts of a contract. Partial profit recognition, based upon the stage of completion (that is to say the percentage-of-completion method) is not permitted to be used for long term contract accounting. Contracts are capitalized in inventory and are valued at production cost. If there is a likelihood that a contract will generate a loss, then inventory must be devalued or a liability for this loss has to be established.

The requirement for conservative accounting, additional extraordinary depreciation and the establishment of accrued and contingent liabilities should not, however, be used arbitrarily to generate silent reserves. Even though the recording of smaller rather than larger profits serves the interests of creditors and the preservation of capital, a too strong emphasis on the principle of conservative accounting can put a burden on the owners of a company, especially the minority owners, for example, by witholding profit allocations, which are influenced by the year-end financial statements. Financial statements are therefore also used to protect minority interests. The reform of the Stock Corporation Act in 1965 focused on the protection of these minority interests. In order to assure an appropriate level of disclosed income, binding minimum values for fixed assets and inventories have been established. In addition, the formation of liabilities has been limited to the extent necessary for risk coverage. These guidelines have been put more precisely in the EC directives and the Commercial Code reform in 1985, and have been declared generally applicable for all companies. As a result, the disclosed income better approximates the economic substance of activity.

Without disputing the usefulness of conservative accounting, there are some regulations which appear to be overly conservative, and thus are open to criticism from an international perspective. For instance, inventories and self-produced fixed assets need only be valued at direct cost (material, labor, special direct costs of manufacturing). When considering the large content of overhead expenses, this approach appears no longer to be appropriate. We suggest manufacturing and material related overhead expenses be included in the production cost, as required by the tax regulations.

The Commercial Code requires the constistent application of valuation methods. This prevents changing to less conservative valuation methods, thus releasing silent reserves without this being apparent, and as a result reducing the transparency of the asset and capital structure. However, a consistency in recording items whose capitalization is not mandatory is not required by law. This benefits particularly the formation of deferred credits for future expenses without obligation. However, a change in accounting methods regarding capitalization and valuation has to be disclosed and explained in the notes to the financial statements.

Profits of a sole proprietorship can be distributed fully. A restriction regarding profit distribution exists for corporations relating to instances where amounts required for the establishment and expansion of business activities are deliberately capitalized in the balance sheet. The limitation on income distribution serves to preserve capital. Further restrictions exist to the extent that legal reserves have not been established to the required extent, or if the company's by-laws require additional contributions to the reserves. Decisions regarding income distribution are not just decisions of management in Germany. Shareholders are entitled to 50 percent of the disclosed profits (according to paragraph 58 of the Stock Corporations Act). This shareholders' entitlement goes some way to explaining the cautious determination of profit, as it encourages management to ensure that distributable profits have been really earned and thus can be paid out.

## PROTECTION OF CREDITORS

From a historical perspective, the oldest established objective in financial statement preparation, which is also reflected in the EC directives, is the protection of creditors, especially from fraudulent bankruptcy. In the interest of creditor protection a complete presentation of all assets and liabilities and a conservative valuation are needed.

The importance of the protection of creditors is partially based upon the fact that bank loans represent a very important financing instrument for German companies. The evidence of credit worthiness demonstrated by the year-end financial statements is of the utmost importance for the financing opportunities of a company. German banks are required by law to verify credit worthiness based on year-end financial statements when issuing large loans.

The protection of creditors is closely related to the preservation of capital. Both supplement each other. They are two sides of the same coin. Both aim at the safeguarding of the company against the uncontrolled removal of assets by the owner.

## TAXATION

In Germany, taxation is generally based on the tax statements of individual legal entities. However, these tax statements are closely related to commercial financial statements because of the principle that the treatment followed for the commercial balance sheet shall also be adopted for tax purposes. This principle, which is designed to assure that taxation is based upon a business relevant income determination, requires that commercial guidelines for financial statements are applied to the taxable income calculation, that is capitalization and valuation. The legislative body has incorporated this linkage between commercial and tax reporting, and exceptions are only allowed in a few instances. This furthers the curtailment of profit disclosure which is required by the principle of protection of creditors and preservation of capital.

Valuations which are lower for tax purposes than for commercial purposes can also be used in the commercial financial statements (paragraph 254, Commercial Code). In fact, the tax authority even requires the usage of the tax values, as the acceptability for taxes usually only takes place when the valuation is also used in the commercial balance sheet. This reversed interdependency leads to the formation of special fiscal reserves or supplemental tax-based depreciation in the commercial balance sheet resulting in less taxable income. Through the resultant tax deferral, this generates an interest and liquidity advantage for the corporation. In the year when supplemental depreciation is recorded, the disclosed income is reduced. Correspondingly, in later years, an increased income is disclosed. These balance sheet items represent "alien elements" in the commercial balance sheet, and their impact on assets and capital has to be explained in the notes to the financial statements, unless they are shown as special fiscal reserves, which is normally the case.

This interdependency between commercial accounting and tax accounting is not mandated for consolidated financial statement purposes. However, as part of preparing the consolidation, there is also no mandate to correct the valuations in the individual financial statements which are based on tax regulations. If a correction takes place at the consolidated level, there is no impact on taxes.

This mandated interdependency between commercial accounting and tax accounting cannot be substantiated on the basis of the preservation of capital and the protection of creditors. This interdependency limits the informational content of the financial statements and should thus, as a requirement from the tax perspective, be abandoned.

## WORLDWIDE CONSOLIDATED FINANCIAL STATEMENTS AS A SOURCE OF INFORMATION

In line with the internationalization of economic ties and integration of the European economies, different requirements for German financial statements have become apparent. These requirements are the result of the increased importance of investor relations (especially for internationally active publicly traded corporations) and because of the influence of Anglo-Saxon based accounting standards. The requirements focus largely on additional information with regard to income generation and on application of internationally accepted accounting practices.

The reform of the Commercial Code in 1985 was designed to partially address this issue. The requirement for worldwide consolidated financial statements, which have to include all financial statements of domestic and foreign subsidiaries was introduced. Also noteworthy is the additional information requirements. For instance, the notes to the financial statements have to disclose the influence on net income due to supplemental tax-based depreciation and special fiscal reserves. In addition, the Commercial Code requires segment reporting, which, however, only focuses on sales. But an increasing number of internationally active German corporations are deliberately disclosing segment income and capital spending information. As part of the disclosure of additional information, the importance of the notes to the financial statements is increasing.

In order to improve the international comparability of German financial statements, companies can elect to structure the income statement based on the cost-of-sales method. Up to then only the expenditure method was permitted in Germany. Further, while not required, it has become standard for publicly traded corporations to disclose a cash-flow statement, large corporations provide more and more statements according to IAS 7. These regulations and customs lead to improved information available to interested foreign parties.

These are examples for the growing tendency among large publicly traded German corporations to deliberately use the options of the Commercial Code according to international accounting practices. This is particularly the case for accounting procedures that do not affect the tax situation due to special tax regulations or are only relevant in the consolidated financial statements, e. g. the translation of foreign currency statements which is not defined in the Commercial Code.

A movement towards Anglo-Saxon accounting methods is shown by the fact that consolidation of investments in subsidiaries have to be recorded under the purchase accounting method. The recorded goodwill has to be depreciated in the ensuing years at 25 percent per year or using a predetermined rate over the useful life. When in doubt, a short useful life has to be used under the principle of conservative accounting. In addition, a worsened earnings situation can make it necessary to have an extraordinary write-off of goodwill. The Commercial Code allows alternatively the elimination of goodwill directly against retained earnings following the 7th EC Directive which is based on the British practice. While in the beginning, German corporations preferred this method, at present internationally orientated German corporations tend towards the capitalization and amortization of goodwill.

The Commercial Code contains the requirement that financial statements, using GoB, display the asset, financial and earnings situation in a way that mirrors the actual situation. This rule follows the "true and fair view" principle of the 4th and 7th EC Directives. However, article 2, paragraph 5 of the 4th EC Directive, which addresses the overriding nature of this principle, was not explicitly adopted. This should not be viewed as a contradiction of the 4th EC Directive, since according to German legal interpretation, this general clause is to be always applied when applying the detail requirements. Furthermore, the "true and fair view" concept is supported by additional disclosure in the footnotes to the financial statements.

In order to improve the information content, consolidated financial statements should:

- value assets and liabilities using uniform principles,
- maintain the consistency of consolidation methods and the consolidation universe,
- value investments in associated companies using the equity accounting method.

## TIES BETWEEN INDIVIDUAL AND CONSOLIDATED FINANCIAL STATEMENTS

The consolidated financial statements of a German company have to be based on the same principles, which are valid for individual companies. This implies that valuation regulations, which have been developed with the protection of creditors and the preservation of capital in mind, need to be applied in the consolidated financial statements. The transfer of valuations used in the individual financial statements to the consolidated statements makes sense from a German perspective because of the following reasons:

- The introduction of less conservative accounting guidelines for the consolidated financial statements will in the long run lead to an erosion of the rules for the individual statements. This would jeopardize the principles of protection of creditors and preservation of capital. In addition there is the possibility that on a long term basis the tax burden would increase.
- The understanding of financial statement preparers and interpreters was influenced over a long period of time by the principles used in the individual financial statements. These principles continue to have a major impact as they are used as a basis for distribution of profits and taxation. However, worldwide consolidated financial statements are gaining in importance as a source of information. For instance, in many German companies the income disclosed in the consolidated financial statements is also used as an indicator for the distributable income.

## CONCLUSION

Overall the harmonized accounting regulations within the EU, and therefore also the German accounting regulations, lead to internationally equivalent financial statements (both individual and consolidated). Analyzed with respect to the specific socio-economic environment they offer equally useful information. The appreciation of accounting standards always has to take into consideration the various purposes intended in the presentation of the financial statements.