Contra: The best of both Worlds – a German view

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In recent years, a steadily growing number of German companies have been reporting consolidated financial statements under US GAAP or IAS, driven by the need for fresh equity capital which cannot be raised to a sufficient extent on the domestic market. This development benefits all those involved. It provides German companies with access to a deep and liquid source of capital – including a "currency" in the form of listed stock available for acquisitions in the U.S. It provides U.S. investors with increased opportunities for the allocation of their investments. At the same time market observers, researchers and regulators point to the fact that financial statements prepared under the shareholder (or investor) model, such as US GAAP or IAS, provide better information than financial statements prepared under the stakeholder model (German GAAP). What is the economic and legal rationale behind these differences?

In common-law economies (US and IAS models), accounting rules are determined largely by the disclosure needs of actual and prospective shareholders. Capital is generally raised in public stock and bond markets. The problem of asymmetric information between managers and shareholders is addressed through financial reporting and other means of timely public disclosure. Thus, the primary focus of US GAAP and IAS is the need of current and prospective shareholders for relevant and reliable information. In a common-law environment, accounting standards evolve by becoming commonly accepted in practice and are generally separate from tax laws. In other words, accounting standards arise in an accounting market and are not determined by government.

In clear contrast to this rather monistic concept of accounting, German accounting standards were developed in a highly politicised environment serving a number of stakeholders as well as taxation requirements. Under the German code-law model of accounting, governments, debt holders, shareholders, employees, suppliers, and managers are viewed as stakeholders of a firm. Net income is distributed amongst stakeholders, as pay increase to employees, bonuses to managers, tax to government, and dividends to shareholders. In Germany, banks traditionally play a key role in providing finance and representing investors. Agents of stakeholders tend to be informed by private and inside access to information. This reduces the need for timely public disclosure of income. Also, the incentives (e.g., minimising taxes) and opportunities (e.g. reserve accounting) to reduce earnings volatility are comparably high. Specifically, with financial reporting the same as tax reporting and with progressive income tax rates, smoothing earnings results in a reduction of distribution of income. The German approach has been labelled quite aptly as paternalistic, in that accounting under traditional German standards operates as a guardian in favour of all of the firm's stakeholders. This makes the firm more reliable for debtors but at the same time less attractive for investors. Moreover, the accounting concept is deeply rooted in the corporate legal system serving as shield against looting the firm's legal capital and as a pretty effective substitute for what in common law jurisdictions is known as financial covenants, i.e. contractual safeguards against the risk of default. Hence, the German accounting system as such is definitely not up for consideration.

Therefore, it appears to be quite a challenge to reconcile the stakeholder oriented German accounting model with the investor oriented common law

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If you want to comment on this topic or react to the opinion expressed here, please visit the CESifo Internet Forum on our web site: www.cesifo.de accounting philosophy in order to facilitate the raising of equity capital on international markets. Various concepts are discussed among experts, one alternative being a careful and gradual modification and adaptation of German accounting principles to IAS, another and quite promising one the implementation of a system of two separated sets of rules for information purposes and for the determination of distributable earnings. This latter approach would permit preserving the traditional German system without keeping German corporations locked out of international capital markets. Market participants would have to learn that a corporation and its performance can be looked at easily through different sets of glasses. However, only the future will tell whether it is possible to combine the best of both worlds.