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Black Sheep on Green Pastures – Prevention und Disclosure of Accounting Fraud in the Federal Republic of Germany – A study on the effectiveness of the legal guidelines for preventing and disclosing Accounting Fraud

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Elsdorf, 18 April 2014





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**ABSTRACT**

According to a study of KPMG in 2010 the share of companies regarding white collar crime as a serious problem for economy increased by nine percent in 2006 to 2010. Blue chips companies even valued this problem at ninety percent. It was assumed that the extend of economy crimes will increase further. The German Federal Office of Criminal Investigation stated that white collar crime is responsible for more than 4 Billion €, which exceeds fifty percent of the total damage for the year 2011.

Criminal offences in financial statements, the topic of this investigation started in spring 2011, are mainly carried out without being realised. Therefore it is impossible to furnish reliable figures in undetected crimes; however according to appropriate literature it is estimated up to 80 percent. The reasons for this are seen in insufficient regulations of legal guidelines by a number of authors.

The focus should especially be directed to the question how the measures of detection and prevention of accounting fraud are presented by the government and how their efficiency is estimated. Therefore the "Catalogue of Measures to Strengthen Companies' Integrity and to Protect Investors" of 2003 and the resulting legitimation are the central point.

The issue of this investigation is to find out how the companies registered in the DAX, MDAX, SDAX and Tec-DAX estimate the efficiency of the Catalogue of Measures of the government in regard to its intention. Hereby the estimation of the efficiency of individual points is reflected and is listed in a ranking by the companies. In addition companies are asked for the estimation of further appropriate and possible measures and the evaluation of the cost-benefit-ratio of the measures taken by the companies. The results of the investigation presented in the following are based on the evaluation of questionnaires sent to 160 companies registered in the four DAX segments in the time of the end of April to the beginning of December 2012.

The results show that the representatives of the companies assess the legal regulations concerning the disclosure and prevention of accounting fraud on the whole as helpful. The majority of the companies claim that the legal implementation of the "10-Point-Program" of the government can be considered sufficient for their own company with regard to disclosure and prevention of accounting fraud. Only one of five possible suggested measures for the prevention and disclosure of accounting fraud was accepted. Concerning the cost-benefit ratio the majority of the companies state that the costs outweigh the benefits.

Whereas the effect of legal measures is differently discussed in the literature, the evaluation by big companies can be defined as sufficient concerning legal regulations but companies even criticise them with regards to the costs.

The given results of the survey correspond to KPMG's research dated 2012, which state, that concerning white-collar-crime-affected companies the number of falsifications of annual statements respectively financial information decreased during spring 2010 and summer 2012 from 13 percent to 3 percent.

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## LIST OF ABBREVIATIONS

AKEU .....	Schalenbach Association for Business Administration
AktG .....	German Stock Corporation Act
AnSVG .....	Investor Protection Improvement Act
APAG .....	Auditor Supervision Act
APAK .....	Auditors' Supervision Commission
AÜG .....	Temporary Employment Act
Az .....	Reference Number
BaFin .....	Federal Financial Supervisory Authority
BDI .....	Federation of German Industry
BGB .....	German Civil Code
BGBI .....	German Federal Law Gazette
BGH .....	German Federal Supreme Court
BilKoG .....	Law on Financial Reporting Compliance
BilMoG .....	German Act to Modernize Accounting Law
BilReG .....	German Accounting Reform Act
BMF .....	German Federal Ministry of Finance
BMJ .....	German Federal Ministry of Justice
BR-Dr .....	German Federal Council Printing
BT-Dr .....	German Federal Parliament Printing
CESR .....	Committee of European Securities Regulators
CDU .....	Christian Democratic Union
cf .....	confer, compare
DGB .....	German Trade Union Association
DCGK .....	German Corporate Governance Code
DM .....	Deutschmark
DPR/FREP .....	Financial Reporting Enforcement Panel
D&O .....	Directors- and Officers Liability Insurance
EEC .....	Law on the Execution of the Council Regulation

EHUG .....	German Act on Electronic Commercial and Co-operative Registers and the Company Register
ESMA .....	European Securities and Markets Authority
Et al.....	and others
EU .....	European Union
f .....	and the following (et seq.)
ff .....	and the following (et seqq.)
FRRP .....	Financial Reporting Review Panel
GmbH.....	Private Limited Company
GmbH & Co KG	German Limited Commercial Partnership consisting of a General Partner and a Limited Partner
GVG .....	German Judicature Act
HGB .....	German Commercial Code
IAS .....	International Accounting Standards
IAASB .....	International Auditing and Assurance Standards Board
IASB .....	International Accounting Standards Board
IDW .....	Institute of Auditors
IDW PS .....	IDW Auditing Standards
IFAC .....	International Federation of Accountants
IFRS .....	International Financial Reporting Standards
Ill.....	Illustration
InsO .....	Insolvency Statute
IOSCO .....	International Organization of Securities Commissions
ISA .....	International Standards on Auditing
KapCoRiLiG .....	Law pertaining to Limited Liability Partnerships
KapMuG .....	German Capital Markets Model Case Act
KG .....	Limited Commercial Partnership
KonTraG.....	Corporate Sector and Supervision Transparency Act
KPMG.....	Klynweld, Peat, Marwick and Goerdeler
LG .....	Regional Court

MicroBilG	Act amending Accounting Law as regards Micro-Entities
no	Number
NZG	New Journal for Corporate Law
OLG	Higher Regional Court
p	Page
PCAOB	Public Company Accounting Oversight Board
PwC	PricewaterhouseCoopers
RegE	Government Draft
SEC	Security and Exchange Commission
SMEs	Small and medium-sized Companies
SOA	Sarbanes-Oxley-Act
UK-GAPP	United Kingdom-Generally Accepted Accounting Principles
US-GAPP	United States-Generally Accepted Accounting Principles
UMAG	German Law on Corporate Integrity and Modernization of the Right of Avoidance
VAG	Laws on Insurance Supervision
VorstOG	Act on the Disclosure of Executive Board Remuneration
VV RVG	Salary Schedule for Lawyers' Compensation Act
WpAIV	Regulation to concretize the Disclosure Notification and Publication Duty as well as the Duty to issue a List of Insiders pursuant of the Securities Trading Act
WpHG	Securities Trading Act
WPK	Chamber of Public Accountants
WPO	Public Accountants Act
ZR	Civil Procedure Law





## 1

## INTRODUCTION

Sometimes a personal event leads a person to deal with a special topic on a scientific level. The following study was driven by such a personal experience. It was the life-changing experience I made during my visit to a prison in Gelsenkirchen Feldmark as part of my studies in July 2010. It rarely occurs that a professor leading the department of criminology is permitted to visit a prison with a group of students. Apart from the tour of the premises, personal contact with the prisoners was also planned. I was lucky enough to be part of such a group. As a result of the visit of the prison in Gelsenkirchen Feldmark, my already existing interest in the subject of white-collar crime was greatly aroused. The impressions gathered were so influential that a deep dive study of this topic was a logical consequence. Even if one spent only one day within the walls of this very restricted world and saw the living standards of the prisoners, people that before they were sentenced had led a “socially inconspicuous life”, then one starts to get a feeling for what this must mean for a person in this situation. That person will never be the same again.

The residential cell is small and only equipped with the basics. The prison in Gelsenkirchen Feldmark does not enable prisoners to take any proper vocational training or a distance learning course. The use of the Internet is not permitted. Prisoners are often affected by strong drug consumption and are given very limited opportunity or incentive to communicate with each other or the outside world. Men and women are separated and live in opposite building blocks. Their communication is limited to signaling with flashlights or communicating with the help of mirrors. If a person requires, for example, pens, books, clothes or newspapers then these must be requested in written form. Whether the request is approved, depends on the decision of the competent official. Once a month family and friends are allowed to visit. Physical contact is prohibited during these visits.

Even if there are good reasons for the rules of everyday prison life, one can feel that prisoners are so disenfranchised that it is hard for a person to endure. This assessment is supported in my view through a statement made by the director of the Gelsenkirchen Feldmark prison. He stated that there was not a single prisoner who did not want to leave the prison as quickly as possible.

All the more, one asks oneself, what drives people who, based on what one can ascertain from their external situations, have no apparent need to enrich

themselves to use criminal means and to risk not only their freedom and a radical change to their bourgeois life but potentially even, as detailed above, being disenfranchised and restricted. This begs the question how high the damage is that people, who do not even have a responsible view of their own life, inflict on companies and the society as a whole. Furthermore, taking into account the immense damage caused, what does the society – here particularly the German society – do to protect itself from this type of damage. In a democratic country, the elected government acts in the name of society. The topic of this paper, therefore, looks into the initiatives that the German Federal Government has taken in the form of the “Catalogue of Measures to Strengthen Companies’ Integrity and to Protect Investors” and the question of its effectiveness.

**1.1****RELEVANCE**

The most spectacular cases of fraud such as Balsam/Procedo (1994), Flowtex (2000) and Comraod (2002) has shaken public trust where accounts were partially manipulated with participation of the management and with high criminal energy. In 1996 the former manager of the health insurance funds company Leuna was able to undertake loss-minimizing balance sheet manipulations which did not come to light until three months after the fusion with other health insurance funds companies. She was dismissed without notice; the Federal Social Security Court (Bundessozialgericht) sentenced her to pay approximately 266,000 euros in damages; criminal proceedings closed in 2009 with an acquittal (cf. NewsAdhoc, 2009, [www.news-adhoc.com/ex-krankenkassenchefin-haftet-fuer-bilanzmanipulation-idna2009050530070](http://www.news-adhoc.com/ex-krankenkassenchefin-haftet-fuer-bilanzmanipulation-idna2009050530070)). In May 2011 the district court Essen sentenced the former Arcandor manager Thomas Middelhoff to pay 2,575 euros damages together with interest to Jan Eric Peters (small shareholder) for wilful and immoral damage to the capital market read in conjunction with Article 826 of the German Civil Code (LG Essen, 05.05.2011 - 4 O 244/09; cf. Jahn/ Knop, 2011, [www.faz.net/-gqp-z3i5](http://www.faz.net/-gqp-z3i5)). Hartmut Fromm the lawyer of Thomas Middelhoff wanted to appeal against the judgement (cf. Jahn/ Knop, 2011, [www.faz.net/-gqp-z3i5](http://www.faz.net/-gqp-z3i5)). In May 2012, however, the paper file was put away, so that probably no appeal was lodged.

Individual companies are increasingly subjected to violations. As such a study on white-collar crime undertaken by the auditing company KPMG<sup>1</sup> in the summer of 2012 came to the conclusion that the topic of white-collar crime in the 332 medium-sized German businesses polled showed that nearly every fourth company had become a victim of economic crime in the past two years. Every minute a company with more than nine employees is damaged by white-collar crime whereby each case of white-collar crime costs a company on average 30,000 euros. Companies subjected to white-collar crime accrue material damage of over 300,000 euros each year. The perpetrators were mainly (48 per cent) own company employees. Management and even top management were involved in the crimes in more than every third case. The situation is even more alarming when taking into account that the companies polled saw the risk of white-collar crime as being

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1 One of the four largest auditing firms, the acronym stands for the founders of the company: Klynveld, Peat, Marwick and Goerdeler.

higher in other companies than in their own and that they were satisfied with the measures they had undertaken to date. This often stands in stark contrast to the actual provisions made as only, for example, about thirty-four per cent train their employees on topics of white-collar crime (cf. KPMG, 2012, p. 3, 6, 7). Referring to the study of KPMG in 2010 they already judged white collar crime as a serious danger and anticipated a further increasing trend (cf. KPMG, 2010, p. 6). Concerning white-collar-crime-affected companies accounting fraud increased from 6 percent to 13 percent during 2006 to 2010 (cf. KPMG, 2010, p. 8).

The Federal Criminal Police Office (Bundeskriminalamt) found that in 2011 white-collar crime had cost over four billion euros and thereby approximately half of the total damage tracked by the German police force's crime statistics. The willingness of companies to involve law enforcement agencies has sadly declined over the past two years. Only in about fifty per cent of the cases determined were law enforcement agencies asked for help (cf. KPMG, 2012, p. 4 f). These facts founded an important source for this study, which started in spring 2011.

The most common forms of white-collar crime are according to the survey conducted by the auditing firm KPMG, classical asset misappropriation such as theft, embezzlement and the illicit use of company resources for personal use. In contrast to these types of crimes, breaches based on balance sheet manipulations - despite occurring less often - have a higher financial impact and cause also hard to calculate immaterial damages which are many times worse (cf. KPMG, 2012, p. 11). To make a concrete statement about this is not possible as the damage is impossible to quantify and estimates in this respect differ substantially from each other. There is no doubt, however, that the immaterial damage caused is a key aspect when assessing the actual damage which occurred. The Situations Report on White-Collar Crime from 2010 published by Germany's Federal Criminal Police Office (BKA) states examples such as (cf. Bundeskriminalamt (Hrsg.), *Bundeslagebild Wirtschaftskriminalität*, 2010, p. 9):

- Distorsion of competition
- Dismay of dependent business partners who were not involved in the crime
- Loss of reputation
- Loss of confidence in the existing free market economy's ability to function.

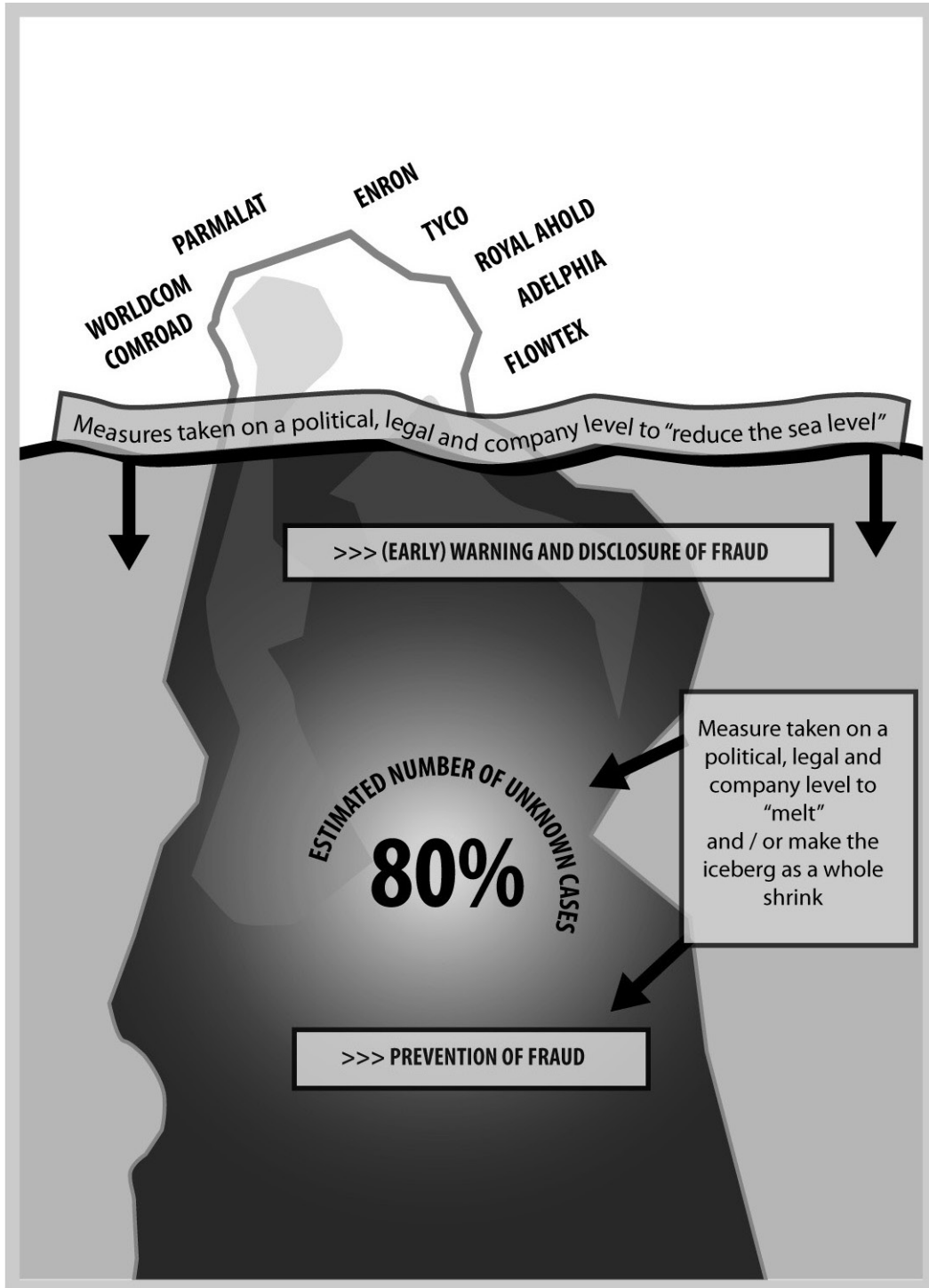
The preceding study of KPMG from 2010 also found that the number of financial information and annual financial statement counterfeits is growing.

Concerning white-collar-crime-affected companies in 2006 it was still six per cent but in 2010 it was already thirteen per cent. Furthermore, the study shows that, with regard to white-collar crime, there has been a strong shift towards the sectors of finance and accounting as well as the credit business. KPMG draws the conclusion from this data that white-collar crimes are increasingly shifting upwards in company hierarchies. They see the reason in the fact that a more senior position as well as considerable expertise is required to circumvent the controls in these sectors (cf. KPMG, 2010, p. 8 f). The current study from 2012 shows that concerning white-collar-crime-affected companies the number of financial information and annual financial statement counterfeits has reduced to three per cent (cf. KPMG, 2012, p. 11).

In 2008 Hofmann assumed that the majority of accounting frauds occur below the threshold of perception and remain undiscovered. A reliable estimate of unreported cases is not possible but is already estimated at approximately eighty per cent. In Germany, at least, every second white-collar crime remains undiscovered. Therefore, Müller (1996) and Lange (2007) speak of a “fraud iceberg”<sup>2</sup> where one normally assumes that one-seventh is visible and six-sevenths are under the water surface (cf. Hofmann, 2008, p. 218 f).

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2 „Fraud-Eisberg“



*Illustration 1: Fraud Iceberg*

The auditing firm PricewaterhouseCoopers (pwc) also concludes in their study in 2011 that many more companies are impacted by white-collar crime than is known. The reason is seen in the fact that white-collar crimes are hard to prove (cf. pwc, 2011a, p. 19).

**1.2****OBJECTIVE**

The objective of this study is to examine the current possibilities for uncovering and preventing balance sheet manipulations. Since balance sheet manipulations form a part of fraud (fraud, tricks, deception, embezzlement) many measures taken to disclose and prevent accounting fraud also apply to other fraudulent crimes. Vice versa measures taken to disclose and prevent other fraudulent crimes also apply to the disclosure and prevention of balance sheet manipulations. Based on this, the following study makes parallel use of the terms balance sheet manipulations, white-collar crimes and fraud. Recent literature has coined the phrase "accounting fraud" that is also applied when reviewing primarily financial accounting fraud.

The responsibility to disclose and prevent balance sheet manipulations is first and foremost with the company itself, specifically the supervisory board and management board, followed by accounting, internal audit and at the end of the day the responsibility of each and every employee. Companies can live up to their responsibility to disclose and prevent balance sheet manipulations within their own organisations in many ways, for example, by putting emphasis on efficient value management or on serious efforts to form company ethics. Red flagging management, crisis management, pre-employment screening and whistle-blowing systems should be operational. Also the effectiveness of the internal control systems should be ensured through the establishment of specific control activities. Additionally, the people monitoring the company as well as internal control and the supervisory board can contribute through observant fulfilment of their duties. A further responsibility for the disclosure and prevention of balance sheet manipulations lies with the auditing firm whose possibilities are assessed by external publications in very different ways. The opinion that disclosure of balance sheet manipulations does not belong to their responsibility is in contrast to the other school of thought which thinks that especially they should be particularly critical with regard to balance sheet manipulations.

The focus of this study is directed at the question of what measures are taken by the government to disclose and prevent accounting fraud and the effectiveness of the measures taken. For this reason the Catalogue of Measures to Strengthen Companies' Integrity and to Protect Investors as well as the resulting legislation form the central point of this study.



Driven by the increase in cases of accounting fraud, the state's responsibility is especially growing in importance as companies can decide for themselves whether they want to introduce an anti-fraud management system and, depending on how upright a company is, this system can be more or less effective. On the other hand, the state can make use of its legislature to enforce binding regulations that need to be adhered to. The goal of this study is therefore to demonstrate to what extent the German Federal Government has established such regulations and what safeguards are in place to ensure its effectiveness. This also includes the question of the form of control and the type of sanctions as both are important for the efficiency of legislative measures. Furthermore, there is an investigation into how companies listed on the DAX, MDAX, Tec-DAX and SDAX rate the effectiveness of the government's Catalogue of Measures with regard to its goals. Hereby the companies were asked to provide their assessment as to the effectiveness of individual points which then were ranked, their assessment of the usefulness of possible further measures and their valuation of the balance of costs and benefits of the measures to be implemented.

### 1.3 THE STUDY'S STRUCTURE

At the start of the study, there is a classification of balance sheet manipulations in the context of white-collar crime. The elements of a balance sheet manipulation offense are narrowed down and explanatory models for the act of committing a balance sheet manipulation are presented. Tackling the question of the effects of balance sheet manipulations shows its possible impact on companies, possible effects on business owners, investors and shareholders, the actual perpetrators as well as on the state, the consumer and the economy as a whole.

This is followed by taking a look at the government initiatives to hinder and disclose balance sheet manipulations. In this context the Catalogue of Measures to Strengthen Companies' Integrity and to Protect Investors is introduced. It involves the personal liability of company organs, the German Corporate Governance, the further enhancements made to accounting regulations and the alignment with international accounting standards. Strengthening the role of the independent auditor, monitoring the legality of actual company financial statements through an independent source as well as the electronic disclosure of company reporting and the improvement of investor protection are some further sectors for which the German Federal Government proposed measures in its 10-Point-Program. The imposed legislature which goes hand in hand with the proposed measures are introduced and scrutinised as to their effectiveness, taking account of external publications published on this topic. The points 9 (Ensuring the reliability of company ratings made by finance analysts and rating agencies) and 10 (Tightening of penal provisions for offences within the capital market sector) have an exceptional position as there is no legislation with regard to point 9 and, with regard to point 10, the Federal Government of Germany also has no legislation planned.

Describing the structure of the proposed research project should subsequently highlight how the practical part of this study is designed. Thus, as a first step the companies questioned as part of the empirical study are categorised. The second step is to define the goal of the investigation. After explaining the methodology applied to the study, the answers to the blocks of questions of the questionnaire, located in the appendix, are presented. As a final step the results are interpreted.

Concluding the study, the key statements of the theoretical part are compared to the results of the analysis of the empirical part of the study. The assessments made in specialized literature are questioned and reflected upon taking into account the empirical research data.

**ACCOUNTING FRAUD**

In order to capture the offense of balance sheet manipulations in a concrete form the following chapters will review it in the context of white-collar crime and its terminology.

## 2.1 ACCOUNTING IRREGULARITIES IN THE CONTEXT OF WHITE-COLLAR CRIME

Sutherland's famous essay "Wild-Collar-Criminality", written in 1940, was the first to draw attention to the fact that, in all the scientific debates around acts of economic fraud, there is no agreed definition or common terminology (cf. Sutherland, 1940, in Peemöller and Hofmann, 2005, p. 19). A German Legal Colloquium on White-Collar Crime in 1984 also failed to reach a consensus (cf. Gisler, 1994, p. 30). The first definitions, which focused on the social background of the criminal, were initially created by the social sciences. They saw economic fraud as a breach of law by the upper class which was often viewed as a "trivial offence". Peemöller and Hofmann however point out that definitions created by other disciplines – and this applies also to broader legal definitions – are only conditionally applicable. This is valid, although the assessment of facts surrounding a case of white-collar crime would encompass elements of economic, legal, psychological, sociological as well as ethical and moral points of view. Peemöller and Hofmann made reference to Müller, who had highlighted the complexity of this relationship (cf. Müller, 1995, p. 839 ff; cf. Peemöller and Hofmann 2005, p. 19).

Ultimately, an all-encompassing general definition of the term is not possible. To enable the circumstances surrounding accounting fraud to be recognized and determined, an indicator model was developed. This model lists factors that can determine the fact that accounting fraud has taken place.

The more indicators apply to a specific case, the higher the likelihood of accounting fraud: (cf. Peemöller and Hofmann, 2005, p. 20; Müller 1995, p. 840):

- Elements of a cause of action: There is a breach of law.
- Breach of trust: The principle of fairness in commercial transactions has been infringed.
- De-personalization of the victim: The victim is either not acknowledged or only partially acknowledged by the offender.
- Economic expertise: Detailed economic knowledge is the basis for the behaviour shown.
- No evidence of force: The overall goal is not primarily reached through the application of physical force.

As there is no generally applicable definition of white-collar crime, but because a definition of the term in a scientific context is of absolute necessity, this

study will make use of the term “white-collar crime” using the competence of the court division of the chamber for economic crimes for business offences according to the German Judicature Act (GVG).

The competences listed in § 74 c include criminal offences according to

“1. The Patents Act, the Utility Model Act, the Semiconductor Act, the Plant Varieties Protection Law, the Law on Trade Marks, the Law on Design Patents, the Copyright Act, the Unfair Competition Act, the Insolvency Statute, the German Stock Corporation Act, the Company Disclosure Act, the Law on Private Limited (liability) Companies, the German Commercial Code, the SE Implementation Act, the Law on the execution of the Council Regulation (EEC) over the European Economic Interest Grouping, the Cooperatives Act, the SCE Execution Law, and the Conversion Law.

2. The laws on banking, deposit, stock exchange and credit institutions as well as the laws on insurance supervision (VAG) and the German Securities Trading Act.

3. The Penal Code for Business 1954, the German Foreign Trade and Payments Act, the Laws on Exchange of Goods, as well as the Financial Monopoly, Tax and Customs legislation, also in terms of the penal provisions that may be applied according to other laws. This is not the case if the same offence occurs under the Law of Narcotics, and also not for tax offences relating to vehicle taxation.

4. The Wine and Food Law.

5. Subsidy fraud, investment fraud, credit fraud, bankruptcy, creditor fraud, and debtor fraud.

5a. Anti-competitive agreements when tendering as well as bribery and corruption in commercial transactions.

6a. Fraud, computer fraud embezzlement, extortion, granting advantages, bribery, and the non-payment and misappropriation of salaries.

6b. The Temporary Employment Act (AÜG) and the third book of the Social Code as well as the Act to Combat Clandestine Employment.

(..).“ (GVG §74 c (1), translated in context by the author)<sup>3</sup>

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3 „1. nach dem Patentgesetz, dem Gebrauchsmustergesetz, dem Halbleiterschutzgesetz, dem Sortenschutzgesetz, dem Markengesetz, dem Geschmacksmustergesetz, dem Urheberrechtsgesetz, dem Gesetz gegen den

The focus of this study, however, is on accounting fraud.

The definition applied to the term white-collar crime will be based upon the systemization of inconsistencies in accounting as published by the Institute of Auditors (IDW) in the Auditing Standard PS 210 section 7.

The systemisation of accounting irregularities published by IDW states that data provided in financial statements and the accompanying management reports are false if one or more statements made within are incorrect. This false information can be provided accidentally (error). These inaccuracies can be caused by spelling or

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unlauteren Wettbewerb, der Insolvenzordnung, dem Aktiengesetz, dem Gesetz über die Rechnungslegung von bestimmten Unternehmen und Konzernen, dem Gesetz betreffend die Gesellschaften mit beschränkter Haftung, dem Handelsgesetzbuch, dem SE-Ausführungsgesetz, dem Gesetz zur Ausführung der EWG-Verordnung über die europäische wirtschaftliche Interessenvereinigung, dem Genossenschaftsgesetz, dem SCE-Ausführungsgesetz und dem Umwandlungsgesetz,

2. nach den Gesetzen über das Bank-, Depot-, Börsen- und Kreditwesen sowie nach dem Versicherungsaufsichtsgesetz und dem Wertpapierhandelsgesetz,

3. nach dem Wirtschaftstrafgesetz 1954, dem Außenwirtschaftsgesetz, den Devisenbewirtschaftungsgesetzen sowie dem Finanzmonopol-, Steuer- und Zollrecht, auch soweit dessen Strafvorschriften nach anderen Gesetzen anwendbar sind; dies gilt nicht, wenn dieselbe Handlung eine Straftat nach dem Betäubungsmittelgesetz darstellt, und nicht für Steuerstraftaten, welche die Kraftfahrzeugsteuer betreffen,

4. nach dem Weingesetz und dem Lebensmittelrecht,

5. des Subventionsbetruges, des Kapitalanlagebetruges, des Kreditbetruges, des Bankrotts, der Gläubigerbegünstigung und der Schuldnerbegünstigung,

5a. der wettbewerbsbeschränkenden Absprachen bei Ausschreibungen sowie der Bestechlichkeit und Bestechung im geschäftlichen Verkehr,

6a. des Betruges, des Computerbetruges der Untreue, des Wuchers, der Vorteilsgewährung, der Bestechung und des Vorenthaltens und Veruntreuens von Arbeitsentgelt,

6b. nach dem Arbeitnehmerüberlassungsgesetz und dem Dritten Buch Sozialgesetzbuch sowie dem Schwarzarbeitsbekämpfungsgesetz,

(...):“ (GVG §74 c (1)).

calculating errors made by the accounting department, by an unknown false application of accounting standards or by overlooking or making wrong assessments of issues. The effects of an accidental non-compliance of other, non-accounting related statutes can result in these types of issues. However, false information provided in the accounts also can be caused by violations (fraud). Violations are deliberate and are undertaken to achieve a specific goal. Deceptions, pecuniary damages and statements are classified as violations that deliberately do not take into account the effects of the law (for example, monetary penalties or obligations to compensate) within the accounts (cf. IDW PS 210, 2006, p. 1423 f).

In cases of deception, there is a deliberate act of putting false information in the annual financial statement as well as in the accounts. It is balance sheet manipulations that are made through deliberate false application of accounting standards. They are undertaken by boards of directors, supervisory boards or employees and in some cases with the help of third parties. A repeal of effective control measures by the management and other executives is often part of the deception (cf. IDW PS 210, 2006, p. 1424).

Pecuniary losses are, for example, embezzlement and theft. Pecuniary losses are, on the one hand, misuse or a diminishment of company assets. On the other hand, it is an extension of commitments relative to company assets. Pecuniary losses are undertaken by boards of directors, supervisory boards or employees and in some cases with the help of third parties. If pecuniary losses are not properly shown in the accounts then this in itself, pursuant to the IDW test standards, is a violation. If they are listed then it comes under the category of other breaches of law (cf. IDW PS 210, 2006, p.1424).

Hauser points out that breaches made by the company are unlawful acts that break private laws as well as public norms. In this category are, for example, acts such as intentional deception of contractual partners as well as intentional breaches of environmental protection regulations (cf. Hauser, 2000, p. 44). These acts are breaches of the law. If these breaches of the law are intentional and lead to a deception of the accounts, then they are to be classified as fraud pursuant to the IDW. Also Henzler applies the aforementioned categorisation (cf. Henzler, 2006, p. 24).

## 2.2 FACTUAL FINDINGS OF ACCOUNTING FRAUD

If accounts and the corresponding sets of financial statements<sup>4</sup> are falsified and not depicted in a transparent form for the recipients to be informed then this is an act of accounting irregularity. Accounting irregularities are made to gain an advantage for the company management or for other people related to the company.<sup>5</sup> The people receiving the accounts are intentionally and purposefully influenced or deceived by the manipulated annual financial statements.

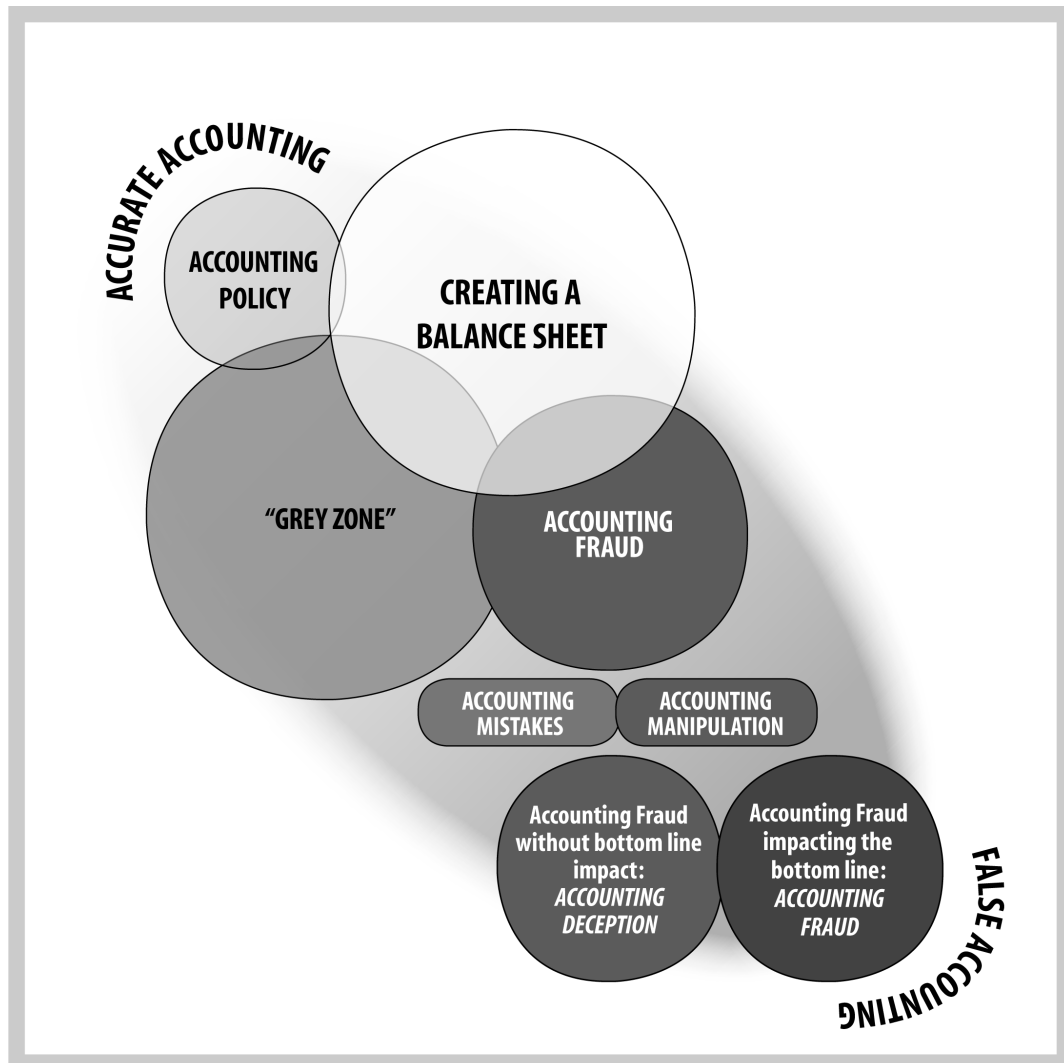
The two extremes of legal accounting policy on the one hand and accounting fraud on the other are not easily separable.

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4 This includes profit and loss statement, the notes and the management report. The profit and loss statement must be created according to § 275 HGB in a staggered format applying the total expenditure format or the cost of sales method. The details of both approaches are defined within. According to § 275 HGB the notes must contain those specifics that are mandatory positions within the balance sheet or profit and loss statement. Also data pertaining to the notes need to be included even if they were not included in the balance sheet or profit and loss statement due to an exclusion based on an exercised right to vote this out. The management report, according to § 289 HGB, must reflect the business development and corporate status in such a way that an accurate and fair view is portrayed. As such the analysis must include the financial key indicators relevant for the business field and these must be explained referencing the stated sums and data as stated in the financial statements. In addition the forecasted development with its key opportunities and risks must be analysed and explained.

5 This can include, for example employees, who receive profit related pay or whose further employment depends on attaining certain goals and who thereby have a personal interest in a particular presentation of the financial statement.





*Illustration 2: Measures of Structuring of Balances according to Kalveram and Le Courtre*

The illustration highlights how difficult it is to establish a clear differentiation. Between the two extremes of legal accounting and illegal accounting exists a more or less wide limbo, in which the boundaries to illegality become blurred. Examples of these are the so-called creative accounting or earnings management. It is not clear if it is a case of aggressive accounting within a legal framework or a breach of the law (cf. Hofmann, 2008, p. 95). Hence a criminal case of the facts cannot always be made. Schmittmann, for example, draws attention to the fact that,

in this context, it is extremely difficult to prove that false statements were made or that a deliberate deception occurred given the existing assessment criteria and assessment scope (cf. Schmittmann, 2006, p. 30).

In addition, the Commerzbank case illustrates the difficulty that occurs when evaluating a company if, on the one hand, nationally valid accounting principles and, on the other hand, internationally valid accounting principles apply. The Commerzbank posted a profit as well as a loss for the year 2011. Pursuant to the German accounting principles of the German Commercial Code (HGB), the Commerzbank made a loss of 3.6 billion euros. In contrast to this, pursuant to international accounting principles of the IFRS it made a profit of 638 million euros. The Commerzbank is, the same as for all other large corporate enterprises, required to apply and publish both types of accounting principles. The result of the loss made pursuant to the accounting principles of the German Commercial Code (HGB) meant that it did not have to pay interest on the government stake of 1.9 billion euros. This is because according to the German Commercial Code (HGB) accounting principles the Commerzbank must only pay interest to the government when it is making a profit. As such the Commerzbank saves the interest payment and the government misses out on the interest payment. The government stake was a result of the financial crisis and to support the distressed large German bank. On the other hand, the Commerzbank was interested in portraying their company as a profitable entity through applying the IFRS accounting principles as it urgently needed to attract new investors for a capital increase (cf. Jungbluth, 2012, p. 26). This case highlights the fact that the evaluations pursuant to the German Commercial Code (HGB) and the IFRS can lead to substantial deviations. Depending on the publication of the respective results in the media the company can, dependant on its own interests, influence the public's view.

The following chapter is looking into accounting fraud and specifically into balance sheet manipulations, as these are deliberate breaches of accounting rules. Balance sheet manipulations are categorized as profit/loss neutral or breaches which affect the balance sheets. Profit/loss neutral breaches are balance sheet manipulations. The breach is against the principles of balance sheet transparency. This occurs through insufficient nomenclature, false grouping, false balancing or omission of necessary balancing as well as through insufficient explanations. Breaches which affect the bottom-line are called accounting fraud. Here there is

a breach against the principles of faithful economic representation. This contains non-inclusion of balance sheet items, inclusion of fictive, non-existent items and evaluation offences (cf. Brinkmann in Freidank, 2005, p. 244 and Henzler, 2006, p. 26). Both types of breaches lead to financial statements not reflecting the true picture of assets, liabilities and the financial position of a company regarding the principles of proper accounting. This is a breach of general standards according to § 264 (2) German Commercial Code (HGB) as well as a breach of consolidated financial statements § 297 (2) German Commercial Code (HGB), which oversees all regulations of accounting (cf. Ransiek, 2012, p. 965).

A reliable statement about the criminal-political significance of accounting fraud is not possible according to Ransiek who refers to Schmedding (1991). This is because there are neither criminal statistics held by the police nor conviction statistics which separate accounting policy frauds. Additionally, the general rule is that damage must occur before you can be prosecuted, although this, i.e. the damage occurring, is not a legal precondition of accounting fraud (cf. Ransiek, 2012, p. 973).

### 2.3 EXPLANATORY MODELS FOR THE ACT OF MANIPULATING ACCOUNTS

The Zurich-based attorney-at-law Marc Jean-Richard-dit-Bressel declared in November 2010 on a Swiss Association of Experts for the Combating Economic Crime Conference that fraud is always occurring (cf. Capodici, Schafft die Krise mehr Kriminelle?, in: Züricher Tageszeitung dated 09.11.2010, found in: Harz et al., 2012, p. 9). Thereby, he referred to the following quote: “If poverty prevails, then need turns you into a thief. Greed tempts him when prosperity prevails.”<sup>6</sup> (translated in context by the author) (cf. Harz et al., 2012, p. 9). Apart from such philosophical statements, business management and economics use many geometric figures to visualize multi-layered phenomena. Against this background Donald R. Cressey developed the “Fraud Triangle” in the 1940s (Fraud Triangle or Crime-Risk Model) that summarizes various research approaches that demonstrate the key drivers of white-collar crime. The Fraud Triangle highlights three main factors that justify white-collar crime occurring. It lists out prerequisites that must be fulfilled before a person can turn into an offender.

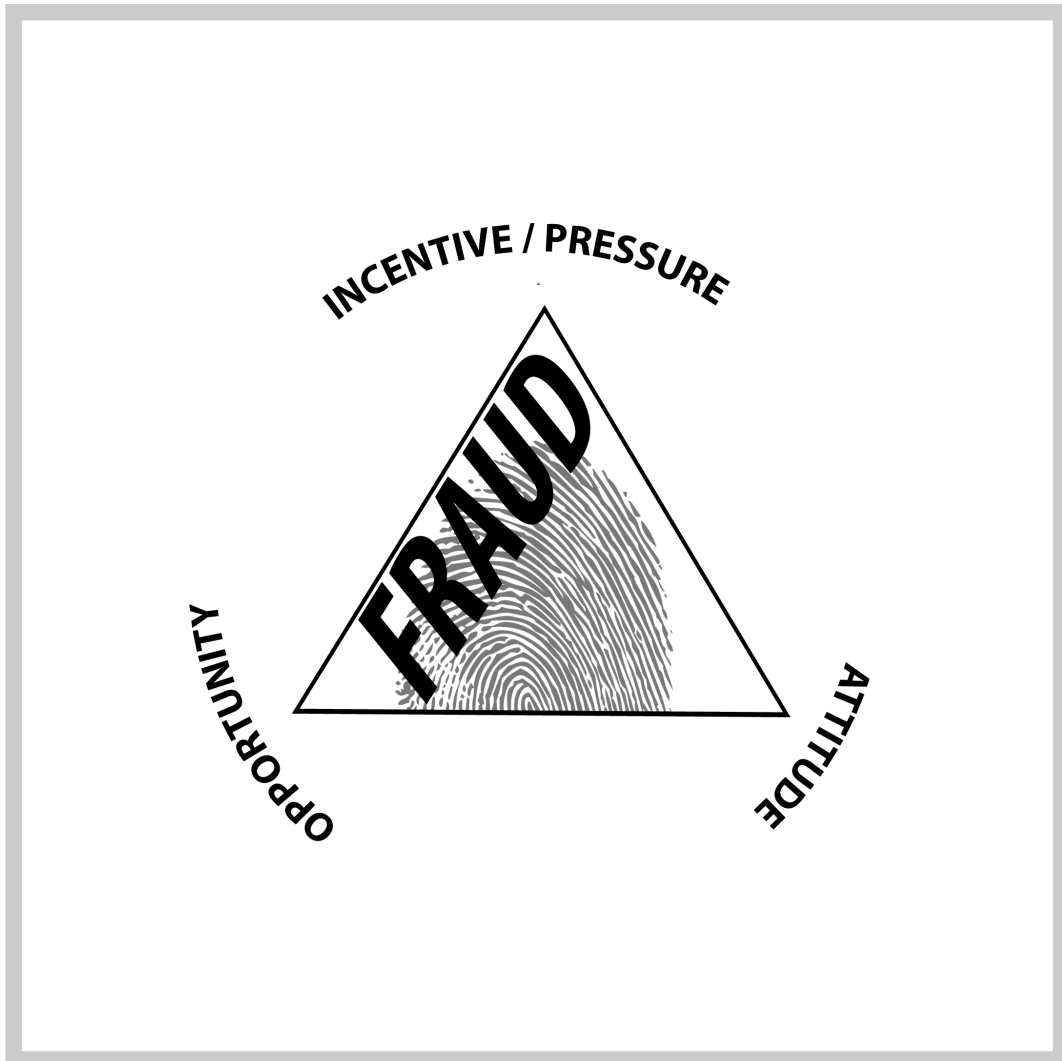
These conditions are specified by Schneider using improved explanatory approaches of the Leipziger Progression Model. The psychological view of the accounting criminal’s personality can be seen in close relationship to their motives. The motives, on the other hand, stand in close relationship to the ever-growing influence of the shareholder-value philosophy.

#### 2.3.1 *Fraud Triangle / Fraud Diamond*

The Fraud Triangle as well as the further developed Fraud Diamond relate to white-collar crime in general and as such are a useful tool for explaining the specific context of accounting fraud. The Fraud Triangle Model identifies the risk of a white-collar crime from occurring as high when the following conditions are met: first there is an incentive for or pressure on the potential offender to commit a white-collar crime, second he is given the opportunity for committing a crime and third the offender can make the act he committed justifiable to himself.

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6 „Herrscht Armut, macht die Not den Dieb. Die Gier verleitet ihn, wenn Reichtum um sich greift“



*Illustration 3: Fraud Triangle*

What the prerequisite of pressure and incentive can look like is highlighted by an example from Tanski regarding the company Worldcom. According to Tanski the key triggers of the balance sheet manipulations discovered in 2002 are the sudden market slump in the telecommunications sector as well as caution in the assessment of the subsequent market situation that had replaced the previous market hype. Declining share prices, significant decreases in profit and an increasing unrest on behalf of investors and creditors placed the company under

growing pressure. By manipulating the balance sheets, the annual financial report is adjusted in order to meet the general expectations. Tanski views the fraudulent proceedings at Worldcom as the phenomenon of a negative control loop (cf. Tanski, 2002, p. 2003 f). In relation to the prerequisite of pressure Knabe et al differentiate between the economic pressure on the company on the one hand, or the perpetrator being in a financial bottleneck on the other hand. In regard to the second aspect, they noticed that honest people, too, can come under such high pressure that they get into the situation to accept fraudulent behavior. (cf. Knabe et al., 2004, p. 1058). Schruoff uses an example for the prerequisite of pressure whereby analysts, institutional investors, important creditors or other third parties have expectations that are possibly unrealistic. Overly optimistic press reports regarding the company earnings or the development of earnings can lead to increased expectations and a corresponding increase in share prices. This can create pressure to undergo balance sheet manipulations (cf. Schruoff, 2005, p. 209). The IDW recognizes that the pressure of the capital markets or of the parent company on the legal representatives to achieve certain financial goals creates a motivation for balance sheet manipulations (cf. IDW PS 210, 2006, p. 1426). Brinkmann points out that management income is often linked to the development of the company which leads to a high vested interest in a positive portrayal of the company situation. As such, it was often personal earning goals by the management that led to balance sheet manipulations whereby the company earnings were portrayed more favorably than they really were. Brinkmann further states that the motivation to manipulate company earnings can be monetary or non monetary. The individual characteristics of different cultures play an important role. Especially top management in the Confucian countries in East Asia (for example, China and South Korea) are motivated to undergo balance sheet manipulations in an attempt to avoid loss of reputation (cf. Brinkmann, 2007, p. 158).

The incentive or pressure that, according to Cressey, leads to criminal behavior can be caused by personal, company as well as macroeconomic developments.

For an act of fraud to occur in the arena of white-collar crime, the second prerequisite of the Fraud Triangle Model must also be fulfilled, namely there must be an opportunity to commit a crime. This is, for example, the case when there is no effective company monitoring of the accounting processes and the internal control systems on behalf of the supervisory board (cf. Schruoff, 2005, p. 209) or

when ineffective controls provide management with the opportunity to overcome controls (cf. Knabe et al., 2004, p. 1058). Brinkmann points out that internal control systems can only effectively protect a company from balance sheet manipulations if all employees, including the management, actually undertake the required control actions. In the case when management is motivated to manipulate financial publications, those employees actively engaged in the creation of the financial publications will possibly be given incentives or, through threat of punishment, will be forced into not undertaking control actions (cf. Brinkmann, 2007, p. 159). Based on the summary of the results of two KPGM studies from 2007 and 2011 Hülberg and Engels noted that in 74 per cent of the cases according to the 2011 study the perpetrator makes use of the weaknesses in the internal control systems. This value was 25 per cent higher than in the study from 2007. Hülberg and Engels see this increase based upon the fact that the topic of white-collar crime has become increasingly important for companies over the last 10 years and that companies are increasing their monitoring activities. They conclude that the perpetrators are possibly becoming cleverer and that criminal energy is on the rise – or that, whilst internal controls are becoming more sophisticated, the adherence to them is insufficiently controlled. As the offenders are mainly in management positions they have the possibilities to overcome the controls (cf. Hülberg/Engels, 2011, p. 15).

The auditing company pwc highlights a paradox situation in their study from 2007 in regard to the development of white-collar crime. One would actually assume that increased controls would lead to a decline in criminality. This is, however, currently not the case; the impact and the prevention have had the opposite effect on crime statistics. The authors of the study explain the phenomenon by the fact that, through an improved control environment, more offences are uncovered, however, without having an immediate effect on reducing crime. The impression is raised that the more aware companies are of white-collar crimes, the more these crimes take place. The authors raise the point, though, that the higher the sensitivity, the more offences are discovered due to an improved control environment which would previously have remained unnoticed. Initially, the improved success record of an improved control environment is alarming as more cases are discovered and the crime rate seemingly increases. Only by and by this effect will slowly decrease. This assessment is also in line with decades of research in the field of deterrence. This has shown that the highest deterrence effect is achieved through an increase in the subjective risk of being discovered, less so by the threat

of strict consequences. Controls are most effective when they are known by everyone, when they are communicated within the company and are perceived by all (cf. pwc, 2007, p. 30). By comparing companies with a relatively weak control environment (up to five control measures) with companies with a high level of control (more than five control measures), the authors were able to demonstrate that not only do the latter have more cases of claims but that they suffer twice the financial damage. They point out that the first group, namely companies with a weak control environment, do not realize the extent of damage being incurred and therefore underestimate the actual risk. This leads to a treacherous confidence that has fatal effects. Companies in this category easily get into a cycle of "ignorance or inability to learn". As they cannot assess the actual damage created, they see less of a need to inform themselves about better control and preventive measures. As a result, only 9 per cent of these companies request consultation, whilst 34 per cent of the companies with a high level of control and prevention do so. These companies have also learnt how to better handle claims (cf. pwc, 2007, p. 37).

The third prerequisite of the Fraud Triangle Model relates to the potential offender. Knabe et al. speak of a personal, quasi character or cultural component that allows the perpetrator to undertake the act and to justify the crime to themselves. They assume that there are individuals that, based on their character, are more likely to knowingly and deliberately commit a fraud. And they assume that honest people, too, can accept fraudulent behavior if under high pressure. The risk of committing a fraudulent act is high if one or more people are motivated to commit a crime, are given an opportunity and are not prevented by business morals from committing the fraudulent act (cf. Knabe et al., 2004, p. 1058). Schruff states examples for the inner justification for fraud as overly high interest on behalf of the management to increase share prices with the motto "for the good of all" (cf. Schruff, 2005, p. 209). The IDW also notes that the inner justification is dependent on the attitude, the character or the moral concept of the person acting (cf. IDW PS 210, 2006, p. 1426). According to Brinkmann, the ethical moral concepts of an employee are not just based on their degree of socialization but also on the acquired moral concepts and the specific situation of a given company. The acquired moral concepts and specific situation within a company determine to what degree an offender subjectively views undertaking a fraudulent act as fair. If an employee feels he/she is treated unjustly compared to a colleague, this situation makes it easier to justify the act. The inner justification is also made easier when an employee cannot



identify with the company culture any more, for example, because he/she is requested to constantly adhere to impossible conditions to reach budget projections (cf. Brinkmann, 2007, p. 158). The auditing firm KPMG comes to similar results in their study from 2006. The aspect of inner justification has a subjective component but the social context of the company plays a decisive role in relation to the personal justification for the undertaking of a fraudulent act. The moral perspectives are comparable to the social context of the company and justifications such as “the others do it as well”, “I deserve this”, “that was not too much” or “we are insured” arise from this (cf. KPMG, 2006, p. 24).

In 1995 Müller already noted that a company culture that is not based on ethical values can lead to a softening of the sense of guilt of the individual employees. These undertake, for example, bribe payments, which are tolerated or requested by the highest levels of company management and which are not seen as indecent and which lead to them possibly trying it themselves to improve their sales turnover using such “creative” measures (cf. Müller, 1995, p. 840). Subsequently, for example, employees that are responsible for the creation of the accounts can be requested by the company management to manipulate the accounts to suit their needs and receive personal advantages for doing this. Müller points out that a company culture which is founded on ethical principles which are also lived can have a positive exemplary function (cf. Müller, 1995, p. 840).

According to the Fraud Triangle, all three prerequisites of incentive/pressure, opportunity and attitude must be present for fraud to occur. Terlinde notes in relation to the study published by Loebbecke/Eining/Willingham in 1989 that, in cases where one or more of the three factors cannot be found, the chances of balance sheet manipulations occurring is zero (cf. Terlinde, 2005, p. 204).

In the course of nearly seven decades since Cressey developed the Fraud Triangle, the three prerequisites and the subsequent criminal profiles have not fundamentally changed. However, due to the dynamics of the market and technological developments the model had to be extended. Wolfe/Hermanson extended the Fraud Triangle model to include “ability” and turned it into the Fraud Diamond (cf. Rienecker, 2009, p. 20 f).



*Illustration 4: Fraud Diamond*

The ability to undertake a fraudulent act assumes that the potential offender holds a position within the company hierarchy that allows him/her to make decisions and to steer employees in the wanted direction. In connection with this position of power, the following perpetrator characteristics can be found: the delinquent is intelligent enough to discover weaknesses in the system and has a certain degree of criminal creativity. Their strong self-confidence leads them to the security of thinking that they will not be discovered and give them the possibility to persuade others of their doings or to overlook them. Furthermore, they are in the

position to disguise their fraud over a long period through the chosen approach. They show themselves resistant to the stress factor created by the house of lies that is created through their fraudulent behavior (cf. Hofmann, 2008, p. 213; Rienecker, 2009, p. 21 f).

### 2.3.2 *Approaches to Further Developments*

The ability to recognise the basic threat of fraud that every company is subject to, the knowledge of the theoretical explanations leading to white-collar crime and the insight into the criminal's motivation are the prerequisite for implementing an effective and sustainable anti-fraud management. For this reason, the previously demonstrated approaches to explain the root causes of white-collar crime have been extended and have undergone further differentiation as part of scientific research. The following chapters explain these further developments in more detail.

#### 2.3.2.1 *The Leipziger Progression Model of White-Collar Crime*

Schneider's Leipziger Progression Modell of White-Collar Crime<sup>7</sup> attempts to concretize the motivational factors driving economic crime (driving force) beyond the motive of greed as outlined by Coleman and to isolate it from other possible triggers. The study develops factors of inner and outer boundaries whose existence can stop the criminal act from occurring, whereas their absence is to be rated as a personal risk factor. As such, it is a supplement to Coleman's study of 1987 "Toward an interpretation theory of white-collar crime" which until then had been the only attempt at developing a specific white-collar crime theory. While Coleman saw the combination of individual motive, structural frameworks as well as neutralization strategies as the trigger for the act of white-collar crime, Schneider lays emphasis on personal risk factors which find nearly no consideration in Coleman's approach (cf. Schneider, 2008, p. 137-139). Schneider bases his approach on the existence of studies which show that, when comparing a white-collar criminal with a non-delinquent employee, one finds there are differences in the value orientation, i.e. in the characteristic interests and basic intentions. Schneider draws on existing theoretical explanation models which he then specified and adjusted taking the

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7 The shown sketch of the Leipziger Progression Model is based on Schneider's publications from 2007 and 2008.

social inconspicuousness of the white-collar criminal into account. The objective of his study is to re-adjust this integrative approach and to specify it according to the given set of problems. The presumption is that personal factors that are crucial for the emergence of a white-collar crime are more subtle and less obvious than with other forms of crime. As such the Leipziger Progression Model analyses the processual character of the act of white-collar crime and the driving factors that occur throughout the process (cf. Schneider, 2007, p. 558).

During everyday work there will often be situations which offer the opportunity to commit a white-collar crime. Even with routine activities, in which safety relevant operations are undertaken by the same employee, without control by a third party, criminal situations can arise. These are situations that can principally be used to take criminal action. In such cases, a prudent employee will at best be able to acknowledge the possibility of a crime occurring, inform accordingly and make proposals for improving the situation. Whether this occurs depends on how the individual employee rates the situation. The rating of the situation on the other hand depends on the varying personal risk constellation. The personal risk constellation is divided into pre-conditions where you are either pre-disposed to crime or resistant to crime. A person who is pre-disposed to crime will likely commit a criminal offence despite otherwise social unobtrusiveness.

Schneider differentiates between five groups of personal risk factors which can be split into crime pre-disposed and crime resistant categories (cf. Schneider, 2008, p. 139 ff).

Based on Agnew "Foundation for a General Theory of Crime" (1992) work he places certain emotions (negative emotions) in the first category. These are emotions stemming from negatively-perceived relationships to other people such as colleagues or superiors. Frustration based on not receiving a, in the persons view, deserved recognition or not receiving an expected promotion increases the risk of committing a white-collar crime. In such cases, the incentive is there to compensate the negative emotions by carrying out a punishable act (cf. Schneider, 2008, p. 139).

On the other hand, you have the crime resistant factors which Schneider relates to satisfaction and an inner balance which is based on a healthy self-assessment, being appropriately remunerated by your employer and being appreciated by colleagues and superiors (cf. Schneider, 2008, p. 140).

The second category relates to life style. Schneider denotes a lack of aspiration and an unrealistic relationship to money as the life style related predilection towards crime. Despite the possibility to fulfill material wishes, these factors lead to delinquency as they create a plausible reason for acting whereas the existence of neutralization strategies help the doer to maintain his self image of non delinquency (cf. Schneider, 2008, p. 140).

In contrast a normal aspiration level and a realistic relationship to money and property are recognized as crime resistant factors. When these personality traits exist, the individual is not expected to commit a crime (cf. Schneider, 2008, p. 141).

Thirdly a personal crisis can be the determining factor leading to an act of white-collar crime. The trigger can be, for example, the need to repay high tax debts or failed investments. Retaining ones aspiration levels can then, in such cases, lead to a pre-condition of being pre-disposed to crime (cf. Schneider, 2008, p. 141).

A crime resistant pre-condition would be to lower ones aspiration levels to adapt to the situation at hand (cf. Schneider, 2008, p. 141).

The next two categories relate to the levels of inner and outer stability (social bonds). Also here Schneider differentiates between crime pre-disposed and crime resistant pre-conditions.

The fourth category refers to job-related sub-cultures within ones working life (work-related subcultures)<sup>8</sup> which are important in determining a pre-condition of being pre-disposed to crime. Such sub-cultures are created, for example, by the extension of a person's working life in to their recreational time, the merging of work and after work time and through the selection and limitation of the contacts selected. Values and certain ways of behavior are thus established whose deviating character even the individual involved can hardly apprehend. Schneider points out that when looking at this newly developed behaviour from a purely formal point of view one would view it as socially nondescript as the sub-cultural orientation is integrated in the person's working life and as such even family members

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8 The term sub culture refers to a within itself closed social sub culture formed by a group of people which differ from the socially dominant culture in their values, norms, needs, behavior and symbols. In sociology the concept of a sub culture describes and explains contemporary value orientation and life-styles as well as describing and explaining deviating or delinquent behaviour.

would interpret it as being integrated at work. Should the person involved have close ties to job related sub-cultures and no opposing relationships exist, then this can support the decision to commit a criminal act not least of all because the perpetrator, should he be discovered, will not expect condemnation from within the sub-culture (cf. Schneider, 2008, p. 142).

The crime resistant counterpart would be to have strong relationships, for example with ones family of origin, with ones procreation family (meaning the family created through marriage) and not to delinquent friends within and outside of ones ' working life (cf. Schneider, 2008, p. 142).

The last of the five categories within the model relates to the person's value orientation. Based on empirical studies, Schneider sees the following factors as pre-conditions to being pre-disposed to crime: economic success, a high living standard, hedonism, power and influence being important to the person, whereas traditional values such as conventional work ethics or law abidance and integrity are not guiding factors for a crime pre-disposed situation. Although, the potential white-collar criminal may proclaim to such values in a situation not pre-disposed to crime. A one-sided orientation towards materialistic values can be categorized as a personal risk factor towards having a pre-disposition to crime (cf. Schneider, 2008, p. 143).

Schneider names the orientation towards traditional and modern idealistic values as the crime resistant counterpart. Referring to Hermann (2003, p. 345 ff) he refers to values such as friendship, an outgoing personality, being in a steady relationship, political engagement, tolerance, self-responsibility, having an inner calm, environmental responsibility, healthiness, emotionality, creativity and social responsibility (cf. Schneider, 2008, p. 143).

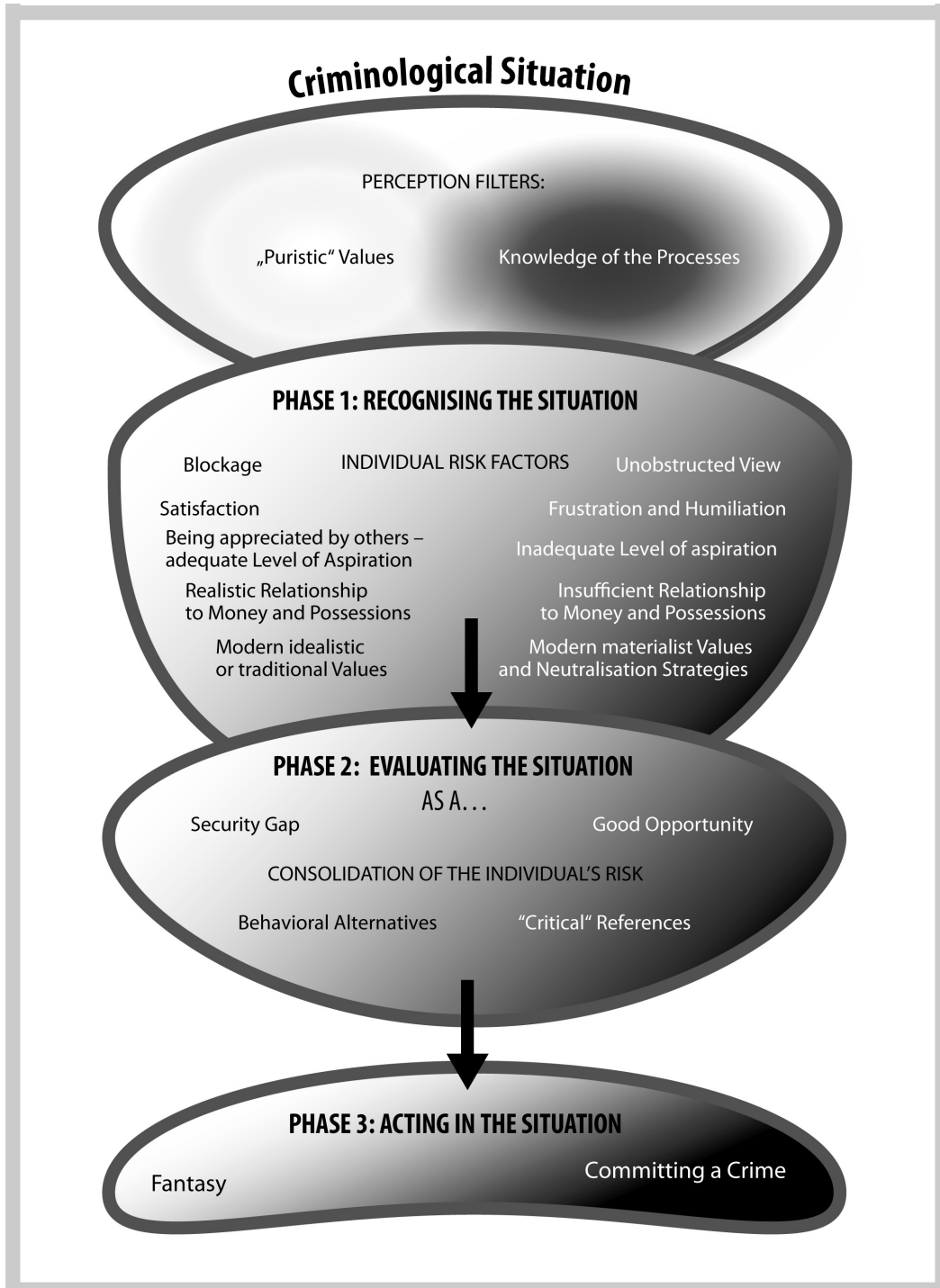
Should a "doer" find himself in a situation which offers a pre-disposition to crime, then it is of importance whether personal risk factors exist or not. Schneider's described risk factors influence the individual person's decision whether or not to commit a crime. Every single risk factor increases the overall risk that situations are viewed as good opportunities by a person with a crime pre-disposition and eventually lead to a criminal act taking place. Should a person's personal risk factors accumulate, then this can lead to a syndrome of criminal endangerment which Schneider reflecting the work of Bock "Kriminologie" (2000) refers to as "relevance of connections". Relevance of connections are basic intentions and especially strong

interests that in summary denote a personality. The importance is not the number but the intensity of the personal risk factors. Should the intensity of the risk factors reach a critical mass, then it will result in a criminal offence taking place (cf. Schneider, 2008, 147).

The starting point of the model sees a person in a situation pre-disposed to crime. In order to be able to make use of the situation as a good opportunity for committing a crime, he must not let it pass (first phase of the progression model). To be able to recognize a situation as a good opportunity for committing a crime, the person must have detailed knowledge of the respective processes and work routines which the potential delinquent can then misuse for his own needs. This is the reason why white-collar crime is generally not committed by people until they have been in the company for around about two years. Should a person not have these insights, then he will not be able to recognize a good opportunity. Another reason for not recognizing the opportunity is a pronounced orientation towards values of conformity. In such cases purist values such as irreproachability, correctness and righteousness act as perception filters.

Should the view of the potential criminal not be obscured by purist values or the lack of procedural knowledge, then the person moves towards the stage of assessing the situation within the progression model (second phase of the progression model). Whether an individual then exploits a situation pre-disposed to crime to undergo a criminal act or not depends on his individual risk constellation. If this includes mostly crime pre-disposed factors, then the situation will be viewed as a good opportunity for committing a crime. In this phase, a person's value orientation also acts as a filter. Crime resistant values can still stop a person from committing a crime in this phase of the progression model. Should however crime pre-disposed values prevail, then the person will commit a crime.

At the time of criminal action the third phase of the progression model is reached. At this stage no new or fundamentally different aspects will intervene. Schneider views that for the act of the crime the increase in mass and intensity of personal risk factors is the decisive factor (cf. Schneider, 2008, p. 144-147)



*Illustration 5: Leipziger Progression Model*



The fact that there may be cases where a crime can be explained simply through being provided with a good opportunity and not by a person's risk constellation, delineates, according to Schneider, the boundaries of the Leipziger Progression Model. According to him, though, the majority of cases of white-collar crime are based, according to current scientific research, on situational and personal conditions being the trigger for committing a crime (cf. Schneider, 2008, p. 147)

### 2.3.2.2 *The Offenders Motives for Committing White-Collar Crime*

The study *Offenders Motives for committing White-Collar Crime* was published in 2008 in Pforzheim (Germany) as part of the sequence "Contributions from the University Pforzheim" and encompasses the analysis and interpretation of thirteen qualitative psychological interviews with perpetrators from various penal institutions. In addition, the authors (Cleff / Luppold / Naderer / Volkert) analysed and evaluated 60 court records of white-collar criminals from eleven nationwide scattered public prosecutors' offices. The focus being on fraud, embezzlement, breach of trust and corruption on a management and executive director level. The intention being that by using these chosen perimeters, it was possible to create clusters of quite similar, empirically relevant cases. The reason for focusing on the management and executive director level was to investigate such white-collar crimes where there was a marked scope for decision making. Naturally the study was based only on known and registered cases which were punished with a monetary and / or prison sentence (cf. Cleff et al., 2008, p. 19). As the authors' findings underpin the Leipziger Progression Model with its empirical data, the most important results of the study will be briefly touched upon.

The study attempts to take specific aspects of the Leipziger Progression Model, which are important for an empirical study and systemization of motives, and thereby also for the prevention of a possible white-collar crime and to develop these further (cf. Cleff et al., 2008, p. 17).

The authors view the part of the Leipziger Progression Model as positive which illustrates the progressive character of white-collar crimes while integrating a great deal of explanatory approaches towards the acts of white-collar crime. The strength of the model is that it illustrates the main moderation variables on the path towards committing a white-collar crime – such as emotional factors and

dissatisfaction as well as social factors like work-related sub-cultures which stand in competition with private social networks (cf. Cleff et al., 2008, p. 16 f).

The authors however note critically that the awareness of the internal relationship between various personal risk factors requires proper detailed investigation which the Leipziger Progression Model in its systemization and interpretation does not offer. This makes it hard to identify further reasons for committing white-collar crimes beyond those of being in a situation that provides a good opportunity for committing a white-collar crime. According to the authors this basis is however required to allow systemic studies on the relevance of individual motives to be placed in a higher context and thus enabling conclusions for the prevention and combating of white-collar crime to be drawn (cf. Cleff et al., 2008, p. 17).

A further weakness of the Leipziger Progression Model the authors say is that it does not take into account the various strategies surrounding potential perpetrators in dealing with inadequate or negative emotional states and the resulting anticipated problem solving strategies. Exactly this is the point where their study starts. Their study supports the Leipziger Progression Model in its fundamentals. It differentiates itself however in so far as that it views and differentiates the progression of a white-collar crime in context with individual aspects such as the individuals emotional state, the personal motivational structure, the differential psychology of an individuals' personality and the subjective perception of potential opportunities for committing a crime (cf. Cleff et al., 2008, p. 17).

Based on the investigation of the crucial motives for committing a crime, typical personality traits and favorable conditions, five different perpetrator profiles were identified that allow for a better understanding of how white-collar crime comes into being. The authors wanted to understand the complex interaction of emotional, motivational and cognitive processes on the path to committing a crime in order to be able to discuss potential consequences for preventing and fighting white-collar criminality. The results of this study will be placed in relation to the portrayal of white-collar perpetrator profiles.

#### 2.3.2.3

#### *Profiles of White-Collar Criminals*

There is insufficient scientifically-based practical knowledge of the person the white-collar criminal is. In face of the lack of a comprehensive theoretical explanatory approach as to the reasons behind white-collar crime, Schneider has

made a substantial contribution with his Leipziger Progression Model. His depiction of the progressional path identifies which phases a potential perpetrator must pass through from finding a good opportunity for committing a crime to actually committing the crime itself and which personal risk factors and constellations were relevant in making the decision to commit the crime. The Pforzheimer authors' findings demonstrate which aspects of the individual personality play an important role. A further study which offers essential data on what type of person a white-collar criminal is and what crimes he committed in detail is provided by the study "Profiles of a Fraudster" by KPMG from 2007. The study is based on investigations into real cases which the forensic department of the KPMG undertook within the EMA region (Europe, India and the Far East as well as South Africa). Structural data from 360 fraud investigations was compiled and summarized. KPMG points out that the survey is not representative from a statistical or mathematical point of view as it only relates to registered cases and ones which they investigated. Despite this, the study is important for two reasons: on the one hand it provides important background information on the perpetrator or perpetrators and on the other hand the study is based on the encompassing knowledge of real cases and not on voluntarily provided information. In addition to this it provides an all-encompassing profile of the perpetrator (cf. Schneider, 2007a, p.3).

The results from the Leipziger Progression Model, the Pforzheimer contribution to a criminal's motives and the KPMG study "Profile of a Fraudster" build the basis for the following description of a white-collar criminal.

The essential data gathered surrounding the person of a white-collar criminal shows that it is predominantly men of middle age who, at the time of discovering an opportunity to commit a crime, had spent at least two years in a senior position working for a company. Seventy percent of the criminals were between 36 and 55 years of age. In eighty-nine percent of the cases, the perpetrators were the company's own employees. There were only thirteen cases where the person had been with the company for less than two years. In sixty-eight percent of the cases the perpetrator acted alone. Sixty percent belonged to the upper management and of these thirteen percent were part of the executive management. Overall, being in a managerial position played a role in eighty-six percent of the cases investigated. In twenty-four percent of the cases the time spent to commit the criminal transaction took less than a year, whereas in sixty-seven percent the perpetrator was

active for one till five years until they were discovered and their activities stopped (cf. Schneider, 2007a, p. 5 f).

The statistical results of the Fraudster-Profile-Study complement the existing theoretical and empirical knowledge about the prevailing conditions that lead to white-collar crime by including, for example, the relevance of factors such as “gender” in relation to the development of white-collar crime. The results of the study show that eighty-five percent of the perpetrators are men and fifteen percent are women. An interpretation into this number is however not possible as one has to take the overall distribution of gender in the affected departments into account. Concerning this there is no data available. It is however remarkable that in every fourth case not committed by a single person, women play a role in committing the crime (cf. Schneider, 2007a, p. 10 f).

Based on the analysis of the interviews conducted, the authors of the Pforzheimer study identified 5 basic types of white-collar criminalists that can be split into two groups. The first group encompasses perpetrators with a visionary personality structure who show characteristics of egocentric, frustrated and narcissistic tendencies. The second group encompasses perpetrators with dependant and naïve personality structures (cf. Cleff et al., 2008, p. 23 ff).

Perpetrators with a visionary personality structure are intelligent people who want to turn their vision into reality. Their actions concentrate on career success with the goal of making a difference (cf. Cleff et al., 2008, p. 23).

A person with a tendency towards being an egocentric visionary is a person who deliberately ignores rules and laws in order to achieve his very ambitious goals. That includes following materialistic goals that allow him to live a hedonistic, luxurious life-style. The satisfaction achieved from committing a crime wears off quickly so that he yearns for ever greater successes (cf. Cleff et al., 2008, p. 23).

Motives and values: with money an egocentric visionary can defy social restrictions. It allows him to live independently and in luxury. He demonstrates his independency and dominance with his house, his yacht. His emotions belong to himself and he remains emotionally untouched by others. He ignores rules and laws and proves (to himself) that he is independent (cf. Cleff et al., 2008, p. 25).

The variant of a frustrated visionary is a type of perpetrator who is a doer. Despite of his intelligence he always falls short of his own high expectations of himself. He strives to achieve something special. His visions appear to be of a quite

non-materialistic and socially motivated nature. He feels misunderstood and left alone in his wish to fulfill his visions and is therefore disappointed and frustrated (cf. Cleff et al., 2008, p. 23f).

Motives and values: Money allows the frustrated visionary to prove himself and to gain social recognition. Just like the egocentric visionary, he places a great importance on status symbols. But it is also important for him to prove to others that he can achieve great things. From this self-realization he gains his emotional satisfaction (cf. Cleff et al., 2008, p. 25).

Both types – egocentric and frustrated visionary – have a narcissistic tendency. This ties in with literature which compares offenders and non-offenders of white-collar crime and which found that offenders show higher values of personality dimensions in the realms of narcissism (cf. Cleff et al., 2008, p. 24).

In a person with the tendency of a narcissistic visionary, this inclination is especially strong. With an exaggerated self-image he wants to receive permanent reassurance from his immediate environment. Career success and money help him to feel reassured. If he gets criticized, he reacts angrily, irritably and provocatively (cf. Cleff et al., 2008, p. 24).

Motives and values: The narcissistic visionary receives reassurance and confirmation through money. His needs are about his narcissistic, smug nurturing of his own materialistic independency, and the demonstration of professional genius and superiority. For that purpose he will also use illegal ways to make himself, at least in his typically, strongly convinced way, invulnerable (cf. Cleff et al., 2008, p. 25).

For the dependent type social relationships are vital. He cannot be alone and is strongly plagued by separation anxiety. This leads to the fact that he accepts heteronomy through others in a passive manner. This in turn can lead to him being persuaded to undergo an illegal act by people with whom he has an emotionally dependent relationship although these actions are against his own personal sense of right and wrong (cf. Cleff et al., 2008, p. 24).

Motives and values: Money gives the dependent type the feeling of belonging. He tries to tie other people to himself through money. He mainly acts in a heteronomous way as he wants to experience the appreciation of others. Money enables him to secure the structure of his personal relationships. It supports him in his struggle against anxiety not to lose social attention and emotional relationships

(cf. Cleff et al., 2008, p. 26).

The profile of the naïve perpetrator is shaped by simple intellectual structures compared to those of the intellectual visionaries. The naïve person tries to act in a conscientious and dutiful manner and holds on to traditional values. He feels quickly overwhelmed, acts without thinking and is gullible. As such he can perform illegal acts without realizing what he is doing (cf. Cleff et al., 2008, p. 24).

Motives and values: For the naïve perpetrator money is a means of securing his existence and that of his family. He tries to please everybody and to fulfill all requests satisfactorily. Thereby he pursues traditional values such as responsibility towards his family, but also towards the company in which he works (cf. Cleff et al., 2008, p. 26).

All of the perpetrator profiles listed are marked by a highly subjective sense of justice. They define their rules and norms themselves and do not question whether their actions are legal or not. For them the deciding factor is whether they perceive the act as legitimate or illegitimate. This subjectivity around their sense of justice is a result of their individual neutralization and justification strategies. Offences are made light of, the general acceptance of the doings postulated, and the offences viewed as compensation for too low income or received injustices. These strategies serve to calm their own conscience and to uphold their self-image (cf. Cleff et al., 2008, p. 27).

While the listed perpetrator profiles all demonstrate a subjective sense of justice, they differ in the perception of potential opportunities for crime and in the assessment of the risks associated with the crime. The egocentric visionary actively seeks opportunities and is fully aware of the possible consequences. The frustrated and narcissistic visionaries are latently ready to act. Whereas the frustrated visionary desperately grabs an opportunity, the narcissistic perpetrator does not fear the consequences due to his exaggerated opinion of himself. The dependent personality is torn between the conflict of social obedience and possible sanctions whereas the naïve quite accidentally finds an opportunity, uses it and is hardly aware of the possible consequences (cf. Cleff et al., 2008, p. 30).

Of the five perpetrator profiles, which differ in the complex interaction of their emotional, motivational and cognitive perception processes on the way to committing a crime, four could be proven based by the cluster analysis of the court records. The differentiation of the narcissistic visionary could not be proven. The

authors of the study base this on the fact that a more encompassing study of the court records is required including insight into psychological evaluations to be able to better identify narcissistic personality structures (cf. Cleff et al., 2008, p. 39).

The categorization of white-collar criminal profiles according to intra-psychological characteristics as undertaken by the Pforzheimer study should contribute to the prevention and countering of white-collar crime. As such, the authors formulated initial conclusions from the results. Thereby they show important proposed prevention measures<sup>9</sup> as published in academic literature and place them in relation to the measure and its potential effect on a certain perpetrator profile. Thereby the measures discussed in the published literature become a further confirmation as to their usefulness. After outlining the profile of white-collar criminals, this chapter will also take a specific look at the accounting fraudster. Finally the shareholder value principle will be briefly outlined as the fraudulent behavior of individuals must be seen in close connection to structural and systemic conditions.

### 2.3.3

#### *Looking at the Accounting Fraudster*

All people that are party to the creation of the annual financial statement and are in a position to influence the accounts can, in principle, commit an act of accounting fraud. This can be members of the executive board, of the supervisory board or employees in the accounting department. Depending on how the accounting fraud is conducted, it can be a single offender or a case of a collusion, whereby a group of people commit the offence together (cf. von Hollen, 2005, p. 7).

Terlinde completed a study in Germany in 2005 which identified the way in which criminal activity is spread over different hierarchical levels. Two percent of balance sheet manipulations are committed by the Supervisory Board, 3 percent by non-managerial positions (lower level personnel), 14 percent by middle management, 39 percent by financial board members or accounting managers, 3 percent by the Executive Board and 41 percent by executives or managing directors (cf. Terlinde, 2005, p. 323). The comparatively high number of 41 percent of accounting

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<sup>9</sup> The study refers to preventive measures that were proposed by the following authors: Busmann/Salvenmoser (2006), Ernst & Young (2007), Menzies/Tüllner (2008), Samson/Langrock (2007), Schmidt (2004), Noll (2002), Wieland (2008).

frauds occurring on the executive or managing director level differs only by one percent point compared to the Beasley/ Carcello/ Hermanson (1999) COSO-study conducted in the USA (cf. Hofmann, 2008, p. 214).

There is also a correlation between the amount of damage caused and the amount of control and empowerment the perpetrator has. Considerable financial damage is caused twice as often by fraud committed by top management as it is by lower level personnel. Accounting fraud committed at higher hierarchical levels causes considerably higher material and immaterial damage to a company. Comprehensive levels of authority allow board members to bypass internal controls and to instrumentalize employees in attaining their goals and misuse them for fraud (cf. Hofmann, 2008, p. 59 f). Apart from material gains, the reasons for committing a crime are the drive for more power, recognition and prestige as well as to satisfy their pronounced personal vanity. This narcissism of top managers, blind to the fact that they are damaging the company long-term, turn them into criminals responsible for accounting scandals (cf. Peemöller/Hofmann, 2005, p. 155).

Also a personal vendetta can be a reason for accounting fraud. In this case, the main aim of the offender is to damage the company without attaining a personal tangible gain (cf. Sell, 1999, p. 19, footnote 14).

Even if balance sheet manipulations are normally committed by people in leading managerial positions, other people are often involved. These are normally people within the accounting department who have performance-related pay and whose further employment depends on the company's success or who are paid for their complicity (cf. Henzler, 2006, p. 33).

The delinquents undertaking an accounting fraud are trying to mislead those people interested in the company accounts about the actual state of the company. The deception can be either to let the company appear in a better financial state as it actually is; or to portray the company in a worse state than it actually is.

Motives for a better portrayal of the company accounts can be, for example, personal enrichment plans on behalf of the management. This can, for example, be the case when a large part of management remuneration is based on share programs (cf. Marten et al., 2003, p. 383). This incentive principle works in such a way that the management participates in the shareholder value by being given a certain amount of shares at a fixed price at a fixed point of time in the future. The



more the share prices grow, the higher the profit the managers stand to gain as they only have to pay the previously determined fixed price (cf. Wöhe/Döring, 2000, p. 97 f). In relation to this point, one should also highlight the fact that a motive is also given by the fact that the future of the company management is also dependent on their ability to increase shareholder value (cf. Marten et al., 2003, p. 383). The 2009 study of the auditing firm pwc comes to the conclusion that the too high pressure to meet targets is also one factor that fosters white-collar crimes (cf. pwc, 2009, p. 45). Here the motive is that managers tied to targets and who want to fulfill these, use an opportunity to show the accounts in a better light than they actually are if they cannot achieve these targets. A further motive can be the need to increase needed liquidity through equity investors or capital providers as the risk of investing is reduced for the potential investors with an improved portrayal of the company (cf. Terlinde, 2005, p. 12). Peemöller and Hofmann also state further motives as being "calculating oneself richer"<sup>10</sup> (translated in context by the author) meaning amongst other things that for an upcoming sale of the company, the company value is corrected upwardly in order to achieve the best possible sales profit. Furthermore, a high company value can protect companies against takeovers as the company planning the take-over must first be able to raise the purchase price. It is also possible to postpone the point in time when insolvency proceedings must be filed in cases where the company is in a financially bad position and is threatened with over-indebtedness. Possibly the company can even find new investors that provide sufficient equity capital in this time (cf. Peemöller/Hofmann, 2005, p. 152).

Motives that lead to a worse portrayal of company financials as they actually are can be in the interest of a company, for example, when low earnings can reduce the tax burden payable. In addition to this, lower company profits can signal to business partners that it is not possible to accommodate them financially. Personal enrichment motives on behalf of the management can then become a motive for accounting manipulations when the company management makes the annual result look even worse than it already is by pulling ahead expenditures into the current fiscal year as they would anyway not be eligible to receive premiums and bonus payments. In the following years the company results are by implication then portrayed better than they actually are. These types of manipulations make

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<sup>10</sup> "eines Sich-reicher-Rechnens"

shareholders and third parties think that the improvements made from the very bad year in relation to the results of the following years are more impressive than a relatively constant profit over several years (cf. Terlinde, 2005, p. 12 f). In addition to this, Brinkmann provides a further reason for portraying accounts in a worse state than they actually are as the attempt to build hidden reserves for the future. In the public sector, it sometimes occurs that worse portrayed earnings can lead to being eligible for higher grants (cf. Brinkmann, 2007, p. 158). The possibility to have easier tariff negotiations and staff reduction measures is a further reason for companies to portray the financial situation in a worse state than they actually are. Also it is easier to compensate a no longer wanted associate (cf. Peemöller/Hofmann, 2005, p. 152).

#### 2.3.4

#### *The Principle of Shareholder Value*

Explanatory models of accounting fraud look at the key motives leading a person to become a perpetrator but one should also look at criminal behavior in relationship to the structural and systematic background. This is especially important due to the ever-increasing importance of short-term company performance as seen since the nineties. Success is more and more often defined through increasing stock prices rather than by long-term sustained growth. The pressure to present good financial statements is growing steadily. Not just prestige and image but also a company's ability to attain capital is widely dependent on it. This is where the role of rating agencies and bank ratings are of particular importance. Banks mostly use the customers' creditworthiness as the basis for lending money and for the credit conditions granted. For companies which are "rated", a change in status, be it rated either up or down, has serious consequences. That is why it is so tempting to make the balance sheets appear better than they actually are. A good rating does not just influence the interest rate of bank credits and the issuing of bonds but primarily influences the current market share. That in turn means the dependence on the development of the share price increases which in turn is the root cause of most accounting fraud scandals. In this context, the liberalization of certain industries should be mentioned, based on the move to market self-regulation. Protective measures were successively reduced and regulatory rights of authorities limited (cf. Peemöller/Hofmann, 2005, p. 153 ff). The result of inflating turnover and profits through questionable business practices and accounting methods to

drive share prices up had catastrophic outcomes. Sablowski states that especially some of those companies which in the nineties had the highest growth rates, the strongest growth in shareholder value and which were seen as exemplary in the eyes of investors collapsed like a house of cards. Not just the individual mistakes were publically discussed but also the institutional problems. But neither the drive for shareholder value, the market share orientated financial system nor the neo-liberal deregulation of energy supplies or telecommunications was ever questioned, although these were the prerequisites for the rise of the later bankruptcies (cf. Sablowski, 2003, p. 201 f).

In Germany, the impact of deregulation and the shift in focus towards shareholder value can be illustrated by looking at the development of energy companies. In the energy provider sector, companies such as RWE, EON, EnBW<sup>11</sup> who were previously more than 50% state owned were privatized. The deregulation and privatization shifted not just the majority but also the power structures. The majority of shares and power now lie in the hands of private investors. This led to a fundamental change in company politics. The overall company goal now became shareholder value. With this orientation towards profit maximization companies had and still have to adjust to market conditions. The energy sector is an oligopoly, as four companies share the sector and, as such, price is not a result of supply and demand. Supply is often artificially throttled so that price can be dictated. There is also the surmise that the big four undergo price-fixing. The state has given away their power but a self-regulation of the market never occurred. Due to the size of the companies, they wield so much power that the proper control of their financial statements seems hardly possible.

*The insight won in this thesis regarding possible models of explanation for the occurrence of balance sheet manipulation has been summed up in a short report that will be published in a scientific journal within the framework as part of the promotion program of the UCAM-FOM.*

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11 This encompasses three of the four largest energy suppliers in Germany (the fourth company is Vattenfall whose headquarters are situated in Sweden). These four companies hold the majority of Germany's electricity market and own the majority of the electricity grids.

## 2.4 RESULTS OF ACCOUNTING IRREGULARITIES

Specialist literature looks at the affects of balance sheet manipulations in relation to the damage caused. Accordingly, the next chapters will firstly look at the effects of balance sheet manipulations on affected companies as well as on investors and shareholders. Then the potential implications for the perpetrator will be explored. As a last point, the overall market implications of balance sheet frauds shall be looked into.

### 2.4.1 *Implications for Companies*

Accounting fraud, when discovered, can inflict serious if not existential damage to companies. The company is liable for damages caused to investors, process costs and penalty payments ruled by court. An example for the downfall of a reputable company is the private bank house Herstatt which was driven into insolvency in 1974 through accounting fraud and currency speculations. At first the accounting fraud and currency speculations led the company into a dangerous imbalance. The banks supervisory board was misled by manipulated status reports. Only when, in April of 1974, the losses of DM 400 million could not be kept secret any longer, did the Supervisory Board request the chief financial officer to undertake a special investigation. The company's equity at this point was already used up. In June of 1974 the Federal Banking Supervisory Authority withdrew the Herstatt Bank's authority to conduct banking business according to § 35 II of the German Banking Act. In addition, it ordered winding down the company and an immediate payment stop (cf. Peemöller/Hofmann, 2005, p. 80 f).

If a company is not completely closed-down, then the discovery of balance sheet fraud leads to liability claims, process costs and fines as well as to costs in relation to correcting the financial information (data gathering, data preparation and data publication). Companies which are on the stock market also have to bear immense share price losses.

In addition, there can also be indirect pecuniary damages caused by external factors. This can be demonstrated using the example of the American energy company Enron. Enron was audited by the auditing firm Arthur Andersen over a period of several years. Apart from the auditing service Arthur Andersen also rendered consulting services to Enron at the same time and was "part of Enron's

creative accounting measures"<sup>12</sup> (translated in context by the author) (cf. Peemöller/Hofmann, 2005, p. 35). Arthur Andersen also destroyed evidence after the balance sheet manipulations were discovered. The result was a direct pecuniary damage but also an indirect pecuniary damage, as the result of the publicising of the fact that documents had been destroyed led to an exceptionally significant negative income return<sup>13</sup> (cf. Peemöller/Hofmann, 2005, p. 35; Hoffmann, 2008, p. 46). This also highlights why dual contracts of auditing and consulting services should be prohibited. This aspect will be discussed in more detail in one of the following chapters (see chapter 3.4.5).

A study published in January 2010 which the audit and management consultancy company KPMG had the Emnid-Institute carry-out and which involved 300 German companies made the following clear: affected companies judge the average damage caused in the last three years by cartel law violations, money laundering, corruption and the manipulation of financial statements or balance sheet information to be over 200 million euros (cf. KPMG, 2010, p. 10).

The study showed that within the area of white-collar crime there was a strong shift towards fraud in the financial and accounting sectors as well as in the credit business. This means that white-collar crime is increasingly performed by people higher up in the company hierarchy. In line with this trend, systemized, internal control systems are uncovering more and more cases of accounting manipulations (cf. KPMG, 2010, p. 9).

Regarding the estimated damage of over 200 million euros (KPMG study from 2010), it should be noted that this value is an average value from the 300 German companies polled. This does not take into account that, on the one hand, there are companies that are being damaged through the discovery of balance sheet manipulations and that, on the other hand, there are companies that at least for a period of time can generate advantages totalling several millions through undiscovered balance sheet manipulations (capital increases, subsidies, taxes).

Apart from the financial damage, one needs to take a look at the indirect damages. Indirect damages can have a great magnitude and can therefore lead to further financial damages. One of these damages is the loss of reputation, with

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12 „an den kreativen bilanziellen Gestaltungsmaßnahmen Enrons beteiligt“

13 The fraudulent behaviour eventually led to the dissolution of Enron as well as the auditing firm Arthur Anderson (cf. Peemöller/Hofmann, 2005, p. 29 und 35).

publically listed companies it also means a drop in share prices, a decline in employee morale, an impairment of business relations as well as an impairment in the relationship with public authorities. The companies' assessment of these indirect damages has changed significantly over the last decade. A study from 2011 that was conducted in Germany on behalf of pwc and the University of Halle-Wittenberg by TNS Emnid showed that the loss of reputation has increased significantly over time. In 2001 only 10 per cent of the German companies affected reported a loss of reputation whereas in 2011 it was already over 40 per cent (cf. pwc, 2011a, p. 22.). As part of this study, 830 German companies that had at least 500 employees were polled (cf. pwc, 2011a, p. 12 und 15). The authors of the study see the occurrence of indirect damages as increasingly hard to calculate and hard to manage. These types of damages have become an increasing threat to companies. The authors of the study also point out the significant management costs that are caused by white-collar crime. The tackling of white-collar crime as well as the judicial prosecution of the cases cost a lot of time and money. Also rebuilding one's reputation with the public requires not insignificant efforts. This can partly be explained by the fact that more than half of the offenders are the company's own employees and that the public as well as the supervisory authorities are reacting increasingly sensitively towards this type of cases (cf. pwc, 2011a, p. 24 f).

#### 2.4.2 *Implications for Company Owners, Investors and Shareholders*

The term Principal-Agent-Conflict describes the prevailing state on the anonymous capital markets. Investors and shareholders (principals) put their capital in to the trust of managers (agents). As investors and shareholders do not have the ability to effectively control these managers, it is possible for them in turn to use their power of authority to commit fraud worth billions of euros. Information asymmetries play a key role here. The financial statement of a company holds an important function in terms of information flow to shareholders. Managers can withhold or falsify information so that the company's statements are false. Statutory auditors cannot see into the finite detail of company's status. Also shareholders often do not familiarize themselves with the complex financial reports but rely on press releases (cf. Hofmann, 2008, p. 48).

Investors only use their right of information in a limited form and so enable a control vacuum to occur. Neither private nor institutionalized investors can close

this gap through their participation at the annual general meeting. Accordingly, increasingly few investors make use of their right to vote. Especially many small investors forgo their right to attend the annual meetings as they know that their single vote has no real influence. The limited influence of shareholders on the strategic direction of a company leads to the already discussed question as to whether shareholders can still be described as sovereigns of companies (cf. Hofmann, 2009, p. 48 ff).

Apart from the large accounting fraud scandals in the US, there were also some sensational cases in Germany where investors were damaged by managers following their own dubious interests. Managers made heavy gains through insider trading whilst the investors hopefully held on to their devalued shares (EM TV/Informatec). In the case of Camroad, the statutory auditors were not able to expose the “empty bookings” and the faked false optimism intentionally created by management (cf. Hofmann, 2008, p. 47 f).

#### 2.4.3

#### *Implications for the Perpetrator*

The prosecution of white-collar offenders is affected by grave structural issues. Apart from the low perceptibility, there is also the high factual and legal complexity of the cases and lengthy proceedings that often stretch over a number of years. Problems proving accountability and personal guilt go hand in hand with an increased defense potential on behalf of the accused (cf. Bussmann, 2003, p. 91). Personal guilt and being punishable presumes pursuant to § 331 of the German Commercial Code (HGB) intentional behavior which must be proven. The accounting fraudster must, for example, specifically have thought it possible that the affected depiction was false or included a deception and have accepted it (cf. Wulf in Freidank, 2005, p. 222). Furthermore, the Public Prosecutors handling these types of cases are insufficiently staffed and professionally overtaxed (cf. Hofmann, 2008, p. 68). If a white-collar offender is sentenced, despite the structural issues with the prosecution, then they can be sentenced to monetary punishment, imprisonment, court trial costs and compensation claim payments.

For pure accounting fraud, i.e. prosecutions which only take the creation of false financial statements or violate the report-back obligations of the statutory auditors into account, a prison sentence of one to three years or a monetary penalty is foreseen (§ 331, 332 HGB). The conviction process, however, is made difficult by the

wide scope of accounting law to define when a wrong accounting case according to § 331 HGB occurred. According to § 332 HGB, a careless audit as such cannot be sanctioned but rather the dishonesty of the auditor which must be proven as clear and deliberate false accounting. As accounting fraud often occurs along with other deceptions such as tax fraud, fraud and corruption, it frequently plays a secondary role in the overall penal procedure. On the other hand, due to the number of major scandals they have increasingly become the focus of law-enforcement agencies (cf. Hofmann, 2008, p. 68 ff).

Specific cases of accounting fraud will be highlighted using three examples. Informattec AG founded in 1988 was one of the first new market companies that was for a long time one of the favored companies on the growth-oriented stock market. The price of Informattec shares rose steadily. After the euphoria came the sudden crash when in August 2000 it became known that the company had issued several ad-hoc publications that had been wrong. The two board members Gerhard Harlos and Alexander Häfele had driven the shares prices up through misreporting data and then sold Informattec shares worth 15 million euros. In 2001 Informattec had to file for insolvency. In November 2003 both board members were sentenced by the Augsburg regional court pursuant to § 400 of the German Stock Corporation Act for deliberate misreporting of data to investors and for insider trading to monetary punishments and imprisonment. Harlos was sentenced to two years imprisonment on probation; Häfele had to go to prison for two years and nine months. One investor who had invested DM 91,000 in Informattec shares based on the misreported data was liable for complete compensation by the two board members. This was ruled by the Federal Supreme Court in Karlsruhe in a civil law proceeding against the defendant. The court recognized that this was a case of personal liability of the board members. It saw the fact of immoral willful intent as fulfilled pursuant to § 826 of the German Civil Code (BGB) (cf. Peemöller/Hofmann, 2005, p. 106 f; Hofmann, 2008, p. 68).

Comroad AG based in Munich was founded in 1995 and was launched on the new market in 1999. According to the auditing firm KPMG, Comroad was already financially over-indebted in 1998 but presented ongoing outstanding business results. After it came to light that customers were actually only phantom customers, KPMG withdrew its audit agreement in February 2002 with immediate effect. In March 2002 the chairman of the executive board Bodo Schnabel was dismissed



without notice and was arrested in April 2002. In November 2002 Schnabel was sentenced to seven years imprisonment by the regional court of Munich. He was found guilty of fraud (§ 263 German Criminal Code) as well as insider trading (§ 14 Securities Trading Act) and of manipulating share and market prices (§ 20a Securities Trading Act). Schnabel's wife was sentenced to imprisonment for two years for aiding and abetting but this was suspended on probation. In addition, the confiscated property of the married couple Schnabel worth 20.1 million euros was declared forfeited (§ 73 German Criminal Code) and was transferred to the Land of Bavaria (cf. Peemöller/Hofmann, 2005, p. 111 - 113).

Management striving for personal profit maximization cannot only be found in capitalistic companies whose structure is based on profit maximization. The union owned construction company Neue Heimat made headlines in the seventies because the chairman of the board Albert Vietor used his position for years for his own personal gain. Vietor and five further managers were fired with immediate effect by the Supervisory Board of Neue Heimat in 1982. False accounting, credit fraud and personal enrichment led to the insolvency of the Co op AG that was part of the German Trade Union Association (cf. Peemöller/Hofmann, 2005, p. 83 ff).

Once one has been sentenced then the loss of reputation and the social decline of the fraudulent manager is pre-programmed. Suitable employment cannot be found and the need to move the family can arise. The whole social environment of the family can break away, being socially ostracized can lead to a break-up of the family itself. The effects on the personal social arena can in its negative impact potentially be even graver than the judicial punishment.

Pursuant to § 332 of the German Commercial Code (HGB) independent auditors and their aids can be sentenced to monetary punishment or imprisonment of up to three years for the false reporting of the auditing results of, for example, the annual financial statement, the management report, the consolidated financial statement, the consolidated management report of a corporation or of an interim financial statement as well as the concealment of relevant events in the final audit report or because of a falsely issued audit certificate. If the breach of reporting duty is done against payment or with the intent of enrichment, then the delinquent can be sentenced to a monetary punishment or imprisonment of up to five years. Apart from the direct financial loss for the independent auditor there can be further financial damage when they, for example, make "voluntary" payments

to avoid negative publicity or a lawsuit that can go on for years. The case of the auditing firm KPMG is a good example to illustrate this point which, without recognition of a legal obligation in the case of Flowtex, paid out DM 100 million to aggrieved creditors (cf. Hofmann, 2008, p. 45 f). In the Comroad case the speaker of the management board, Harald Wiedmann, tried to counter the loss of public image of the corporation by announcing that the already attested financial statements from 2001 of all 45 KPMG mandates that were listed on the new market would be re-audited (cf. Peemöller/Hofmann, 2005, p. 113).

#### 2.4.4 *Implications for Society: State, Consumer, Economy*

As already stated in the explanation of the shareholder value principle, the financial-political development led to the liberalization of certain industries and placed trust into the self-regulation of the markets. Safety precautions were successively reduced and intervention rights of authorities limited. At the same time the incentive to portray oneself better than reality grew. The dependence on good ratings drives company policy and can tempt people into manipulating the accounts. In cases of accounting embellishments, countries can suffer high losses if they embark on salvage operations by granting government guarantees or subsidies. Should a company go insolvent after all, then the government money is irretrievably lost. A deliberate deceit in the form of worsened balance sheets and understated operating results leads to the country losing tax income. Worsened balance sheets are also used to attain government subsidies, leading to an increase in profit which the state pays for. Use of state assets for surreptitiously attained subsidies or for the salvage of irresponsibly and fraudulently led companies has indirect implications for society. Tax increases may become necessary. The society loses general trust in companies as well as in the capital markets, and in accounting and auditing practices (cf. Henzler, 2006, p. 38 f).

This loss of trust has negative consequences for the overall economy of a country. It creates uncertainty and as such a reduction in people's willingness to invest and engage. The overall existing capital is not invested as heavily, which also leads to a reduction in consumption. This can lead to problems in attaining capital and can impact interest rates, which in turn can lead to a company's downfall. Ultimately the mistrust in the economic system grows (cf. Henzler, 2006, p. 38 f). Such developments will impact the prosperity of a country and its society.

Now that the terminology of balance sheet manipulations has been reviewed, explanatory models for the act have been shown and the impact of accounting fraud on those affected understood, the attention will now turn to the legislative provisions for stopping balance sheet criminality from occurring.



### 3 CATALOGUE OF MEASURES TO STRENGTHEN COMPANIES' INTEGRITY AND TO PROTECT INVESTORS

In February 2003 the German Government issued the final version of the catalogue of measures to strengthen companies' integrity and to protect investors (Maßnahmenkatalog der Bundesregierung zur Stärkung der Unternehmensintegrität und des Anlegerschutzes, 2003). This so-called 10-Point-Program is orientated towards the proposals made in 2001 by the "Corporate Governance" commission, was discussed in detail from the legal policy point of view at the 63rd Association of German Jurists in 2002 and was subsequently once again revised (cf. Hofmann, 2008, p. 262 f; on page 263 Hofmann wrongly calls it the 64th Association of German Jurists; this is however the 63rd Association of German Jurists). The catalogue of measures consists of non-committal proposals and thereby offers only directional guidance for legislative definitions. Through legislative implementation of these proposals, the framework for strengthening the self-regulation of the capital market should be improved and behavior damaging the capital markets should be prevented. Since then different, separate legislative procedures are looking to legislatively codify selective measures.

The legislative implementation of the 10-Point-Program shall now be reviewed in detail. For this purpose, a short overview of the relevant codified measures will be provided beforehand.

- Point 1: Personal liability of executive committee and supervisory board members towards the company: Improving the shareholders right of action  
Implementation: (01.11.2005) German Law on Corporate Integrity and Modernization of the Right of Avoidance (as well possible for "Right of Avoidance" is "Right of Rescession") (BGBl issue 2005 part I no. 60, page 2802 ff)
- Point 2: Introduction of personal liability of executive committee and supervisory board members towards investors in the case of deliberate and grossly negligent false information to the capital market; improvement of the collective enforcement of investors' claims  
Implementation: (13.10.2004) Draft of the Capital Market

- Information Liability Act; (01.11.2005) German Capital Markets Model Case Act (BGBl issue 2005 part I no. 50, page 2437 ff) changed on (01.11.2012) German Capital Markets Model Case Act (BGBl issue 2012 part I no. 50, page 2182 ff)
- Point 3: Further developed German Corporate Governance Code, especially relating to the transparency of share-based or incentive-based compensation of board members  
Implementation: last issue of the German Corporate Governance Code dated 13.05.2013, (Governmental Commission of the German Corporate Governance Code, 2013)
- Point 4: Improvement of accounting rules and adaption of international accounting principles  
Implementation: (10.12.2004) Accounting Law Reform Act (BGBl Volume 2004 Part I No. 65, Page 3166 ff); (29.05.2009) Act to Modernize Accounting Law (BGBl Volume 2009 Part I No. 27, Page 1102 ff)
- Point 5: Strengthen the role of the final auditor  
Implementation: (10.12.2004) Accounting Law Reform Act (BGBl Volume 2004 Part 1 No. 65, Page 3166 ff); (01.01.2005) Final Auditor Supervision Act (BGBl Volume 2004 Part I No. 76, Page 3846 ff); (06.09.2007) Professional Supervisions Reform Act (BGBl Volume 2007 Part I No. 45, Page 2178 ff); (29.05.2009) Act to Modernize Accounting Law (BGBl Volume 2009 Part I No. 27, Page 1102 ff)
- Point 6: Inspection of the legality of specific financial statements through an independent party (Enforcement)  
Implementation: (21.12.2004) Law on Financial Reporting Compliance (BGBl Volume 2004 Part I No. 69, Page 3408 ff)
- Point 7: Continue reforming the stock exchange and further development of regulatory law  
Implementation: (01.01.2007) The Electronic Commercial and Co-operative Registers and Company Register Act (BGBl Volume 2006 Part I No. 52, Page 2553 ff)
- Point 8: Improving investor protection including the area of the “grey” market

Implementation: (30.10.2004) Investor Protection Improvement Act (BGBl Volume 2004 Part I No. 56, Page 2630 ff); (15.05.2009) second issuer guideline of the German Federal Financial Supervisory Authority (BaFin) (German Federal Financial Supervisory Authority, 2009)

- Point 9: Ensuring the reliability of company ratings made by finance analysts and rating agencies  
Implementation: There are currently no specific legislative initiatives
- Point 10: Tightening of penal provisions for offences within the capital market sector  
Implementation: There will likely be no separate legislative initiative

The listing of these laws shows impressive, promising names of acts. The description of the content of these acts should answer the question whether they are actually sufficient to put a stop to accounting fraud and insufficient capital market information provided by corporations.

### 3.1 PERSONAL LIABILITY OF EXECUTIVE BODIES

The Board of Management, Supervisory Boards and Final Auditors must adhere to the faithful representation and accounting transparency requirements. The party who has to prepare the accounts must inform faithfully, by reporting all that can be said about the state of the company. They are not allowed to omit or conceal anything substantial. Assets, debts and risks are not allowed to be fabricated or kept secret, so that the actual economic condition of the total company can be portrayed correctly. The Supervisory Board signature on the annual financial statement documents their personal liability towards the shareholders. The legal manifestation is made with the signature on the annual financial statement confirming that the legal requirements of accountability are fulfilled (cf. Luttermann, 2010, p. 342 ff).

Luttermann refers to the endeavors of Executive Bodies to decouple the general standard of faithful representation from the commercial law principles of proper accounting. This decoupling would lead to a dominance of individual rules. This dominance would in turn allow creative and fraudulent Supervisory Boards to apply evaluation and accounting patterns that suit their current corporate situation best and thereby enabling the Annual Financial Accounts to be manipulated in either direction (cooking the books). However, general standards and individual rules systematically complement each other in Accounting Law, as in every other field of law. The general standards provide the common thread for the guideline to faithful representation and transparency, whereas the individual rules provide the concrete framework. Luttermann calls the attempt to separate the general standards from the individual rules as “an unacceptable attitude of arbitrariness<sup>14</sup>” (translated in context by the author) (Luttermann, 2010, p. 344). This attempt goes against the current legislation. Luttermann demands that one controls those in power, as the accounting law should stop Executive Boards and Supervisory Boards from using other people’s money to deceive and manipulate, to succumb to their personal weaknesses and amend results in the direction they require. The judicature is called on to review cases of accounting fraud and to increase the perpetrators liability (cf. Luttermann, 2010, p. 341 ff).

In principle the personal liability of the Board Management and the

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14 „inakzeptable Geisteshaltung der Beliebigkeit“



Supervisory Board Members can deter them from committing a fraudulent act. If caught breaching their duty, they must expect negative consequences. In particular, the fraudulent behavior of various managers within the former “new market” turned the liability of Board Management and Supervisory Board Members into an important issue at the Corporate Governance discussion. The Federal Government reacted to the situation by incorporating proposals into the “10-Point-Program” catalogue of measures to target a change to the legal prerequisites of executive body liability for giving out false capital market information. The proposed measures affect the area of the so-called executive body internal liability (this refers to the liability of the executive body towards the corporation) as well as the area of the executive body’s external liability towards third parties, in particular that towards shareholders. The stricter laws in relation to the liability of executive boards affect primarily their board members but they also relate to the supervisory board members.<sup>15</sup> Whether the intended goal of increasing the threshold to committing a fraudulent crime can be achieved through the specific changes made to the law will be scrutinized below.

Before the implementation of the “10-Point-Program”, the corporation as such was generally liable towards third party claims. Members of the board or of the supervisory board are only liable for shareholder damages in exceptional circumstances (cf. Hofmann, 2008, p. 264 f).

### 3.1.1

#### *Liability Towards the Corporation*

According to §§ 93 and 116 of the German Stock Corporation Act board and supervisory board members that breach their duties are jointly and severally liable towards the corporation for the damage done. “The liability is unlimited from a monetary perspective and is also applicable for simple negligence. Provided the legal prerequisites apply then even a minority of shareholders can force such a regress according to §§ 147 f of the German Stock Corporation Act”<sup>16</sup> (translated

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<sup>15</sup> According to Seibert the act does not increase the liability of the supervisory board members. To the contrary the later explained “Business Judgement Rule” restricts their liability (cf. Seibert, 2004, p. 2).

<sup>16</sup> „Die Haftung ist betragsmäßig unbegrenzt und greift auch bei einfacher Fahrlässigkeit. Sofern die gesetzlichen Voraussetzungen vorliegen, kann auch

in context by the author) (Duve/Basak, 2005, p. 2645 f). § 93 of the German Stock Corporation Act defines in more detail the liability of the board members. Here it is stated that the “board members must apply the diligence of a reputable and conscientious managing director. A breach of duty does not occur when a member of the board makes a corporate decision where he/she could reasonably assume, based on sufficient information, to be acting in the best interest of the company. Regarding proprietary data and company secrets that became known to board members in line with their job as board members, they must maintain silence”<sup>17</sup> (translated in context by the author). A case for want of care can be, for example, when there is a violation of the statutorily regulated individual’s duty, for example in relation to the founding of a company, regarding mandatory reports in relation to the accounts or insolvency. In addition, there is a general obligation towards diligence and loyalty whereby this is measured against the benchmark of a reputable and conscientious managing director. A lack of skill or knowledge does not allow board members to evade their responsibility. For example, a lack of accounting knowledge does not free the board member of their liability to ensure regular accounting (cf. Dilger, 2004, p. 444). In the case of “ARAG/Garmenbeck” the Federal Court of Justice (German) had in 1997 already made the decision (21.04.1997, Az: II ZR 175/95, [www2.wiwi.hu-berlin.de/institute/im/docs/CG/arag.pdf](http://www2.wiwi.hu-berlin.de/institute/im/docs/CG/arag.pdf)) that claims regarding recourse for corporations against their negligently acting board members are enforceable. Only in particularly well-reasoned exceptional cases, can a deviation from this rule be applied (cf. Hofmann, 2008, p. 265). According to the ruling of the Federal Court of Justice (German) in the case of “ARAG/Garmenbeck” board members are liable to pay damages if: “...the boundaries of a corporate transaction made in a responsible manner, in view of the company’s best interest based

eine Minderheit von Aktionären einen solchen Regress nach §§ 147 f. Aktiengesetz erzwingen“

17 „die Vorstandsmitglieder bei ihrer Geschäftsführung die Sorgfalt eines ordentlichen und gewissenhaften Geschäftsleiters anzuwenden haben. Eine Pflichtverletzung liegt nicht vor, wenn das Vorstandsmitglied bei einer unternehmerischen Entscheidung vernünftigerweise annehmen durfte, auf der Grundlage angemessener Informationen zum Wohle der Gesellschaft zu handeln. Über vertrauliche Angaben und Geheimnisse der Gesellschaft, die den Vorstandsmitgliedern durch ihre Tätigkeit im Vorstand bekannt geworden sind, haben sie Stillschweigen zu bewahren.“

on diligent investigation of decision making facts must be clearly overstepped, the willingness to undergo a business risk unacceptably extreme or the behavior of the board members must be for other reasons contrary to duty<sup>18</sup> (translated in context by the author) (21.04.1997, Az: II ZR 175/95, [www2.wiwi.hu-berlin.de/institute/im/docs/CG/arag.pdf](http://www2.wiwi.hu-berlin.de/institute/im/docs/CG/arag.pdf)). The “ARAG/Germenbeck” ruling, for example, forces the supervisory board to assert corporate claims against board members should, after proper consideration, a claim appear promising. A message (letter or email) of a shareholder to a supervisory board member is sufficient to ensure that he/she must trigger an investigation and if applicable assert the claims, if he/she does not want to expose himself/herself to the danger of becoming liable (cf. Hauschka, 2004b, p. 257).

The supervisory board members liability is generally covered in § 116 of the German Stock Corporation Act, which refers to the duty of diligence § 93 of the German Stock Corporation Act. Due to the hierarchical positioning of a supervisory board member, the specific tasks they perform cannot be compared to those of board members. The supervisory board members duties are regulated in § 111 of the German Stock Corporation Act whereby their top priority is overseeing the management body (cf. Hofmann, 2008, p. 265). Concerning this aspect, the German Corporate Governance Codex follows the same direction as the German Stock Corporation Act. It also requests internal liability of board members for culpable breaches of duty. In point 3.8, which defines the working rules of the board and supervisory board member’s as follows “board and supervisory board members heed to the rules of proper business management. Should they be found guilty of breaching the proper conduct of a reputable and conscientious board or supervisory board members role, they are liable to pay compensation to the company”<sup>19</sup>

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18 „...die Grenzen, in denen sich ein von Verantwortungsbewußtsein getragenes, ausschließlich am Unternehmenswohl orientiertes, auf sorgfältiger Ermittlung der Entscheidungsgrundlagen beruhendes unternehmerisches Handeln bewegen muß, deutlich überschritten sind, die Bereitschaft, unternehmerische Risiken einzugehen, in unverantwortlicher Weise überspannt worden ist oder das Verhalten des Vorstands aus anderen Gründen als pflichtwidrig gelten muß.“

19 “Vorstand und Aufsichtsrat beachten die Regeln ordnungsgemäßer Unternehmensführung. Verletzen sie die Sorgfalt eines ordentlichen und gewissenhaften Geschäftsleiters bzw. Aufsichtsratsmitglieds schuldhaft, so haften sie

(translated in context by the author) (DCGK, 2013).

The Act for Corporate Integrity and Modernization of the Right of Avoidance (Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts - UMAG) that implements "Point 1" of the Federal Government's catalogue of measures dated 25 February 2003 follows the same approach. To which extent this applies will become clear in the following references to the most important sections of the act. The changes to the act were based on the recommendations of the "Corporate Governance" government commission from July 2001 as well as on the decisions made at the 63rd German Legal Colloquium.

The Act for Corporate Integrity and Modernization of the Right of Avoidance came into effect on 1 November 2005. It continues the reform process of the past few years of the German Stock Corporation Act. Specifically, the rights of shareholders in relation to their options to control breaches of duty made by board members and illegal decisions made at shareholders' meetings are strengthened. The ability of a minority shareholder group to force liability claims against the board and supervisory board members is made easier (§ 148 German Stock Corporation Act) and the action of voidance against unlawful decisions or decisions violating the articles of associations within shareholders' meetings is made harder (§ 243 (4) German Stock Corporation Act). The legislature strengthens the control rights of shareholders by lowering the thresholds for special audits of the German Stock Corporation Act (§ 142 (2) German Stock Corporation Act). In addition, it strengthens the communication possibilities by introducing a shareholders' forum (§ 127 a German Stock Corporation Act). At the same time though, it also strengthens the rights of the Corporation's executive body by safeguarding the board members' freedom to take entrepreneurial decisions by introducing the so-called "Business Judgment Rule" (§ 93 (1), sentence 2, German Stock Corporation Act) (cf. Fleischer, 2005, p. 3525, 3527).

Shareholders' lawsuit: The recently passed §§ 147-149 of the German Stock Corporation Act grants the ability to undergo a general shareholders' lawsuit to make liability claims against founding and board members within the German judicial system. Above all, the legislature wants to strengthen the rights of action for minority shareholder groups. It will in future be made easier to start a judicial process for liability claims, especially those against board members for

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der Gesellschaft gegenüber auf Schadensersatz."

gross negligence of their duties. A shareholder minority who, at the time of application, together hold more than one percent of share capital or a partial sum (not stock exchange value)<sup>20</sup> of 100,000 euros are entitled to claim liabilities against the corporation in their own name. This considerably reduced quota leads to a situation where nearly every institutional investor but also many larger private investors can start a liability claim process against board members (cf. KPMG, Audit Committee Quarterly, I/2004, p. 15). In contrast to KPMG, the German Federal Council (Bundesrat) rates the new thresholds as positive. Through this standardized approach, a differentiation should be made based on economic importance between shareholders with a corporate interest and shareholders with a primarily investment orientation. Based on the new threshold of nominal 100,000 euros, this typological approach can be seen as meaningful differentiation criteria (cf. BR-Dr. 3/05, p. 42).

In order to avoid hopeless or improper cases, a legal approval procedure was introduced. The respective state court gives a ruling on the application for a case to be heard. If it makes a favorable decision then, once the ruling has obtained legal force, the lawsuit must be raised within 3 months. The lawsuit must be raised against the responsible board members or company founder while making the corporation liable (§ 148 (2) and (4) of the German Stock Corporation Act). After legal admission of the lawsuit, the application for admittance as well as the end of the

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<sup>20</sup> The UMAG government draft included a stock value threshold of Euro 100,000. The Act though – based on the results of the deliberations of the Committee of Legal Affairs of the German Federal Government (BT-Dr 15/5693, p. 17) – changed this to a nominal value of Euro 100,000. This makes the calculation of the threshold easier. For a well established company with a normal share price development this means though that the threshold reduction is not that significant compared to the original approach. The quota was in effect reduced by one-fifth compared to the previous legal binding. The decision was justified by the argumentation that companies who become victims of fraudulent acts must live with the resulting sharp falls in market prices. Especially some scandalous companies who were listed on the so-called new markets often developed into “Penny-Stocks”. For minority rights having the threshold linked to share price value would have achieved the opposite of what the initiators of the changes to the Act wanted to achieve (cf. Seibert, 2005, p. 1457).

process has to be posted without delay by the corporation in their company news or at least in the electronic Federal Gazette. This publication must detail the type of legal settlement in detail, the complete wording of all the relating agreements as well as the names of all affected parties (§ 149 of the German Stock Corporation Act).

The conditions subject to which a claim will be heard are fulfilled if:

- Pursuant to § 148 (1), no. 1, of the German Stock Corporation Act, shareholders must prove that their shares were bought before the time when they should have been aware of the alleged breach of duties or the alleged damage.
- Pursuant to § 148 (1), no. 2, of the German Stock Corporation Act, shareholders must substantiate that the Company failed to make a claim for damages within an appropriate deadline set by the shareholder.
- Pursuant to § 148 (1), no. 3, of the German Stock Corporation Act, a claim will be heard if the court, based on the principle of plausibility, comes to the conclusion that facts have come to light justifying the suspicion that the Company has sustained a loss as a consequence of dishonestly or flagrant breach of the law or of the Articles of Association.
- Pursuant to § 148 (1), no. 4 of the German Stock Corporation Act, a claim will be heard if there are no prevailing interests on the part of the company providing grounds to prevent enforcement of the claim.

The motivation of the legislative power that is behind these conditions is, on the one hand, to exclude shareholders who bought shares knowing that a possible breach of duty exists and thereby possibly acquired the shares for improper use from raising claims. Proof can be in form of a deposit statement from the credit institution or by showing the actual certificates. The intention is to avoid lengthy evidence gathering when clarifying whether a case will formally be heard (cf. BR-Dr 3/05, p. 43). On the other hand, the corporation is to be given the chance to raise their own lawsuit in order to avert the damage to the corporation (for example the company's public reputation) that can be caused by being sued by shareholders. A deadline of two months is reasonably assumed as adequate. The deadline is not required if a corporation can credibly declare that they do not want to sue (cf. BR-Dr 3/05, p. 43 f). By limiting the claim options to the loss sustained to the company by the breach of loyalty or through gross violations of law or of the articles, the legislator is, on the one hand limiting the costs of the lawsuits to be progressed. In

addition, it demonstrates that the court will only give a case permission to proceed if the lawsuit has sufficient chances of success (cf. BR-Dr. 3/05, p. 44). Having no claim limitation could also lead to an overburdening of the courts. On the other hand, the limitation of the claims limits the negative press for companies through the media. Frequent negative press reports can damage the economic efficiency of a company which in turn can have a negative impact on society as a whole. There is also the provision that to enforce the claim no prevailing interests that would damage the company's welfare are allowed, which implies a tendency to protect corporations. It is emphasized that multiple claims must be allowed only in exceptional cases in order to protect companies from the financial impact. This is justified by the fact that individual claims of shareholders cannot be pursued using legal means but, only through application of a special regulation for minority shareholders, is it possible to make claims against companies using legal force (cf. BR-Dr 3/05, p. 45).

KPMG referring to the fourth point pursuant to § 148 (1) of the German Stock Corporation Act in their publication titled "Obligation of the Supervisory Board – duty standards and responsibility"<sup>21</sup> (literal translation by the author) (see KPMG, Audit Committee Quarterly, I/2004, p. 16) speaks of "common good" instead of "welfare of the company". They stipulate that the wording of the law means "common good" when it states "welfare of the company". §148 (6) of the German Stock Corporation Act makes it clear though that it must mean the welfare of the corporation. This becomes clear through the formulation "based on reasons affecting the welfare of the company, which the company could have communicated ahead of raising a claim"<sup>22</sup> (translated in context by the author). A company can ultimately only provide reasons for their own welfare themselves. That the term "welfare of the company" cannot mean "common good" also becomes clear in all the other formulations within the § 148 German Stock Corporation Act where it is clear that the word society actually refers to corporations.

With respect to the decision on costs, the following rules apply: If a claim is allowed to be heard at court then the final decree decides which party is to carry the burden of the costs. This applies to the application of a claim and to the principal

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21 „Haftung des Aufsichtsrats – Pflichtenmaßstab und Verantwortlichkeit“

22 „auf entgegenstehenden Gründen des Gesellschaftswohls, die die Gesellschaft vor Antragstellung hätte mitteilen können“

court case. Pursuant to the principles of §§ 91 and 92 of the code of civil procedure all shareholder costs have to be carried by the board member sued in the case of a successful claim. If a claim is rejected or partially rejected, then the costs are borne by the corporation. The corporation should not just profit from successful lawsuits but they must shoulder the risk of losing lawsuits. Under certain circumstances the shareholders can claim reimbursement of the costs occurred through application of a claim against the company. This does not apply if the claim was allowed to progress based on false pleadings (cf. KPMG, Audit Committee Quarterly, I/2004, p. 17; Fleischer, 2005, p. 3527).

Special audit: For special audits pursuant to the law, the barriers for special audits for minority requests have also been lowered. In line with § 148 (1), sentence 1 of the German Stock Corporation Act the § 142 (2), sentence 1 of the German Stock Corporation Act allows shareholders who alone or jointly hold one percent of the stock capital or shares of a nominal value of 100,000 euros to raise the respective application. The rule of a minimum three-month ownership still applies. A special audit may be required to uncover events that could lead to a future claim or to enforce a claim with appropriate evidence. To avoid improper applications, the UMAG applies a different rule of cost distribution. The applicant must bear the costs of the special audit himself/herself if it turns out that he/she knowingly or grossly negligently made a false pleading. There must also be facts available that support the suspicion that there is a case for improprieties or gross violations of the law or the articles having occurred. Similar to the approach for declaration of admissibility for legal action pursuant to § 148 of the German Stock Corporation Act, the extent of the breach of duty and the consequential damage must be compared to the costs and the negative consequences of a special audit (cf. Keunecke, 2006, p. 111 f; Fleischer, 2005, p. 3525, 3527). It is astounding that a court can rule, based on an application by a Supervisory Board, that certain facts should not be included in the special audit report. This can occur if the prevailing needs of a company demand this and it is not necessary to prove that improprieties have occurred (cf. KPMG, Audit Committee Quarterly, IV/2004, p. 21). According to Duve and Basak, the lowered threshold to start a special audit allows controversial investment funds and major investors to assert the necessary pressure to protect their interests even if they hold only small stakes. This can lead to an increased control of corporations through capital market oriented investors. Forensic science has shown that already there are more disputes between big investors and



management which end in court hearings. To attain a balance of interests between shareholders and corporations, it is worth taking preventive measures such as cultivating a direct contact as well as ensuring a high level of transparency. Regular, intensive communication between shareholders and board members can reduce the number of conflicts. If companies' follow-up internally on suspected improprieties or gross violations of the law or the articles and inform the shareholders of the results in a timely manner, then the number of special audits can be contained (cf. Duve/Basak, 2006, p. 1350).

Shareholders' forum: In December 2005 the shareholders' forum was established pursuant to § 127 a (5) of the German Stock Corporation Act as part of the Federal Gazette so that shareholders can find the necessary shareholder majority for special audits (§ 142 (2) of the German Stock Corporation Act), to undergo a lawsuit led by the shareholders (§148 (1) of the German Stock Corporation Act) or to call in a shareholders' meeting (§ 122 of the German Stock Corporation Act) (cf. BR-Dr 3/05, p. 28). The form of the meeting is defined in detail by the decree of shareholders' forums (BGBl issue 2005, part I, p. 3193 ff). Here the form, content and structure of the shareholders' forum is defined and it provides direction for the regulation of registration, shareholder or shareholder association incitements, suggestions to the corporations, inspections and data security. The reasoning behind the new procedure is to offer an internet platform for shareholders and shareholder associations where shareholders can ask other shareholders if they want to jointly or in representation raise a claim or pursue a demand according to the German Stock Corporation Act or want to use their voting power at a General meeting in a certain way. These requests must obviously adhere to § 127a of the German Stock Corporation Act and it is not allowed to include information or opinions which go beyond the lawfully prescribed content. Improper use also occurs when it contains advertisements for products or services which are not related to the implementation of the proposal. In such cases of improper use, the requests have to be deleted without delay by the operator. In addition, it is then not allowed to publish further rationalizations of the requestor. An internet link to your own homepage is however allowed. Corporations are also allowed to publish their statement on their homepage after a request has been published in the shareholders' forum (§ 127a (4) of the German Stock Corporation Act) (cf. BR-Dr 3/05, p. 28 f; Keunecke, 2006, p. 112 f; Fleischer, 2005, p. 3525, 3527).

Jahn stresses that the usage of modern communication (internet) for exchanging information and for enacting one's voting power is very useful, especially when certain statutory thresholds must be met. He assumes that the legislator is hoping to overcome in part the shortcomings of fundamental corporate and governance deficits, namely that of insufficient control of ownership. But he also views this situation critically and asks the question if this is not creating another means by which to name and shame companies if or unless they are willing to pay protection money in advance. This fear is founded on the fact that the Federal Ministry of Justice does not want to take responsibility for the content of the internet platform. On the other hand he is aware that, according to the law, only neutral requests are allowed to be published (cf. Jahn, 2005, p. 12).

Board members discretion: As shareholders rights have been strengthened through the shareholder claim, the special audit and the shareholders' forum processes, the rights of companies' risk-taking board members have also been strengthened in order to balance this through § 93 (1), sentence 2 of the German Stock Corporation Act. According to this "There is no case for a breach of duty if the board member had reasonably believed, based on an appropriate level of information, they were making a decision in the best interest of the company (§ 93 (1), sentence 2 of the German Stock Corporation Act)"<sup>23</sup> (translated in context by the author). Regarding the objective justification of this so-called "Business Judgment Rule", Fleischer highlights several aspects: "On the one hand it ensures that board members do not become too averse to risk which in turn would not be in the shareholders' interest and would also have a negative impact on the economy. Secondly, it pays tribute to the intricacies of company decisions as decisions are mostly taken under uncertain conditions and under time pressure. And thirdly it reduces the risk that courts, knowing the effects of decisions made, place excessive demands on the board members' duty of care. From a technical viewpoint in Germany, the legislator uses the not widely known metaphor of a "safe haven" pursuant to § 93 I 2 AktG (Stock Corporation Act). In order to encourage clear and calculable behavioral requirements, it clarifies from the beginning under what circumstances there is absolutely no case for a breach of duty. This clarification is binding and blocks

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23 „Eine Pflichtverletzung liegt nicht vor, wenn das Vorstandsmitglied bei einer unternehmerischen Entscheidung vernünftigerweise annehmen durfte, auf der Grundlage angemessener Information zum Wohle der Gesellschaft zu handeln.“

the recourse to apply § 93 I 1 AktG (Companies Act), even if the person applying the law thinks that, according to general law, there is a case for a breach of duty. Conversely, one cannot generally assume that there is a breach of duty if the prerequisites of § 93 I 2 AktG (Stock Corporation Act) are not fulfilled<sup>24</sup> (Fleischer, 2005, p. 3527 f) (translated in context by the author).

All five of the following pre-conditions have to be fulfilled to be entitled to the so-called "Safe Haven" pursuant to § 93 (1), sentence 2 of the German Stock Corporation Act, whereby the pre-conditions are not weighted equally within the legislature:

1. Corporate decisions
2. Acting in good faith
3. Acting without special interests and third-party influence
4. Acting in the company's best interest
5. Acting based on an appropriate level of information

(cf. BR-Dr. 3/05, p. 19)

Corporate decisions: Due to their forward-looking nature corporate decisions, according to UMAG, are characterized on prognosis and evaluations. This

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24 „Zum einen wirkt sie einer übertriebenen Risikoscheu der Organmitglieder entgegen, die den Interessen der Aktionäre zuwiderliefe und auch volkswirtschaftlich schädlich wäre. Zum zweiten trägt sie den Besonderheiten unternehmerischer Entscheidungen Rechnung, die nahezu immer Entscheidungen unter Unsicherheit sind und nicht selten unter großem Zeitdruck gefällt werden. Zum dritten mindert sie die Gefahr, dass die Gerichte in Kenntnis der später eingetretenen Tatsachen überzogene Anforderungen an die organschaftliche Sorgfaltspflicht stellen. Regelungstechnisch bedient sich der Gesetzgeber in § 93 I 2 AktG der hierzulande noch wenig verbreiteten Figur des ‚sicheren Hafens‘. Um die Klarheit und Berechenbarkeit der Verhaltensanforderungen zu fördern, legt er im Vorhinein fest, unter welchen Voraussetzungen auf keinen Fall eine Pflichtverletzung vorliegt. Diese Festlegung ist verbindlich und sperrt den Rückgriff auf § 93 I 1 AktG selbst wenn der Rechtsanwender meint, es liege nach allgemeiner Gesetzesauslegung eine Sorgfaltspflichtverletzung vor. Umgekehrt kann daraus, dass die Voraussetzungen des § 93 I 2 AktG nicht erfüllt sind, nicht ohne weiteres darauf geschlossen werden, dass ein Pflichtverletzung vorliegt.“

differentiates them from clearly defined legal, statutory or contractual duties without leeway of judgement. That is why the “Business Judgment Rule” does not apply to misfeasance or breaches of legal, statutory or contractual duties without latitude (cf. Hauschka, 2004a, p.66). Hauschka finds this definition in terms of its results as correct. He does, however, not think it is meaningful to tie this definition of a commercial decision to release board members from their liability. The following example will help clarify this: If a board member buys a new factory property or establishes a branch abroad or hires a new senior auditor then these are all corporate decisions. This is still the case even if, at a later point in time, it becomes clear that in the case of property or overseas business or for hiring above a certain salary level one should have included a second board member in the decision-making process. An incorrectly made corporate decision can therefore not be retroactively turned into a corporate non-decision (cf. Hauschka, 2004a, p. 66).

For Fleischer a corporate decision is characterized by its prognostic nature. For him it remains unclear to which extent the organizational, planning and control tasks have a corporate slant under stock corporation law. Without doubt he agrees that the board of directors have the following duties: they are responsible for proper corporate organization, planning and control. But in terms of the way in which the board of directors fulfill their duties, one must give them entrepreneurial discretionary latitude (cf. Fleischer, 2005, p. 3528).

Acting in good faith: Along with the other facts of the case, there is no autonomous meaning to the term “in good faith”. Hauschka assumes that it does not apply to the good faith in terms of the German Civil Code. He prefers the following definition of “good faith” in line with the “Business judgment Rule”: uninfluenced by any consideration other than what they (the directors) believe to be in the best interest of the corporation (cf. Hauschka, 2004a, p. 66).

Acting without special interests and third-party influence: This fact indicator should demonstrate that the acting person was not affected by conflicting interests, third-party influences and was not acting in their own interests. In other words he/she should be impartial and independent. Special factors outside of the company’s best interest are not allowed to affect their decision, whereby such decisions made in one’s own interest or in the interest of people close to the Board Members or Partners are viewed as self-evident. The way in which the German Corporate Governance Codex handles such conflicts of interest follows the same

guideline (cf. Hauschka, 2004a, p. 66).

Acting in the company's best interest: This prerequisite is fulfilled if the decision was made to retain long-term profitability and competitiveness of the company and its products or services. The question remains unanswered whether the criteria "long-term" relates to the strategy applied to attain quarterly results in some multinational companies or whether this means simply a general trend of sustainability (cf. Hauschka, 2004a, p. 67).

Acting based on an appropriate level of information: This prerequisite is not intended to legalize or make corporate decisions objective. It wants to demonstrate that corporate decisions are also made based on instinct, experience, imagination and intuition for future developments and a feeling for the markets. The act does not want to take away the courage to take an entrepreneurial risk but it also does not want to foster imprudence and carelessness at the cost of the shareholders and employees. Therefore one assumes that a Executive Board Member sensibly applies an appropriate level of information in making his/her entrepreneurial decisions. This provides Board Members a substantial margin to operate within his/her care of duties. How much effort must be put into attaining information in relation to the prerequisite of "suitable information" is left to the Board Members to decide based on advance warning time, the impact and the type of decision to be made and under consideration of widely accepted economic behavioral standards without gross negligence of duty. The Executive Board should act according to corporate necessities as well as their own company's capabilities and not according to formal hedging strategies (cf. BR-Dr 3/05, p. 20 f).

Fleischer highlights that, in relation to the pre-conditions that need to be fulfilled, there is no general duty to attain every possible piece of information but there is a duty to carefully prepare a decision and to thoroughly assess the potential risks. The act does not call for formal hedging strategies such as regular attainment of expert valuation reports, consultants' opinions or external market analysis. The company's own capabilities or rather the economic necessity should be the deciding factors if and to what extent external assessments must be obtained. § 93 (1), sentence 2 of the German Stock Corporation Act sets the adequacy requirement into the right context through its assessment from the perspective of the acting person. This interpretation of the law is explained by the fact that an unbiased assessment of the quality of the decision-making process is not always possible if one

is aware of the outcome (cf. Fleischer, 2005, p. 3528).

Hauschka has a slightly different viewpoint. He thinks that the Board Members have been given too much leeway in the boundaries of their care of duty. He/she should be expected to assess the need for information and be able to draw his/her own conclusions. Then it is at the Executive Board Member's discretion to decide which information he/she attains as long as they do not undergo a gross breach of their duty. According to Hauschka, it is often the intuitive performance decisions that cause companies to go bankrupt and for employees to lose their jobs. There are Sales Executives who trust their own experience more than that of their engineers and who meddle with construction technology. Or Finance Executives who listen to their intuition instead of listening to the experts from the controlling department although already several project calculations have turned out to be optimistically calculated and therefore have been wrong. Or Engineering Executives who, based on their own instincts, have made deals with foreign customers without consulting their lawyers. Furthermore, one can often find structural weaknesses. For example, the Holzmann Group had developed a structure which downright forced a culture of being uninformed. There were 457 participating interests inland and abroad. Because of this vast number of participating interests, it was not possible for the Executive Board to attain an appropriate basis of information. In addition, there were weak and insufficient internal systems in the Controllers' Office, the Business Management and Risk Management departments. As such a blatant mistake was preprogrammed (cf. Hauschka, 2004a, p. 67).

Hauschka demands that decisions, which often are around multi-billion amounts or which affect thousands of jobs, are taken by the legislator placing more trust in the information and risk assessments through experts and staff. When making judgment calls for stock corporations in the 21st century, it is pertinent that they prefer to base decisions in the interest of their investors and employees on an "Informed Judgment" basis rather than on their intuition. Large stock corporations have more than sufficient capital reserves to enable them to hold enough information, know-how and resources over which the Executive Board can and must dispose of. All sensibly available entrepreneurial information should be evaluated. Only then is it acceptable for a Executive Board to go against the internal and external entrepreneurial advice (cf. Hauschka, 2004a, p. 67).

Past experience has shown that a lot of leeway in decision making leads to

dangers which should not be underestimated. The only requirement that needs to be fulfilled is an almost uncontrollable quality of abiding to a care of duty. Personal interests of Executive Board Members are not uncommonly placed in an unreasonable or even criminal way above the business interests of the company. The examples shown prove this. The wish to lead the company better than the predecessor leads to cost-intensive changes without a guaranteed chance of success. This type of behavior can cause a company to incur high costs which could have been spent more sensibly. If there is a short-term success, then the *modus operandi* is continued as this guarantees continued high Executive Board salaries. At the time when the short-term nature of the positive trend becomes clear the Executive is already looking around for a new company in which they can try to apply the same procedures to maximize their personal gain.

The outcome of UMAG: The former media entrepreneur Kirch was the first to test the new UMAG procedure for pursuance of liability claims in his dispute with the former chairman of the supervisory board of the Deutsche Bank AG. After the Federal Supreme Court had only partially allowed the claim Kirch against Breuer to progress in January 2006 (Verdict dated 24.01.2006 – XI ZR 384/03, Notification of the Federal Supreme Court Press Office, No. 13/2006), the former Managing Director from Kirch, Dieter Hahn, tried the following: He placed large advertisements with the goal of soliciting Deutsche Bank shareholders to jointly press for a proceeding pursuant to § 148 of the German Stock Corporation Act. This was done in order to get the Deutsche Bank AG to enforce a regress against their former Chairman of the Supervisory Board for the already accumulated costs as well as for the future costs of a court case. On the one hand, Hahn was successful in soliciting a sufficient number of shareholders to achieve the 1% threshold pursuant to § 148 (1) of the German Stock Corporation Act. On the other hand this case also uncovers the problematic side of the new regulations. The fight between Kirch and Breuer was titled by the observing press as a “campaign” or a “vendetta”. This does not lead to the presumption that the initiators of the lawsuit were acting primarily in the best interest of the company which in turn is the requirement for the fiduciary nature of a claim pursuant to § 148 of the German Stock Corporation Act (cf. Duve/Basak, 2006, p. 1350).

Duve and Basak assume that the lowered threshold to initiate special audits and proceedings to force criminal prosecution provides controversial funds and

major shareholders even with small shares with additional leverage to pursue their interests. Capital market orientated investors now have more ability to control corporations. In cases of contentious arguments, the company's council should make sure that the courts do not allow too broad a definition of the threshold of suspicion of improprieties or also of gross infringement of the law and the Articles (cf. Duve/Basak, 2006, p. 1350).

Seen in totality, the UMAG has led to significant procedural changes in the law on stock companies. But outside of the scope of the law on stock companies the situation has also changed. In hard economic times, mistakes made by corporate management as well as employee representatives are pilloried likewise. Insolvency administrators and empty-handed creditors are trying to claim back their entitled capital by pursuing board members. The actual process of pursuing claims is being made easier through constantly changing and new laws. Other factors are also making it easier to pursue claims. These are the improved information procurement through the internet, specialized law firms, lawyer-led class action lawsuits, legal insurances which participate in successful claims as well as increased Shareholder-Value-Awareness by stockholders (cf. Hauschka, 2004b, p. 258).

The liability of Board and Supervisory Board members remains a controversial topic. In the past, attempts by shareholders to make the Board and Supervisory Board members also liable for undesirable developments or even insolvencies often failed due to the high procedural obstacles. This is supposed to change with the Act for Corporate Integrity and Modernization of the Law of Avoidance. The Federal Government wanted to make it easier for shareholders to get the corporation to make a liability claim against its Board Members. Board and Supervisory Board Members should be made liable for wrong decisions if they were not completely aware of their duties or did not fulfil them properly. This is at least UMAG's aspiration.

The extension of possibilities for shareholders to raise claims for the previously named goals is to be rated as a positive development. Liability claims as well as special audits or the application to have a special auditor exchanged is now easier for minority shareholders to enforce with the less stringent prerequisites. The possibility of a joint internet forum makes it easier for shareholders to communicate, which in turn supports their ability to undertake joint actions against Board members' fraudulent behaviour.



On a critical note though, one has to say that, although the UMAG can help uncover blatantly grave cases, it has little influence over wrongdoings that are less obvious. As such, the potential delegation of liability is tied to the definition of an entrepreneurial decision which is broadly defined and can be subjectively displayed. Hauschka assumes that, for example, large stock corporations have enough capital, information, expertise and resources to allow Executive Board Members to analyse entrepreneurial information correctly. Should a Board Member after such analysis decide to go against the recommendations from internal and external sources then this can be justified as an entrepreneurial decision. If Board and Supervisory Board Members do not utilize the above mentioned possibilities then their decision cannot be classed as entrepreneurial. Here the UMAG gives Board and Supervisory Board Members too much leeway. A strong restriction in enabling claims to be raised is made on minority shareholders through the admission process by the courts. On the one hand the restriction to allow claims only for breaches of duty which border on the criminal and for flagrant breaches of the law or of the Articles of Association which was introduced to avoid hopeless or improperly used lawsuits plays a role. Another point is the fact that shareholders are potentially liable to bear the costs of losing a petition to claim. This could deter shareholders willing to sue from submitting an application to raise a claim at the court responsible as a conviction of the accused would merely benefit the corporation and a dismissal of the claim provides the risk of shareholders having to bear the accrued costs.

### 3.1.2

#### *Liability Towards to Shareholders*

In the past the liability situation was as follows: Usually only the corporation was liable for third party liability. Board Members were only liable towards their corporation. The external liability of a corporation – for example for false “ad-hoc reports” – often came to nothing. The corporations were often already in insolvency proceedings at the time legal proceedings were started so that the shareholder demands could not or only partially be met. On the other hand, the former Board and Supervisory Board Members often still had high personal fortunes even after the insolvency proceedings were finished. In the case of misconduct by Board and Supervisory Board Members they damaged not just their own corporation but proportionately also each shareholder. That is why shareholder associations requested

that sustainable improvements to protect investors were to be made by allowing wronged shareholders direct access to the liable party (Board Members). This is the so-called “direct management liability”<sup>25</sup> (translated in context by the author) (cf. Hofmann, 2008. p. 268).

### 3.1.2.1

#### *Infomatec-Decisions*

In July 2004, the Federal Supreme Court (BGH) rulings in the case Infomatec made it clear for the first time that a personal liability of Board Members towards their shareholders was principally allowed pursuant to § 826 of the German Civil Code (BGB).<sup>26</sup> The company was a corporation listed on the new market against which an insolvency proceeding was instigated in 2001. Following the two Board Members’ instructions, the corporation had published some ad-hoc announcements, two of which were grossly false. In one ad-hoc announcement dated 20 May 1999 a new major contract worth 55 million Deutschmarks was published when in reality the contract was only worth 9.8 million Deutschmarks. After being questioned at the shareholders’ meeting on 24 June 1999, the Chairman and his deputy were compelled to correct the false information. Despite this, the false information was published again in an ad-hoc announcement on 30 August 1999. Only on 22 August 2000, a whole year later, was the correction made in another ad-hoc announcement (cf. Sester, 2006, p. 3).

After the false announcement, the share price correspondingly soared. The Chairman and his deputy had accrued double-digit millions of profit through skilful sales during this time. Other investors who did not see through this fraud made corresponding losses (cf. Sester, 2006, p. 3).

The claim of a shareholder, who was not aware of the happenings at the shareholders’ meeting, was ruled positively by the BGH. On 28 July 1999<sup>27</sup> the

<sup>25</sup> „direkte Managerhaftung“

<sup>26</sup> In total there were three rulings on Infomatec made by the Federal Supreme Court (Rulings dated 19 July 2004 – II ZR 217/03, II ZR 218/03, II ZR 402/02, Announcement by the press office of the Federal Supreme Court No. 87/2004).

<sup>27</sup> Sester states that the date the shares were bought was 28 July 2004 (cf. Sester, 2006, p. 3). This must be a mistake as the BGH’s ruling justification states 28 July 1999 as the date of purchase and the pronouncement was already made on 19 July 2004 (cf. Ruling dated 19 July 2004 – II ZR 402/02).

shareholder had bought, using his current-account overdraft facility, 230 shares of Infomatec AG for 40 euros per piece. The total cost plus charges amounted to DM 90,945.70. The BGB ruled that there was a case for a claim for damages against the Board Members of Infomatic AG pursuant to § 826 BGB. It established that there was a case for intent and for violation of moral principles as the board members not only knew about the false nature of the ad-hoc announcement but had even published it twice. They had gained personally as they had sold their own shares after they had undergone their criminal act. The BGB ruled that the accused board members had to pay back the original share prices plus interest against the transfer of the shares. The claimant's entitlement was thereby not limited to the so-called differential damage but he was also able to achieve the annulment of the purchase made thus restoring the original state upon proof of a direct causality ("restitution in kind" as understood by § 249 (1), 1 BGB). The BGH found that the two board members' behavior went against the minimum requirements of legal dealings on the stock market to such an extent that they were liable to compensate individual shareholders for the financial losses occurred (cf. ruling dated 19 July 2004 – II ZR 402/02; Sester, 2006, p. 4).

Regarding the causality between the false ad-hoc announcement, dated 20 May 1999, and the order to purchase dated 28 July 1999, the Federal Supreme Court ruled this as given (cf. ruling dated 19 July 2004 – II ZR 402/02; Sester, 2006, p. 4). In two further Infomatec cases, the claims of two plaintiffs were dismissed by the Federal Supreme Court. They had given their orders to buy shares approximately nine months (8 February 2000) and approximately twelve months (17 May 2000) after the first false announcement. The Federal Supreme Court wanted to avoid the danger of disappointed but not causally deceived investors from correcting their independently made investment decisions by making damage claims towards Board and Supervisory Board Members. The timeframe in which there is a causality between ad-hoc announcements and the decision to invest is rather short (cf. ruling 19 July 2004 – II ZR 217/03). Ad-hoc announcements convey different to, for example, stock exchange listings, information which is situation-dependent and specific. Here one cannot assume that there will be a long-term sustainable impact on the shareholders. The Federal Court in its ruling against Infomatec did not however set a time limit. It justified this by maintaining that with the danger of arbitrariness as setting a specific timeframe would be arbitrary and would therefore inevitably lead to significant injustices (cf. ruling dated 19 July 2004 – II ZR 217/03;

Sester, 2006, p. 5).

The precedent-setting judgments by the BGH in the case of Infomatec give shareholders who have become victims of deliberate deceit by managers new courage. Since the Infomatec rulings there have been several similar cases where shareholders were awarded compensation for the damage suffered.

### 3.1.2.2

#### *The Cases Comroad and EM.TV*

The rulings dated 17 March 2005 (Higher Regional Court Frankfurt am Main, 17.03.2005 - 1 U 149/04) and 20 April 2005 (Higher Regional Court Munich, 7 U 5303/04 or Betriebs-Berater, 2005, p. 1651) found that Comroad AG's Chairman was guilty of unethical and deliberate behavior pursuant to § 31 BGB. At the same time, the shareholders were freed of any contributory negligence and the company convicted to pay back the share purchase price. In connection with the previously described Infomatec case, the unethical acts by the Board of Comroad were even graver. While in the Infomatec case the business numbers were merely declared by a multiple higher than their actual value, in the Comroad case nearly all company data was freely invented. The stock exchange prospectus showed a detailed and lucrative business relationship with an electronics group situated in Hong Kong called VT Electronics Ltd. A special audit conducted in February 2002 uncovered that nearly all dealings with this company were fictitious as it did not exist. At the end of the day, only 1.4 percent of the shown 2001 turnover of 93.6 million euros shown could be proven. Of every 1,000 euros company turnover only 14 euros was real. Also here there was a clear case of personal gain on the part of the Board Members so that the courts had no difficulty in confirming the unethical dealings of the Board Members (cf. Möllers, 2005, p. 1637).

As the claimants were requesting the payback of the buying price, the courts had to position themselves regarding the question whether the false information was a deciding causal factor for the decision to invest. Here the courts came to different conclusions. The district court Frankfurt (28.04.2003 – 3 – 7 O 47/02, NJW-RR 2003, p. 1049) and the Higher Regional Court Munich (20.04.2005 – 7 U 5303/04, Betriebs-Berater 2005, p. 1651) assumed a so-called "buying mood". This was based on the grounds that the false announcements made in the time from 1999 to early 2002 had led to a high over-estimation. After all these euphoric announcements, the share price was listed between 10 and 20 euros. But after the true company

situation was announced the share price plunged to a few cents (cf. Möllers, 2005, p. 1638).

The Higher Regional Court Frankfurt am Main (17 March 2005, 1 U 149 /04, Hessenrecht Landesrechtsprechungsdatenbank) came to a completely different conclusion. It denied the “investment mood” as the false stock exchange prospectus was published one and a half years before the relevant share purchases and could therefore not be used as a reason for the buying mood. The court did however rule a direct causality as the claimant was successful in producing full evidence. In conclusion, one can say that the question of causality must be answered on a case by case basis.

In the case of EM.TV there were claims by initially 59 and later another 44 damaged investors against the two Haffa brothers, the former Board Members of EM.TV and against the corporation. In several ad-hoc announcements, EM.TV had placed the acquisition of other companies in a too optimistic light. This was the case for the acquisition of the Jim Henson Company in the ad-hoc announcement dated 21 February 2000 as well as the takeover of the SLEC Formula One Group ad-hoc announced on 22 March 2000. Furthermore an ad-hoc announcement dated 22 September 2000 published EM.TV’s mid-year figures which in this form were not correct. On 9 October 2000 a corrective announcement was made which in turn led to a steep plunge in the share price. In contrast to the rulings in the case of Comroad the Federal Supreme Court did not rule all issues in the case EM.TV but deferred it back to the Higher Regional Court Munich for further resolution. Only the case for unethical behaviour was confirmed by the Federal Supreme Court (cf. Möllers, 2005, p. 1637 f).

### 3.1.2.3 *External Liability of the Board Pursuant to § 826 BGB*

Pursuant to § 826 of the German Civil Code (BGB) there is an obligation to compensate for damages, “who deliberately damages another person in an immoral way”<sup>28</sup> (translated in context by the author). This principle is applied by the Federal Supreme Court to solve the problem of manager liability for deliberately spreading false information about their company. Duve and Basak established that to fulfill the prerequisites pursuant to § 826 BGB “there must be a deliberate and

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28 „wer in einer gegen die guten Sitten verstößenden Weise einem anderen vorsätzlich Schaden zufügt“

unethical deed (1), that leads to a damage (2), and there must be a causality between deed and damage (3)<sup>29</sup> (translated in context by the author). They point out that the draft of the Act Governing Liability for Capital Market Information wants to make gross negligence already constitute as a liability, but that the ruling practice of the courts shows that this extension of scope is not really required (cf. Duve/Basak, 2005, p. 2646).

Müller-Michaels and Wecker conclude that a special statutory regulation is missing, based on the fact that the Federal Supreme Court applies the over hundred-year old § 826 BGB to solve a modern problem such as the liability in cases of false capital market information. Despite the fact that the Red-Green government under the German Federal Chancellor Schröder tried, in their last term of office, to implement the Act Governing Liability for Capital Market Information, the Act in a draft stage had already been put ad acta. The reasons provided were on the one hand massive criticism from the economy and on the other hand the current EU level plans for new directive proposals. A further reason, according to Müller-Michaels and Wecker, for the Federal Supreme Court using § 826 BGB is the different ways of calculating damages that this regulation allows. Otherwise, according to German law, the principle applies, that damages can only be claimed in cases of bodily harm, damage to property or other absolute rights. But § 826 BGB also allowed the compensation of pure financial losses. Normally false information alone would not lead to a damage of absolute rights, for example, property damage. Applying § 826 BGB allows not only the justification of a personal liability of Board Members but also via § 31 BGB the liability of the corporation. Admittedly the corporation could also be made liable for false ad-hoc announcements pursuant to §§ 37 b and 37 c of the Securities Trading Act. According to these guidelines though, an investor could only claim compensation for the damage created by the difference in share prices but could not claim for the rescission of the total transaction. In contrast, pursuant to § 826 BGB the possibility exists to sue both Board and the corporation in parallel for the total damage created (cf. Müller-Michaels/Wecker, 2007, p. 208).

To better understand the content of the law text there seems to be a need to

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29 „das vorliegen einer vorsätzlichen und sittenwidrigen Handlung (1), die zu einem Schaden führt (2), sowie die Kausalität zwischen Handlung und Schaden (3)“

clarify the meaning of the terms violation of moral principles, malice and causality in relation to false capital market information. According to Müller-Michaels and Wecker these terms can be given more meaning as follows:

Violation of moral principles: Behavior is classified as immoral if it violates “common decency of all fair and equitable thinking people”<sup>30</sup> (translated in context by the author) (Supreme Court of the (German) Reich 11.04.1901; decisions made by the Supreme Court of the (German) Reich in civil matters 48, p. 114, 124). In relation to the question how this viewpoint can be implemented in the modern capital market theory, Müller-Michaels and Wecker refer to the Federal Supreme Court. The Federal Supreme Court applies a surprisingly simple definition. The Federal Supreme Court established that taking a direct deliberate improper influence on the secondary market community through a grossly false ad-hoc announcement induces a violation of moral principles. In addition, the sentenced Board Members of Infomatec AG as well as EM.TV – as founding members with substantial shareholdings – had also acted in an objectively unfair way for their own use. They had acted knowing that their false announcements would lead to a substantial increase in their investments (cf. Müller-Michaels/Wecker, 2007, p. 208).

Malice: Conditional malice is sufficient for a liability pursuant to § 826 BGB. This means that the perpetrator was well aware about the damage that would occur and had approved of the consequences. Müller-Michaels and Wecker emphasize that pursuant to the ruling by the Federal Supreme Court dated 19.07.2004 (II ZR 402/02) the perpetrator does not need to know in detail who and how many people they damaged through their behavior (cf. Müller-Michaels/Wecker, 2007, p. 208).

Causality: § 826 BGB makes the condition that there must be a causal connection between the damaging behavior and the subsequent financial loss. This means in relation to the information tort liability that there is only a case for liability if the false information led the investor to buy, sell or hold his / her shares. The circumstances showing and proving a causality are the responsibility of the claimant. He / she must prove that their acting was based on the event causing such liability. There is no special burden of proof legislation for false information provided on the secondary market (cf. Müller-Michaels/Wecker, 2007, p. 208).

Müller-Michaels and Wecker emphasize in relation to the (German) Reich

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<sup>30</sup> „gegen das Anstandsgefühl aller billig und gerecht Denkenden“

Legislation dated 11.10.1912 (II 106/12) that the possibility for causality is already given if the investment community goes into a buying mood generated by a prospectus and the purchaser is then lured into making a purchase. It is hereby of no relevance whether the buyer has read the prospectus. In the case of the Infomatec ruling, the German Federal Supreme Court denied the general applicability of the so-called buying mood of investors for the tort liability pursuant to § 826 BGB. In their opinion the buying decision of the claimant was always their own volition and required individual case-by-case investigation (BGH 19.07.2004 – II ZR 217/03). Müller-Michaels and Wecker also highlighted the fact that positive signals within ad-hoc announcements could lead to a buying mood for shares by investors. This was clarified by the Court. The German Federal Supreme Court pointed out during the proceedings that this would be dependant on the momentousness of the information. With increasing time distance to the publication the momentousness decreases. It ends in any case at the point in time in which the evaluation of the value of the share would be determined by new company data. Also the German Federal Supreme Court ruling in the case of EM.TV dated 09.05.2005 (II ZR 287/02) negated that there is a blanket approach to the numerous individually made volitions by the claimants and as such denied the consideration of the investment mood. Nevertheless, it was mentioned in this case that, based on the fact that wrong mid-year numbers were published, the assumption of a buying mood was entirely conceivable (cf. Müller-Michaels/Wecker, 2007, p. 208 f).

Müller-Michaels and Wecker point out that the Federal Supreme Court in the case of Comroad (ruling dated 04.06.2007 – II ZR 147/05) again clarified that waiving the concrete causality of capital market information and the decision to invest is in principle not considered. Disappointed general investor trust in the integrity of the price information on the market is not sufficient as a proof of causality. The Federal Supreme Court, in their ruling, explicitly declared themselves against the applicability of the US-American Securities Law based “fraud on the market theory”. According to this theory, there is a case for causality if the investor trusted the integrity of the share-price reflected information. The claimant must only prove that at the time of purchasing shares, the capital market was graded as efficient. According to the Federal Supreme Court if one only looks into the general market situation, which is portrayed in a false light due to widespread false information, then one dispenses with the need for proving a causality between deception and the decision to invest. This leads to an endless extension of the already broadly



defined case for liability pursuant to § 826 BGB. That is why one must always prove the concrete causality (cf. Müller-Michaels/Wecker, 2007, p. 209).

Provided that there is a case of causality, the question should now be answered how the damage caused should be portrayed and calculated. Duve and Basak point to the fact that a damage pursuant to § 826 BGB can be portrayed in different ways. The claimant could either request the complete reverse transaction of the investment taken based on deception. On the other hand, they can only request the balance between the share price actually paid and the price of the investment structure if the false information had not been published. In this case one speaks of the so-called differential damage (cf. Duve/Basak, 2005, p. 2647).

Already in its Infomatec decisions, the Federal Supreme Court established that within the framework of § 826 BGB the damaged investor could demand a reverse transaction in form of a restitution in kind. This means a reimbursement of the purchase price against transfer of the shares or the offset against a meanwhile made sale proceedings. The prerequisites for the application of § 826 BGB would be given if the investor could prove that given correct information they would not have bought or sold the securities in question. Duve and Basak correspondingly state that, for example, damaged shareholders of EM.TV could request the purchase price against transfer of the shares or the offset of the sale proceedings realized. This case law poses numerous objections as the share price is established based on numerous highly diverse factors and not only on individual misinformation. The investor would then, if this were approved, have the possibility of a no-risk investment if their investment expectations were not met, they could then reverse the transaction at the cost of the share company or its Board Members (cf. Duve/Basak, 2005, p. 2648).

For this reason, Duve and Basak think that, in relation to the securities law, a limitation of liability to differential damages is absolutely appropriate. The differential damage is made up of the difference between the actual share price at the time of the transaction and the actual warranted price. The person damaged has to therefore portray and prove what the price would have been if the market information had been correct. Duve and Basak substantiate their argumentation by pointing out that the German Federal Supreme Court in their EM.TV ruling referenced that, also within the framework of cases applying the law of tort, only the differential damage and not restitution in kind could be claimed. These statements

complement the previous law. The differential damage should be concretized with the help of external experts applying the methods of modern financial management. The Federal Supreme Court wants to use an appropriate proxy for establishing the hypothetical price by looking at the share price changes directly after the announcement of the true state of affairs and then apply the process of backward induction to approximately establish the true value of the investment on the day of the business deal. Applying this process of backward induction, for example, the investors of EM.TV could only claim the part of the losses incurred which can be placed directly in relation to the false information. The part of the losses which was created by the New Market bubble bursting would have to be carried by the shareholders themselves (cf. Duve/Basak, 2005, p. 2648).

#### *3.1.2.4 Board Members' Internal Liability Pursuant to Further Claims Based on Tort*

According to § 400 (1), 1 of the German Stock Corporation Act those people will be punished who as a member of the Board or the Supervisory Board portray the circumstances of the company in a wrong or obscured way, be this in representations or overviews. Müller/Michaels and Wecker point out that the protective character of this directive in relation to the corporation and its current and potential shareholders pursuant to § 823 (2) of the German Civil Code is well known. That is why the Federal Supreme Court does not generally negate the applicability of § 400 of the German Stock Corporation Act for cases of false ad-hoc announcements. The deciding factor is whether the contents of the ad-hoc announcement provides a complete overview of the economic situation and thus creates the impression of completeness. This was not the case in the lawsuit against Infomatec as here it was merely a case of incorrect announcements regarding individual business deals. In contrast, in the case of EM.TV complete mid-year financials were published. That is why the Court assumed here that the announcement included a representation of the company's wealth (BGH dated 09.05.2005. II ZR 287/02; cf. Müller/Michaels/Wecker, 2007, p. 209 f).

Duve and Basak highlight that protection acts - such as §§ 264a Criminal Code, 331 Code of Commercial Law, 400 German Stock Corporation Act - similarly the § 826 of the German Civil Code postulate willful intent of those responsible. Furthermore, Duve and Basak point out that by applying § 830 of the German Civil Code, Board Members who were not directly responsible for the fraudulent act but

who knew of and accepted it without taking appropriate action can be made liable. In the case of EM.TV these circumstances applied for other Board members who, knowing of the faultiness of the quarterly reports, had willingly accepted their publication and had thereby aided through refusing to act (cf. Duve/Basak, 2005, p. 2650).

### 3.1.2.5 *A Bill: the Act Governing Liability for Capital Market Information*

In the summer of 2004, the former Federal Government under Helmut Schröder planned to strengthen the rights of damaged investors with the Act of Governing Liability for Capital Market Information. This is because, if the cases are not obvious cases of fraud like with Infomatec, EM.TV or Comroad, then damaged investors normally have no chance of reimbursement of the damages incurred if they want to make the Board Members liable pursuant to civil law for untrue statements made. The goal was to provide a statutory basis for increased liability rules for Board and Supervisory Board Members who publish false capital market information. The draft law was designed to make Board Members personally liable towards investors if they provided the capital market with deliberate or grossly false information, for example, at a shareholders' meeting. The amount of liability which could be claimed was to be limited to up to four annual salaries (cf. Drost, 2004b, p. 29).

The planned regulation of the Act of Governing Liability for Capital Market Information applied to the external liability of Board and Supervisory Board Members was to apply also for cases of gross negligence. This would have resulted in a high increase in managements' liability.

In terms of calculating the damage incurred, the draft of the Act of Governing Liability for Capital Market Information oriented itself towards the differential damage approach. But it also generalized it. The differential value between the actual price of the questionable transaction and the weighted average share price during the first thirty days after the announcement of the correct facts was what claimants could request. Both parties were allowed to present their own damage calculation. An example of this would be: The suing EM.TV shareholders could have used their acquisition price and compared this to the average share price of the EM.TV shares in the thirty days after 9 October 2000 to calculate the amount of damages they could claim. This was because on 9 October 2000 the false

information regarding the half-year results was corrected (cf. Duve/Basak, 2005, p. 2647 ff).

Regarding causality, the draft of the Act of Governing Liability for Capital Market Information applied a three-month time assumption for causality. The draft law refutably assumed that transactions within a time frame of three months would be affected by a false or, contrary to duty, omitted information to the capital market. In the case of EM.TV this would have meant that: All shareholders who bought their shares within three months after the false announcement of the mid-year financials or the false revenue and result prognosis were liable for compensation. Other buyers of shares would have had to carry the full burden of proof.

The opinions regarding this draft law were in part very opposing. Therefore Jürgen Kutz from the German Society for the Protection of Securities Holders hoped that the act would close the current large gap in shareholder protection. To date, he did not see a possibility for shareholders to make managers and Supervisory Boards directly responsible for intentional and grossly negligent false statements regarding the company's situation. Fraudulent people normally got away with their wrongdoings. Jan Wulfetange had a completely different view on the planned law. He was the capital market expert for the Federal Association of the German Industry and predicted that this act would lead to an increasing legalization of entrepreneurial decision making (cf. Drost, 2004a, p. 27).

In November 2004 – meaning only one month after the second draft bill was published on the 7th of October – the German Federal Government withdrew the draft for an indefinite period of time due to the harsh criticism from corporations and the German Bankers' Association. The official explanation issued by the German Federal Government was that they wanted to wait for the initiatives being developed by the European Union. In addition, the Federal Ministry of Finance wanted to work through the objections raised by the associations in order to pass the law at a later point in time. A detailed time plan was not provided (cf. Drost, 2004b, p. 29).

The reaction to the withdrawal of the draft act was also varied. Jürgen Kurz from the German Society for the Protection of Securities Holders thought that the German Federal Government had obviously become scared of its own courage. He still held the hope though that the law would not be completely overturned (cf. Dorst, 2004b, p. 29). His hope however was not fulfilled as after the planned bill

was withdrawn, the law was completely forgotten during the election campaign of 2005. In contrast, Klaus Bräuning, member of the executive board of the Federal Association of the German Industry, was pleased about this decision. He thought it was a good sign that the government was rethinking the draft bill. The government had unnecessarily put themselves in a position where their hand had been forced. In principle, he did not see it as proven that tightening liability rules was really necessary (cf. Drost, 2004b, p. 29). There was a similar reaction from Thomas Weisgerber, member of the board of the German Bankers' Association. He thought that it was not in the interest of the financial markets in Germany if the German Federal Government implemented its own ruling. For foreign corporations listed on the German Stock Exchange this would be deterring if false information were to be handled differently in Germany from in their home country. At this point, European-wide regulations were simply indispensable.

In the literature on the draft of the Act of Governing Liability for Capital Market Information this act was controversially discussed. Duve and Basak are of the opinion that the jurisdiction in the cases of Infomatec, EM.TV and Comroad made it clear that the general norm of the law of torts is sufficient. For this reason, they do not think a new legal regulation in the area of external board member liability is necessary (cf. Duve/Basak, 2005, p. 2650). In contrast, Gerke assesses the situation as such that the existing cause of action according to civil law has not proven itself as suitable for providing effective help in claiming liability for damaged investors (cf. Gerke, 2004, p. I). Hofmann explicitly agrees with Gerke and points out that the cases Infomatec, EM.TV and Comroad have shown that the existing options under civil rights are altogether insufficient for damaged investors. Managers cannot be made "directly" liable for compensation. Hofmann emphasizes that the causal correlation between false information and damaged investors is rightly titled as "muddy waters" in discussions around the securities law. He assumes that also in future it will not be possible to prove deliberate and unethical behavior of Board Members and that the rulings around compensation claims made by the BGH in the three described cases will likely mainly remain isolated cases (cf. Hofmann, 2008, p. 273 f).

The federal election in 2005 was won by the CDU and CSU parties. This meant that the former German Federal Government (SPD/Grüne) was replaced. In its place, the large coalition consisting of Christian Democrats and Social Democrats

came to power. The topic of manager liability was not part of the agenda of the coalition agreement. It was, in view of the financial problems of the German Federal Government, not viewed as a priority. While hopes were dashed that the “last big gap” in investor protection would be closed borne by the people protecting investors, such as the German Society for the Protection of Securities Holders, the Federal Association of the German Industry was satisfied. They think the introduction of manager liability is absolutely unnecessary as the German Law according to their view holds enough possibilities to make Board Members personally liable (cf. Meister, 2005, p. 29).

To date, the Act of Governing Liability for Capital Market Information has not been brought before the German Federal Parliament as a legislative initiative. This means that the large gap in investor protection has not been closed. So there is still no possibility for shareholders to make managers and Supervisory Board Members directly liable in cases of deliberate and grossly negligent false information regarding the state of the corporation. The Federal Government has missed its chance to protect investors against fraudulent activities by managers. They could have taken a pioneering role at European level. The objection of Thomas Weisgebers from the Managing Board of the Association of German Banks that it would not fare well for the financial markets in Germany if the Federal Government formed its own regulation was not accepted. His opinion that foreign companies that are listed on the German Stock Exchange would be deterred if false information was handled differently in Germany compared to their home country is a statement that goes in a completely wrong direction. It cannot be viewed as positive for a country's economy if companies are situated in it whose information policy is founded on false information. That such companies would be deterred cannot be viewed as a disadvantage. To the contrary, the financial market Germany would profit from such a regulation. The indefinite postponement of the Act of Governing Liability for Capital Market Information has made it clear that with regard to this, the protests made by company and bank associations wield more power than from the government's intended legal protection of investors from fraudulent managers.

#### 3.1.2.6 *The German Capital Markets Model Case Act (KapMuG)*

Although the draft bill of the Act of Governing Liability for Capital Market Information was pulled back after only a few months (cf. Meister, 2005, p. 29), a

further draft bill which was aimed at reducing the deficits of the German Civil Procedure Law did not share the same fate. On 1 November 2005, the German Capital Markets Model Case Act (KapMuG) came into force. With this law, the Federal Government reacted to an increasing number of deficits occurring in recent years regarding the legal regulation of the capital market. Especially the proceedings against Deutsche Telekom AG made it more than apparent that there is a necessity for extending the legal requirements. Falsified annual statements, false descriptions provided in the brochure for the initial public offering as well as false or not issued ad-hoc announcements had misled an enormous number of investors. In the legal proceedings against Telekom, around 17,000 small investors sued for compensation due to the alleged excessive evaluation of the Telekom's property assets. They received on average 3,500 euros compensation (cf. Hofmann, 2008, p. 275 f). The claimants accused Telekom of damaging the initial public offering through false real estate evaluations. The proceedings were led as a master lawsuit by the Higher Regional Court in Frankfurt. Thereby it also became the most spectacular test case for the German Capital Markets Model Case Act (KapMuG). According to Jahn, the German Federal Parliament created the KapMuG especially for these kinds of mass proceedings so that the judiciary system would not end up collapsing under a mountain of files (cf. Jahn, 2012, p. 11).

The act stipulates that a single model case lawsuit should be carried out representing all claims. The ruling is then binding for all claimants. The legislator thereby reduces the costs for the claimants as the pursuance of compensation formerly did not work well from an economic perspective in relation to the expenditure. Costly hearing of evidence and expert opinions drive the procedural costs up and often deter investors from suing. In addition, the legislator sees the German Capital Markets Model Case Act (KapMuG) as a way to speed up the proceedings against Telekom (cf. Hussla, 2005, p. 37).

The focus of the claims in the case of Deutsche Telekom was to answer the question whether Deutsche Telekom had over-rated their properties ahead of the planned change to become a public holding company and had thereby deceived the investors in the initial public offerings. The corporation, situated in Bonn, had written off 2.8 billion euros for their properties in 2000 after the third tranche of public offerings. The special process (cluster process) in which Telekom had rated their properties in groupings was, according to the claimants, not rightful. This

was also the view of the presiding judge at the Regional Court in Frankfurt in his first statement. Telekom however pointed out that the evaluation process was legitimate. Also the depreciation of the property assets had had no effect on Telekom's share price (cf. Hussla, 2005, p. 37). It took ten years until the Higher Regional Court in Frankfurt gave a ruling in the model case proceeding in May 2012. It dismissed the plaintiffs (cf. Jahn, 2012, p. 11).

The reasons for this were clearly and concisely summarized by the editorial staff of the journal "Wirtschaftsrecht und Insolvenzpraxis (ZIP)" (Editorial Staff of ZIP, 2012, p. 1236):

"1. The KapMuG is also applicable for cases where a part of the initial proceedings was pending prior to the commencement of the act on 01.11.2005.

2. The planned purchase of a stake in a company – based on the prevailing valid law in the year 2000 – is only then an obligatory item of the prospectus pursuant to § 111 (4), 2 AktG if the Supervisory Board has taken a decision on it. It is not of significant relevance that the negotiations between the parties involved in the investment have commenced.

3. A 12% overrated value of the property assets by the corporation is within the allowed tolerance band and does not mean that the brochure is inaccurate.

4. In the opening balance sheet dated 01.01.1995 the Telekom was allowed to deviate from the principle of individual evaluation and portray the evaluation in their developed evaluation units (so-called cluster process)."<sup>31</sup> (translated in con-

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31 „1. Das KapMuG ist auch dann anwendbar, wenn Teil der Ausgangsverfahren bereits vor dessen Inkrafttreten am 01.11.2005 anhängig gemacht worden ist.

2. Der geplante Erwerb einer Unternehmensbeteiligung stellt – auf Basis des im Jahr 2000 geltenden Rechts – erst dann eine prospektierungspflichtige Tatsache dar, wenn der Aufsichtsrat hierüber nach § 111 Abs. 4 Satz 2 AktG entschieden hat; auf die Verhandlungen zwischen den Partnern der Investition kommt es nicht maßgeblich an.

3. Eine um 12% zu hoch angegebene Bewertung des Immobilienbestands des Unternehmens hält sich innerhalb der zulässigen Schwankungsbreite und führt nicht zur Fehlerhaftigkeit des Prospekts.

4. Die Telekom durfte in ihrer Eröffnungsbilanz zum 01.01.1995 von dem Grundsatz der Einzelbewertung ihrer Immobilien abweichen und eine Bewertung anhand der von ihr gebildeten Bewertungseinheiten (sog. Clusterverfahren) vornehmen.“



text by the author).

A second large court case in which a model case ruling was already made, is the proceeding against the MLP AG<sup>32</sup> and its former chief executive officer. The model case ruling was made by the Higher Regional Court in Karlsruhe. MLP AG shareholders claimed damages against the company and partly against the former chief executive officer in 32 parallel court cases at the Regional Court in Heidelberg. The charge was: The two defendants were guilty of deliberate immoral damage towards their shareholders based on the publication of false capital market information in the years 1998 to 2002. The false capital market information was released in the form of ad-hoc announcements, company reports, press releases and interviews. The damages claimed amounted to altogether over 30 million euros. The plaintiffs raised model case applications according to the German Capital Markets Model Case Act. Based on this, the Regional Court in Heidelberg raised an order for reference on 30.12.2008 and submitted to the Higher Regional Court in Karlsruhe several finding requests so that a uniform clarification of the conditions of entitlement could be made. The Higher Regional Court then nominated one plaintiff as the model case plaintiff (cf. Higher Regional Court Karlsruhe, 2012, p. 1).

The 17th Civil Chamber of the Higher Regional Court in Karlsruhe, responsible for the proceedings pursuant to the KapMuG, obtained encompassing expert opinions to help clarify the circumstances (cf. Higher Regional Court Karlsruhe, 2012, p. 2). On 16.11.2012 the court then determined mistakes made by two subsidiaries in the accounting of factoring and reinsurance business. The Civil Chamber, however, rejected the motion for a declaratory judgment that the former chief executive officer had condoned the publication of false capital market information relating to the company's results and turnover. The Senate also rejected the motion for a declaratory judgment in relation to the former chief executive officer having acted in a deliberately damaging way and that the publication of false financial indicators was unethical. The Senate based their decision on the fact that the extent of mistakes made and the fact that it was very hard to recognize the mistakes found in the annual financial statement spoke against a case of deliberate publication of

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32 The MLP AG is the management holding of the MLP Group which consists of several companies. The company is listed on the SDAX and provides financial services including bank and insurance services.

manipulated indicators. Only people who had to have substantial knowledge of financial accounting, as well as additional considerable actuarial knowledge, could have found the mistake after in-depth investigation. In addition, the effect on the financial results had been negligible (cf. Higher Regional Court Karlsruhe, ruling dated 16.11.2012 – 17 Kap 1/09).

The following outline of the content of the German Capital Markets Model Case Act (KapMuG) dated 01.11.2005 is based on Zypries' description and positive assessment. This will be followed by the critical assessment of this act by Hess. And finally the draft bill which was presented after the five-year development phase in the summer of 2011 will be compared to the currently applicable German Capital Markets Model Case Act (KapMuG) dated 01.11.2012.

The German Capital Markets Model Case Act (KapMuG) is aimed at improving the individual's legal rights by introducing the collective form of legal protection. The Code of Civil Procedure viewed from a historic context is a proceeding based on individual rights and tailored to the enforcement of individual claims. In the arena of capital markets law, it often occurs, however, that the individual's loss is fairly low but that the total damage could well be in the range of multi-digit millions. Compensation claims of these mass damages are often not financially liable for the individual small investor. The majority of the legal proceedings require extensive evidentiary hearings with expensive subject-matter experts in order to debate the complex problems related to the securities law. The individual investor is confronted with having to carry the high proceeding costs and risk. That is why the individual investor often loses interest in suing for compensation through the courts. As a result the liability provisions of the capital market legislation cannot fulfil their basic regulatory function (cf. Zypries, 2004, p. 1).

Traditional ways of combining proceedings such as the joinder of parties, consolidation of proceedings or the stay of proceedings can only insufficiently manage mass claims. Here the German Capital Markets Model Case Act (KapMuG) is trying to break the mold with the following goals: It attempts to group if possible all compensation claims relating to published false or misleading capital market information at the local and legally responsible District Court where the company is based. In addition, the disputed and similarly-based sample questions derived from individual claims are to be decided upon in a joint model case proceeding. The model case questions would include, for example, the correctness of an ad-hoc

announcement, a stock exchange prospectus or of an annual financial statement. The ruling made in the model case proceeding then forms the basis for the individual lawsuits (cf. Zypries, 2004, p. 1).

The model case proceeding is based on the initiating lawsuit but is uncoupled from it and should be viewed as an independent hearing. Every damaged investor can apply for a model case proceeding to be initiated. The basis is merely the judicial enforcement of a compensation claim based on false or misleading public capital market information. By logging the application, the aim is to have a model question which was raised in various lawsuits uniformly answered. The trial court publishes the investor's application in the specially developed Litigation Register within the electronic Federal Gazette. Should it then happen that more than ten such applications from different litigations ask for the same model question to be answered then the responsible trial court will request a model ruling with the Higher Regional Court, i.e. the next higher authority. During the time it takes for the model case proceeding to progress, the individual litigations of the affected investors are suspended (cf. Zypries, 2004, p. 1).

The Higher Regional Court will appoint a plaintiff as a model plaintiff in order to complete a model case proceeding. The Higher Regional Court assigns the model plaintiff at its own discretion. This should avert the danger of a so-called "run to the courtroom" as often occurs in class action lawsuits according to US law. In the USA, the group member who was first to request "class action" represents the whole group when applying for commencement of action. According to German jurisdiction it is not the first applicant who becomes the model plaintiff but the person who is claiming the highest damages and who can be expected to have an appropriate representation of interests for the proceedings. Of course, the remaining plaintiffs are invited to the model case proceedings as intervening parties. They play the role of intervener and can also actively take part in the model case proceedings' hearing. In contrast to the US-American procedure of "class action", the model case proceedings' hearing process allows all plaintiffs (through being invited as intervening parties) to have a right to be heard by the court (cf. Zypries, 2004, p. 1).

The claimants are not in danger of having to pay additional court or legal costs. The costs created in the model case proceedings – often the costs for relevant expert opinions play a crucial role – are later apportioned to the individual court

cases according to the value of the claims asserted. This immensely reduces the risk of bearing all the litigation costs for the individual plaintiff (cf. Zypries, 2004, p. 1).

Hess notes, however, that the German Capital Markets Model Case Act (KapMuG) does not solve the guiding principle issue of the discrepancy between the two-party process and the actual collectivization but merely excludes it. In practical terms, this deficit has the effect that the people participating in the model case proceeding do not take an active role but simply await the ruling. The intention of the legislator to allow joint plaintiffs to participate in the model case proceedings has not been accepted in judicial practice. A further note for concern according to Hess is that the German Capital Markets Model Case Act (KapMuG) has moved a long way away from the legal guiding principles. While in a general Civil Rights process the parties can jointly agree the start, content and the end of a hearing, the procedural rights in a model case proceeding are literally suspended. The Higher Regional Courts decide at their dutiful own discretion who should become model plaintiff. The desired outcome of the model case proceeding is established by the Regional Court responsible. The empowerment of the model plaintiff to end the proceedings through a settlement or acknowledgement is not permitted pursuant to § 14 (2) KapMuG (cf. Hess, 2011, p. 69).

The German Capital Markets Model Case Act (KapMuG) was initially supposed to be restricted to a time period of five years. In this timeframe the legislator wanted to test through practical experience if collective legal protection has its rightful place in the German civil rights and securities law. The validity of the German Capital Markets Model Case Act (KapMuG) was then extended to 31 October 2012. An evaluation study requested by the Federal Ministry of Justice determined that the German Capital Markets Model Case Act had in principle proven itself worthy. The only amendments that were required were changes to the detail. This could partly be achieved though through the appropriate juricature. In practical terms though this act is not viewed so positively. Judges, plaintiffs' lawyers as well as investor representatives are of the opinion that the introduction of the German Capital Markets Model Case Act (KapMuG) has not had the desired effect. During the model case proceedings, the proceedings turned into a "monstrosity". One should let the act expire and allow the fact finding process to occur at the lower level courts in its established form. They view the German Capital Markets

Model Case Act (KapMuG) as unsuitable (cf. Schneider/Heppner, 2011, p. 2947).

Since the introduction of the German Capital Markets Model Case Act (KapMuG) in 2005, there was really not even one legally binding ruling in a model case proceeding up until the end of 2011. Even the number of model case proceedings which were registered in the specially created lawsuit register was very low<sup>33</sup>. Because of this, Schneider and Heppner assume that the German Capital Markets Model Case Act (KapMuG) provided the solution only to an exceptional situation. The initial listing of Deutsche Telekom and the prevailing shareholder euphoria at that time created by the so-called new market and its miserable end which resulted in thousands of investor claims will not find a fast repeat. Also in the sector of closed investments, it appears that model case proceedings are out of fashion which is probably, among other things, due to the developments of legislation related to liability for non public distribution fees and the lack of ability to apply the model case proceedings process to such type of claims (cf. Schneider/Heppner, 2011, p. 2947). The EU-Commission is also looking into the topic of collective legal protection and is observing the developments in Germany.

In the summer of 2011, the German Federal Ministry of Justice published a draft bill for the reform of the German Capital Markets Model Case Act (KapMuG) but whilst it refrained from looking into a conceptually completely new approach, it did however draw on various results of the completed evaluation study. Changes to the enhancement were planned to extend the factual application section to include cases of broker and consultant liability within the securities law, and changes to the prerequisites for starting and expanding the model case proceedings as well as to the individual cost regulations. In addition, it should be made easier to achieve a settlement in the model case proceedings. The legislator had planned to redesign the German Capital Markets Model Case Act (KapMuG) through a reworked principle regulation. Another proposal that planned to integrate the German Capital Markets Model Case Act (KapMuG) into the code of civil procedure was discarded at the draft stage of development. This led to the situation that the existing rules were modified in their detail without however changing the base structure of the German Capital Markets Model Case Act (KapMuG). The new act was to come into effect without a new time limitation by latest 1 November 2012 (cf. Schneider/Heppner, 2011, p. 2947 f; Shearman/Sterling, 2011, p. 1).

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<sup>33</sup> Up to 28.11.2011 (cf. Schneider/Heppner, 2012, p. 2947).

A following short overview will show, on the one hand, the draft bill of the most importantly potential changes to the German Capital Markets Model Case Act (KapMuG) and on the other hand show the actually implemented legal changes to the German Capital Markets Model Case Act (KapMuG):

According to Shearman and Sterling, the applications covered by the German Capital Markets Model Case Act (KapMuG) were to be extended. The German Capital Markets Model Case Act (KapMuG) was in future to include all proceedings in which false, misleading or omitted public capital market information played a decisive role. The act was therefore in future to be applicable for cases of investment consultant agreements as well as investment mediation contracts so that cases of so-called improper prospectus liability were taken into account in which the liability arising from the use of a faulty prospectus as part of a consultation or mediation can be legally pursued. The extension of the applicability could lead to claims against share issuers as well as investment consultants and investment brokers based on a faulty prospectus, being jointly heard in a model case proceeding (cf. Shearman/Sterling, 2011, p. 2). These changes were pursuant to § 1 (1), 2 KapMuG legally implement on 01.11.2012. Bernuth and Kremer however do not view this extension of applicability of the KapMuG as sensible. So the Federal Supreme Court ruled according to prevailing law that the faulty capital market information of a share issuer not necessarily implied the liability of a third party (investment consultant, investment broker) for a breach of their obligation to provide information and vice versa faulty capital market information does not necessarily exclude a case for liability to apply (BGH, NZG 2011, 151, speaker no. 16). Bernuth and Kremer see in this new regulation the danger of plaintiffs being pulled into lengthy and cost intensive model case proceedings whose result do not influence their chance of winning their case (cf. Bernuth/Kremer, 2012, p. 892).

According to Shearman and Sterling, a further goal of the reform should be to expedite the model case proceedings. This should be made possible, for example, through a faster decision-making process for approving a request for a model case proceeding. The completed evaluation shows that in the past it mostly took a long time from the point of application to the ruling of the validity of a model case proceeding as well as the subsequent publication. These vast time-spans were supposed to be shortened with the new regulation. The trial court should rule within three months from the time of application, whether a model case proceeding

should take place or not (cf. Shearman/Sterling, 2011, p. 2). To speed up the model case proceeding, there were also changes made to the course of procedures within the law. Pursuant to § 3 (3) KapMuG, a required time-limit of six months<sup>34</sup> is introduced at the beginning of the proceeding for the publication of the model case proceeding application. Pursuant to § 15 KapMuG the responsibility for the extension of the content of the charges has been extended to include the Higher Regional Court. Legal means are partially limited, so that, for example, pursuant to § 3 (1) KapMuG the ruling of the inadmissibility of an application for a model case hearing is incontestable.

Bernuth and Kremer as well as Schneider and Heppner have issues with the introduction of the six-month deadline for the announcement of the model case proceeding application. The deadline is regularly viewed as too tight as the trial courts do not have the required time to process the applications (cf. Bernuth/Kremer, 2012, p. 894; Schneider/Heppner, 2011, p. 2947, 2948). In a statement made by the German Federal Council (Bundesrat) of Germany regarding the draft bill, it also pleaded for this requirement to be withdrawn (whilst the envisaged deadline in the draft bill was still three months) (RegE, BT-Dr 17/8799, p. 32 f).

One of the most important changes to the planned reform (draft bill) included the possibility to end the model case proceeding and the main proceedings by reaching a settlement. The reaching of a settlement was up to that point in time based on the prevailing legal framework. This was a seemingly impossible task as the corresponding end to proceedings had to be agreed by the model case plaintiff, the model case defendant and all attending intervening parties. Now a judicially accepted settlement should be made possible between only two parties, namely the model case plaintiff and the model case defendant. A settlement reached in the model case proceedings should also reach an agreement over the claims raised in the main proceedings. The process of reaching a settlement should be made as follows: model case plaintiff and model case defendant can jointly agree the desire to reach a settlement to end the model case and the main proceeding and accordingly inform the Higher Regional Court in written form. A second possibility was also conceded, whereby the Higher Regional Court can make a proposal for a settlement to the model case plaintiff and the model case defendant (cf. Shearman/Sterling, 2011, p. 4).

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34 The government draft bill still assumed a time-limit of three months

The settlement proposal should at least clarify the following aspects: It should include a coherent, understandable concept for distributing the promised payments to the wronged parties. The proposal for a settlement should, for example, make a clear statement about how the exact distribution of the damages to each individual wronged party should occur. It should include agreements that can be implemented in the main proceedings without the need for new judicial clarification. In addition, the settlement proposal should clarify how the plaintiff has to verify the justification for receiving the agreed settlement payment and its exact amount towards the model case defendant. Also here the proof of entitlement should be organized in such a way that it does not require further judicial support. Furthermore, the regulation of how the costs of the model case proceeding are to be borne should be conclusively agreed upon. Otherwise the legislature does not request any other content requirements to be agreed upon for a settlement pursuant to statutory requirements (cf. Shearman/Sterling, 2011, p. 4 f).

The intervening parties should have the possibility as a last point to make a statement regarding the proposed settlement. The Court would then have to check whether the proposed settlement is appropriate and whether the interests of all parties are appropriately covered. If the Court found that the settlement can be seen as including an appropriate amicable agreement in relation to the suspended lawsuits then the settlement is approved as a final decree and legal certainty comes into effect (cf. Shearman/Sterling, 2011, p. 5).

The approved settlement is then to be served to all intervening parties. They should have the possibility within one month after receipt to proclaim in written form their wish not to be part of the settlement. The intervening parties who do not wish to take the settlement should have the possibility to continue their lawsuit following the ruling of the settlement. The lawsuit would then begin anew at the phase it was in before it was suspended. In order to keep as few intervening parties from exempting themselves from the settlement, it was viewed as sensible that a certain predetermined number of quorums as effectiveness requirement could be individually negotiated. Otherwise many proceedings – like after a legally binding decision in a model proceeding – could be continued in individual lawsuits at the Civil Courts (District Courts). This could turn out to be very time and cost intensive for both parties (cf. Shearman/Sterling, 2011, p. 5).

The judicially approved settlement should lead to the end of the model case



hearing and be applicable to all involved after the period for not accepting the settlement has expired (cf. Shearman/Sterling, 2011, p. 5).

Finally, the topic of ending a model case proceeding through agreeing a settlement was regulated by the legislator in the following way: Pursuant to §§ 17-19 and 23 KapMuG model case plaintiffs and model case defendants can agree upon a settlement that, to take effect, must be approved by the Higher Regional Court. The Court will grant approval if it views the overall settlement proposal as appropriate. In reaching this ruling pursuant to § 18 KapMuG, all affected parties must be heard. The approved settlement is binding for all parties affected. But pursuant to § 19 (1) KapMuG the approved settlement is to be made available to all intervening parties. They in turn have the option within one month after receipt of the ruling to declare their wish not to participate in the settlement (§ 19 KapMuG). Should an intervening party not participate in the settlement, then the respective individual hearing must continue. During the legislative process, the German Federal Council (Bundesrat) had suggested that should thirty percent or more of the intervening parties not agree to the settlement then the settlement should not become legally binding (Statement by the German Federal Council (Bundesrat) in respect to RegE, BT-Dr 17/8799, p. 34). This thirty percent quorum was subsequently added to § 17 (1), 3 KapMuG.

Bernuth and Kremer raise the objection that a settlement is only sensible for the defendant if the proceedings can finally be brought to closure through the settlement. However, this goal is endangered through the withdrawal option. In the worst case, a model case defendant would have to pursue a further model case proceeding with the same content with the remaining claimants. As such lawyers can only give their recommendation to their clients on the side of the defendants to take the settlement if there is a very high quorum – way higher than the legally required thirty percent – of claimants willing to agree to the settlement. Then there is the possibility to subsequently find separate compensation agreements for the remaining claimants (cf. Bernuth/Kremer, 2012, p. 893).

A second important change that was introduced with the new German Capital Markets Model Case Act (KapMuG) from 01.11.2012 was to suspend the statutory limitation period through a simple claim registration process. Following background to this point: During the legislative process, especially through the statements made by the German Federal Council (Bundesrat) in respect to (RegE,

BT-Dr. 17/8799, p. 31), there were multiple attempts to discontinue the factual necessity for raising a claim. According to Halfmeier, this necessity for raising a claim leads to a certain awkwardness of the German Capital Markets Model Case Act (KapMuG). In addition Halmeier states that because each model case hearing only applies to previously raised claims, each individual claimant who wants to firstly avoid the limitation of the claim and secondly wants to be included in the outcome of the model case proceedings must raise a conventional claim. This will more likely lead to an overloading of the Courts rather than an easing of the Courts. Also the claimant must ask himself whether the pursuance of the compensation claim due to the cost involved is economically feasible. Due to the current general set-up, taking legal action does not make sense unless you are claiming much more than 5,000 euros as otherwise the cost risk is too high. But if raising a claim does not make sense for small investors due to the high cost risk and they subsequently do not take legal action, then one can assume that the German Capital Markets Model Case Act (KapMuG) will not help to achieve improved law enforcement (cf. Halfmeier, 2012, p. 2146). The Legal Committee of the German Federal Council (Bundesrat) based on the above-mentioned concerns but also other objections, subsequently introduced the option of the "Application for demands from a model case proceeding"<sup>35</sup> (translated in context by the author) pursuant to § 10 (2-4) KapMuG. According to § 10 (2) KapMuG, claimants who have not yet raised a claim can file a suit before the Higher Regional Court. This must be in written form and entered into the lawsuit register within six months after the model case plaintiff is announced. Thereby they must, pursuant to § 10 (3) KapMuG, amongst other formalities (party representation) also provide the justification for the claim and the amount of damages claimed. The effect of this application is limited to the suspension of the period of limitation of the declared demand pursuant to the newly created § 204 (1), 6a BGB. The declared demand must be based on the same circumstances as the stated goals of the model case proceeding. The applicant does not however take part in the proceedings. The result of the model case proceedings cannot be used for or against him. After the model case proceeding is finished, the applicant must raise their own claim within three months or their suspension is no longer valid.

Pursuant to § 10 (2), 3 KapMuG the application for an enforcement of a claim

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35 „Anmeldung von Ansprüchen zum Musterverfahren“

to have the statutory limitation period suspended needs to be made through a lawyer. The goal is to ensure appropriate consultation of the applicant. Despite the need to be represented by a lawyer, Bernuth and Kremer warn that a largely risk-free participation in the tribunal system also holds a high potential for abuse similar to US-American class actions (cf. Bernuth/Kremer, 2012, p. 891). The legislator has also in principle realized that this is the case (BT-Dr. 17/10160, p. 25). Bernuth and Kremer even assume that an application for an enforcement of a claim is possible without significant costs as only a half a percentage of the court fees and to their own lawyer an eighth of a percentage of the procedural fee accrue (cf. Bernuth/Kremer, 2012, p. 891). This statement by Bernuth and Kremer is only partially correct according to Halfmeier. It is true that the legal fees for the application pursuant to § 10 (2) KapMuG are slightly lower than the also applicable method of attaining the suspension of the statutory limitation period by using a default summons [an eighth of a percentage of the fees according to the legal counsel fees regulation (VV RVG No. 3338) compared with one percent of the fees for a default summons according to the legal counsel fees regulation (VV RVG No. 3305)]. But despite this, the costs of an application pursuant to § 10 (2) KapMuG are for example approximately still 400 euros for a claimed amount of 5,000 euros, this is eight percent of the claimed damage and is split between 121 euros court fees and 240.80 euros in lawyer costs plus turnover tax (cf. Halfmeier, 2012, p. 2147). Also according to Söhner the potential for misuse by the plaintiff similar to the US-American class actions is not discernable as the application to claim carries a cost risk and is in addition verified by professional judges (cf. Söhner, 2013, p. 12).

Bernuth and Kremer, who seem to be more committed to supporting the rights of the model case defendant, criticize that, relative to the declared demands, a following examination of whether the conclusions based on the facts is warranted does not take place. They fear that many unsubstantiated and arbitrary claims could be handed in. But most of all they assume that the applicant, when registering their application for a claim, will provide so little data that the model case defendant will find it nearly impossible to evaluate the risks of the claims submitted. This in turn helps the plaintiffs and claimants as they can place vast pressure on the model case defendant through the amount of claims submitted (cf. Bernuth/Kremer, 2012, p. 891). Also Söhner raises the question how precisely the reason for the claim must be individualised. He assumes though, unlike Bernuth and Kremer, that based on past jurisdiction by the German Federal Supreme Court the

claim, whose statutory limitation period is to be suspended, must be sufficiently individually portrayed. A distinction from other possible demands must be clear cut (cf. Söhner, 2013, p. 12).

In the end Bernuth and Kremer come to the conclusion that it is appropriate to make mass trials more efficient and more cost effective. However, they see a one-sided and unjustified advantage for the claimants in the possibility of being able to evoke the statutory limitation period by simply filing an application to claim. They also fear that this new regulation stands in opposition to other, in principle, endorsable changes such as the promotion of the model case proceedings for attaining settlements<sup>36</sup> (cf. Bernuth/Kremer, 2012, p. 892).

As already demonstrated, the new German Capital Markets Model Case Act (KapMuG) is leading to numerous changes. The Federal Government of Germany is of the opinion that the old KapMuG has proven itself worthy and as such the new KapMuG need not be limited from a time perspective. The German Federal Parliament (Bundestag) does not share the Federal Governments opinion and suggested that also the new German Capital Markets Model Case Act (KapMuG) should undergo a pilot phase (cf. RegE, BT-Dr 17/8799, p. 16). At the end of the day, the new KapMuG was limited to eight years to 31 October 2020 (cf. BT-Dr 17/10160, p. 27).

### 3.1.2.7

#### *Conclusion*

The second point of the catalogue of measures to strengthen companies' integrity and to protect investors suggests that the commenced improvement process for investor claims for false information on the capital market (§§ 37b and 37c of the German Stock Corporation Act) as initiated with the fourth Financial Markets Improvement Act should be continued. In future, not just the issuer of shares should be liable towards investors but also in addition the Board and Supervisory Board Members responsible should be made personally liable (Catalogue of Measures, 2002, Point 2, p. 2). This recommendation made by the legislator has to

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<sup>36</sup> The decision whether to agree to a settlement is made harder by the fact that in future it will be very hard to assess within model case proceeding if and to what extent the claimed damages are justified. This only applies however to a settlement that includes claimed damages through stipulation (cf. Bernuth/Kremer, 2012, p. 892).

date not been implemented. An attempt hereto was made in the summer of 2004 with the Act Governing Liability for Capital Market Information; the bill though quickly failed due to the resistance by lobbyist associations of the industry and banks. Currently, it is only possible to claim liability against Board Members and Supervisory Board Members pursuant to § 826 BGB. Prerequisites for being liable pursuant to § 826 BGB are the existence of a deliberate and unethical act that lead to damage as well as proof of causality between the fraudulent behaviour in form of a false statement and the damage occurred to the investor.

By contrast, in the US the assumption of causality prevails, if the investor placed their trust in the integrity of the information reflected in the share price (fraud-on-the-market-theory). As such the burden of proof is reduced to having to assess the efficiency of the capital market at the time of share purchase. In order to avoid a boundless extension of claims, such an approach does not seem worth applying within German law. Müller-Michael and Wecker assume that the actual causality must be proved even in cases of extremely dubious capital market information (cf. Müller-Michaels/Wecker, 2007, p. 209). One could counter that, based on the situation portrayed here, a strengthening of the rights of damaged investors seems to be required.

In this context, it should be noted positively that the legislature has toughened the manager's liability for capital market information. As such the Federal Supreme Court ruled in the case of the Haffa brothers and the EM.TV AG beyond the legal principles established in the case of Infomatec. It accepted the external liability of Board Members and pursuant to §§ 826 and 823 (2) BGB placed it on a broadened basis. The personal liability of Board Members pursuant to § 31 BGB was attributed to the enterprise; the requirements of proof of causality and damage were lowered. Here it becomes clear that the case-law is accommodating the objectives of the Federal Government in two central aspects. This is also expressed in the fact that the German Federal Supreme Court wants its Infomatec ruling to be seen as a "decision in principle" (cf. Möllers, 2005, p. 1642).

Furthermore, it was recommended to investigate in how far compensation claims should be allowed not just for false or omitted ad-hoc announcements but also for other falsely provided information, for example, through statements in the entity's financial statements, status reports and interim reports or also for misleading statements made in speeches or interviews (Catalogue of Measures, 2002,

Point 2, p. 2). To date, in relation to this specific recommendation there has been no bill enacted by the German Federal Government. Currently the only possibility is to pursue an action for liability according to § 823 (2) BGB in conjunction with § 400 of the German Stock Corporation Act. § 400 (1), 1 of the German Stock Corporation Act determines the punishment of those, who as member of the Board or Supervisory Board, provided untrue or obscured representations or summaries of the company's financial situation.

The last recommendation in relation to the second point of catalogue of measures is to provide damaged investors with an improved methodology for enforcing a claim for damages. Enforcement of damages in individual hearings requires in most cases extensive evidentiary hearings with costly expert opinions. The individual investor is faced with high litigation risks and litigation costs which lead to the situation where damaged investors do not claim their damages in Court as the foreseeable economic disparity prevents them from taking this step. The result is that fraudulent behaviour is not punished and the person damaged does not receive justice. Even if the individual investor would only make a fairly small loss, the damages occurred in the capital market arena can be multi-digit million amounts. To change this situation, the catalogue of measures aimed for the introduction of collective legal protection to ease the procedural implementation of substantive law within the capital market arena. The recommendation was to introduce a mechanism which offset the former deficits without leading to mass claims. There is to be no obligation to join a collective representation. Also a commercialization of the claim law through, for example, multiple representation and success fees should not be possible. The underlying idea was: Firstly to introduce requirements that all claims of affected investors must be heard by the same court close to the entity's place of business, so that all claims of affected investors are heard at the same court. The second point is the selection of a claim for use in a model case proceeding during which time the other proceedings are discontinued. In this model case proceeding, all claiming investors should get the important question clarified whether there really is a case based on a false or omitted ad-hoc announcement. The third point is the publication that a model case proceeding will take place so that further investors get the chance to raise their claims (cf. Catalogue of Measures, 2002, Point 2, p. 3). These recommendations found their first-time legislative implementation with the German Capital Markets Model Case Act (KapMuG) dated 01.11.2005. After a period of five years the Act was reviewed

once again. It was then, after a transition period of two years, re-published with some changes made on 01.11.2012 with a renewed time limitation of eight years. However this Act, whose term of validity has been extended until 31 October 2020, shows too many weaknesses to guarantee achievement of the intended goal. For example, since the Act came into effect in 2005 until the end of 2011 not one single enforceable ruling was made in a model case proceeding. The number of model case proceedings with only 15 listed model case proceedings in the lawsuit register is extremely low<sup>37</sup>. Judges as well as lawyers that have come into contact with the German Capital Markets Model Case Act (KapMuG) think the process applied in these proceedings is “monstrous” (cf. Schneider/Hepper, 2011, p. 2947). For the aggrieved shareholders, especially for the many small and minority shareholders, it is a shame that the legislator has not decided upon making a fundamental reform to the collective legal protection. It would have been possible, for example, to introduce into the Act a “simple participation”<sup>38/39</sup> (literally translated by author) clause to the model case proceedings as already implemented in Denmark and Sweden. This means that the statement of participation is under the threshold of raising a claim. This would enable claimants to participate in the model case proceedings and its results with a calculable cost risk and also correspondingly low participatory rights (cf. Halfmeier, 2012, p. 2146). This was however rejected by the German Federal Parliament (Bundestag) because the participation in a positive model case ruling based on the low cost risk is problematical and could encourage many people to jump on the bandwagon (BT- Dr. 17/10160, p. 25).

As such, it can be noted that the planned improvements for the procedural enforcement of investor rights have not, to date, shown an overwhelming success and that the legal protection of the individual investor through the introduction of a collective legal protection process has not really be seen as strengthened.

As such, it remains questionable if Schneider’s assumption of 2005 that reimbursement claims based on false or omitted publication of share price relevant facts pursuant to §§ 37b, c of the Securities Trading Act, which since its enforcement through the 4th Financial Market Improvement Act has practically played no role, will attain more importance through its (at least from a legal perspective)

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37 Up to 28.11.2011 (cf. Schneider/Heppner, 2012, p. 2947).

38 This phrase was characterized by (Bergmeister, 2009, p. 330).

39 „einfache Teilnahme“

collective enforceability in the model case proceeding process will in future be realised. He assumed that through the combination of slightly tougher rules on liability and easier legal enforceability, the risk of being sentenced would rise in total. Despite this optimistic assumption, one must criticize Schneider's view if one believes that damaged investors, if they have the possibility to sue in the US, will not make use of this right. Of course they will sue in the country where the chances for success are the greatest. As such Schneider views the KapMuG also in future as not competitive compared to the US (cf. Schneider, 2005, p. 2258).

On the other hand – when speaking of importance – one must consider that in principle one must assume that alone the theoretically higher chance of being sentenced for fraudulent behaviour could at least curb it. The fact remains that: The more likely it is for a manager to be made personally liable for the damage they created towards the aggrieved investors, the less they will behave in a deliberate and unethical and thereby legally punishable way.



## 3.2 GERMAN CORPORATE GOVERNANCE

Point three of the Catalogue of Measures to Strengthen Companies' Integrity and to Protect Investors refers to the further development of the German Corporate Governance Code. Particular focus is placed on the transparency of share or incentive based payments to board members. It lists individual points that are suggested for inclusion into the Code or which could also be put into effect on a legislative basis. For this reason this section provides a short elaboration of the Corporate Governance in general, of the German Corporate Governance Code and the influence of the Catalogue of Measures to Strengthen Companies' Integrity and to Protect Investors. These initiatives will be illustrated and critically examined.

### 3.2.1 *Corporate Governance*

The term Corporate Governance has been defined in several different ways in the literature. The original definition came from a publication by Adolph A. Berle and Gardiner C. Means from 1932. Berle and Means focussed on the separation of ownership and control, the resulting incentive issues from this separation as well as the question about how one ensures that the management board of a company makes their decisions in favour of the shareholders or members and not in favour of their own personal interests (cf. Boecker, 2010, p. 240).

In order to highlight the complexity of the term and the formulated understanding of the term Corporate Governance, a few examples will be briefly recalled at this point. Hüffer understands the Corporate Governance as meaning the leadership principles of board members. This concerns the quality of the management board in particular about sustainable and lawful value in the interest of the shareholders, creditors, employees and last but not least of all the public. Apart from the principles of leadership, often the rights of shareholders and the lived transparency are in the foreground (cf. Hüffer, German Stock Corporation Act 2008, § 76 AktG, see recital 15a, p. 370). For Hilpisch all mechanisms that ensure that the shareholder receives a reasonable return on their invested capital define Corporate Governance. This includes, for example, markets, institutions, bodies, laws and contracts (cf. Hilpisch, 2005, p. 26). For Picot, Corporate Governance encompasses, on the one hand, all rights, tasks and responsibilities of the corporate bodies, the shareholders, the employees and all other stakeholders. This refers therefore to the

rights of those that profit or stand to lose from the performance and success of a company. On the other hand, one can understand according to Picot that Corporate Governance means the transformation of social orders. Here the goal is pursued to create a management and monitoring function that meets the interests of investors on the capital market in an efficient and reliable manner (cf. Picot, 2001, see recital. 30). In total the guidelines of Corporate Governance can be viewed as a kind of principles of the company.

Although the term Corporate Governance cannot finally be defined there are, however, similarities which can be seen across the different approaches. The lowest common denominator can be found in the structure of the relationship between management and control of a company as well as its relationship to the capital market. This is supported by the fact that the guidelines of Corporate Governance deal with the web of relationships between the board, the supervisory board and shareholders. The Berlin-based German Code of Corporate Governance Initiative supports this view of Corporate Governance meaning the lawful and factual regulatory framework that regulates the management and monitoring of companies (cf. Boecker, 2010, p. 242 f). The German Corporate Governance Code (DCGK) – which will be dealt with in the next chapter – orientates itself towards international and national standards of good and responsible management (cf. DCGK in the version dates 13.05.2013, Foreword).

Since with large companies the separation between management and those who carry the risk – for example the equity investors – is often inevitable, the main concern of Corporate Governance is to improve the management and monitoring structure (cf. Boecker, 2010, p. 243). Applying the principal-agent approach, there is a yawning information asymmetry between both groups that can lead, for example, in the case of a corporation that the expectations of the shareholders cannot be fulfilled by the board (cf. Chapter 2.4.2 of the investigation: Implications for company owners, investors and shareholders). The goal of effective Corporate Governance is thus to reduce substantial independence of the company management from the owners, on the one hand, as well as, on the other hand, the monitoring supervisory board and final auditor to a reasonable level (cf. Boecker, 2010, p. 243). Affected by this are not only company internal structures, processes and people but also aspects of transparency and monitoring (cf. Wöhe, 2008, p. 70). These areas take different forms. Partly they are legally binding formulated as

legal regulations or they are noted as individual company or general regulations that companies can voluntarily apply (cf. Wöhe, 2008, p. 73).

Many fundamental concepts of the German Corporate Governance owe its origin to the nineties of the last century. At this time there was a rapidly growing internationalisation and globalisation of markets and connected with this also an increase in the number of international investors in Germany. As the regulations for management were anchored in different parts of the German legislation, it became necessary to bundle these. In addition, they were extended to include further customary international practices and summarised in the Code in order to provide foreign investors with an easier to understand overview of the prevailing regulations in Germany (cf. Cromme, 2001, p. 2; Boecker, 2010, p. 244). Many of the rules that affect the rights and duties of individual company organs of a corporation<sup>40</sup> in Germany can be found in the Stock Corporation Act. Hereby the emphasis is on the corporation as it is the focus of the Corporate Governance discussions and developments in Germany. A transfer to other legal forms is certainly possible. In addition, the German Commercial Code (HGB) includes detailed regulations that include mandatory provisions for corporations.<sup>41</sup> Compared to the legal systems in other States, Germany has numerous regulations which define the tasks and responsibilities in more detail<sup>42</sup> included in company law rather than in capital market legislation (cf. Boecker, 2010, p. 245). The capital market legislation in Germany mainly regulates the organisational structure of the capital market but does not include further detailed regulations regarding the organisational structure of companies that use this market. By summarizing the central regulations into one Code, it should be made easier for international market participants to understand the German system for corporate constitution and to balance their different interests in Germany (cf. Boecker, 2010, p. 245). This is one of the reasons that led to the development of the German Corporate Governance Code. The sense

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40 This includes the board of executive directors, the supervisory board as well as the general meeting of shareholders.

41 One of these regulations, for example, is the in the German Commercial Code (HGB) standardized obligation for a legal representative of a corporation to prepare the annual financial statement and the management report.

42 Herein details of the relevance of Corporate Governance for a company are justified.

and purpose of the German Corporate Governance Code will be reviewed in more detail in connection with its depiction.

First though, the concept of the DCGK will be highlighted. In particular the current version dated 13 May 2013 including the changes made in recent years will be considered<sup>43</sup>. This is followed by an examination as to if and to what extent the proposals made by the German Federal Government in its final version of the Catalogue of Measures to Strengthen Companies' Integrity and to Protect Investors – also known as the 10-Point-Program – published in February 2003 were applied in the further development of the German Corporate Governance Code. In a separate point, the changes to the version from 2009 to 2010 are listed as these changes as well as the design of the currently valid edition from June 2013 (here the publication by the DCGK was made through the Federal Gazette) highlight the current concerns of the German Federal Government over a longer period of time. The Commission for the German Corporate Governance Code has addressed also issues in its continuous recommendations and suggestions that, although they were not mentioned in the 2003 Catalogue of Measures to Strengthen Companies' Integrity and to Protect Investors they are in the meantime, however, statutory. These points shall be reviewed in the conclusion.

### 3.2.2

#### *The German Corporate Governance Code (DCGK)*

In 2001 the former German Federal Government under Gerhard Schröder instituted the so-called Code Commission in order to establish a Corporate Governance Code for Germany. The Commission was given the task to formulate a voluntary code of conduct for Corporate Governance in Germany. The Code Commission presented its first discussion draft titled "German Corporate Governance Code"<sup>44</sup> (literally translated by author) on 18 December 2001. People interested in providing feedback were given the chance to state their opinion within a certain timeframe.

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<sup>43</sup> The Code in its version dated 13 May 2013 was publicised in the Federal Gazette in June 2013 (German Federal Ministry of Justice BAnz AT 10.06.2013 B3). The changes made are not highlighted. A version with highlighted changes can be found on the internet page of the Code Commission [www.corporate-governance-code.de](http://www.corporate-governance-code.de). There one can also find an archive with all previous editions.

<sup>44</sup> „Deutscher Corporate Governance Kodex“

After this deadline had expired, the first German Corporate Governance Code was published on the homepage of the Code Commission on 26 February 2002 and on the Federal Gazette on 30 September 2002. Typically it is subjected to an annual review to ensure it is up-to-date with national and international developments and adjusted, if necessary (cf. Cromme, 2001, Internetresource). Currently the version dated 13 May 2013 is valid (cf. Commission of the German Corporate Governance Code, 2013, <http://www.corporate-governance-code.de/index-e.html>).

The meaning and purpose of the DCGK is to make the German Corporate Governance system transparent and understandable. This is also done to promote the trust of international and national investors, customers and employees, and of the public in the management and monitoring of listed companies. It highlights the duties of the executive board and supervisory board to ensure, in line with the principles of the social market economy, the survival of the company and sustainable value creation (cf. DCGK, 2013, Foreword).

The requirements made by the Federal Ministry of Justice to the Commission to formulate a voluntary code of conduct, however, already highlights the fact that there was never the idea to create a legal framework for Corporate Governance principles in its entirety for Germany.

The German Corporate Governance Code was to constitute a short, precise and self-contained set of rules. Its main emphasis is on listed corporations and corporations with access to the capital markets pursuant to § 161 (1) sentence 2 of the Stock Corporation Act. It is, however, also recommended for non-listed corporations to follow these regulations. It looks at the relationships between shareholders, executive board and supervisory board and extends the already existing legal framework of Corporate Governance to include national and international best practices (cf. DCGK, 2013, Foreword; Wöhe, 2008, p. 74). In addition, it includes specific choices for company management and monitoring. The Code is structured in such a way that its content can be subdivided into three different levels of obligations. Firstly, the regulatory framework includes legally codified provisions that are mandatory for companies. In addition, one can find recommendations and suggestions. The recommendations of the Code are marked by the use of the word “shall”. Companies can deviate from them, but are then obliged to disclose this annually and explain the deviations. This enables companies to cater for sector and enterprise-specific requirements. A well justified deviation from a

recommendation may be in the interest of good corporate governance. In this way the Code contributes to more flexibility and more self-regulation in the German corporate constitution. For suggestions the Code uses the term “should”. In contrast to recommendations, suggestions can be deviated from without disclosure (cf. DCGK version dated 13.05.2013, Foreword). The application of the standards beyond those that are legally binding is in any case principally voluntary.

With regard to the content of the German Corporate Governance Code it is to be noted that in relation to the executive board it goes beyond the legal requirements in some points and concretises them. This applies, for example, to the reporting of the executive board members’ remuneration or the requirements relating to compliance. The discussion over compliance has moved into public focus in Germany following the accounting scandals. Compliance does not just mean adhering to applicable law but also following all forms of rules and regulations. Compliance is an integral part of every form of management control. The emphasis here is on measures to ensure compliance to accounting, stock exchange and anti-trust rules as well as to fighting against corruption. Hereby the scope of compliance measures taken is dependent on the size of a company. In any event compliance is a self-determined segment of a companies’ organisation. In accordance large companies and corporations have their own compliance departments. For credit institutions and investment companies, there are special obligations for the adoption of compliance regulations in Germany (§ 25 a German Banking Act and § 33 German Securities Trading Act). The goal of compliance is to ensure that a company as a whole as well as its management and all employees in particular adhere to the law, provisions and regulations as well as to general business principles. Thereby ethical and moral standards such as honesty, fairness, transparency, decency and trust should shape the relationship of the company to external people. Compliance should make liability risks personally controllable for the company and its members of the management board and thereby claims for damages can be avoided. The German Corporate Governance Code has been addressing the topic of compliance since 2007 and thereby contributes to the promotion of compliance concepts in German enterprises. For instance, the Code requires that the executive board in line with compliance has to take steps to ensure that the legal requirements and company internal guidelines are being adhered to. Further, the executive board has to inform the supervisory board about all aspects of compliance. The Audit Committee which has to be formed by the supervisory board has to also

address the question of compliance. As a company can most likely prove its integrity through social fairness and responsibility, compliance is of great importance. Breaches of the law and breaches against other regulatory norms can cause, apart from financial damage, also other serious consequences that can damage a company's reputation. If one succeeds through the application of compliance systems to ensure adherence to applicable laws and directives and to guarantee an ethical and morally unimpeachable conduct of a company, then this can be an effective contribution towards the fight against unlawful acts in general and against accounting fraud in particular (cf. Boecker, 2010, p. 264 ff; for the definitions also refer to Harz et al., 2012, p. 1-2; Rotsch, 2012, p. 47-50).

Instead of following the German Corporate Governance Code companies are also allowed to develop their own Corporate Governance Code (cf. Boecker, 2010, p. 249). § 161 of the Stock Corporation Act obligates, however, the executive board and supervisory board of corporations listed on the capital markets to issue an annual declaration concerning conformance to the Corporate Governance Code (declaration of compliance)<sup>45</sup>. This must be published in the official section of the electronic Federal Gazette. Herein the executive board and supervisory board must declare to what extent they have followed the recommendations of the German Corporate Governance Code. If recommendations were or are not applied, the reasoning has to be provided. These are changes from the German Act to Modernize Accounting

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45 In § 161 of the Stock Corporation Act (Declaration in respect of the Corporate Governance Code) is stated that: „executive board and supervisory board of listed companies issue an annual statement that the company has been and is in conformity with the recommendations of the Government Commission on the German Corporate Code announced by the Federal Ministry of Justice in the official section of the electronic Federal Gazette were and are being complied with, or to list the recommendations which were or are not being explained and explain why not. The same shall apply to the executive board and supervisory board of a company which has exclusively issued securities other than shares for trading on an organised market within the meaning of § 2 (5) of the Securities Exchange Act and the issued shares of which shall, on the company's own initiative, only be traded via a multilateral trading system within the sense of § 2 (3) sentence 1 No. 8 of the Securities Trading Act. The declaration shall be continuously available to the public on the company's internet page.”

Law, article 8. Since this time, deviations from recommendations must not only be declared but also substantiated. A further change that resulted from the German Act to Modernize Accounting Law is also the change to § 161 (2) AktG which explicitly requests that the declaration of the Corporate Governance Code (declaration of compliance) is continuously available to the public on the company's internet page. The role of the external audit of the annual financial statement is simply to check whether the respective details are available. The auditor must not evaluate whether the company management and monitoring systems are compliant with the regulations of the German Corporate Governance Code (cf. Cromme, 2001, p. 2; Boecker, 2010, p. 250). Also Theisen and Raßhofer point out that, the declared acceptance to the Code by a company's management does not necessarily mean that the rules of the Code are also lived out in practice. The declaration of compliance can therefore not unequivocally mean that the requirements are really being met. The declaration of good corporate governance therefore does not necessarily mean that there is factually good corporate governance (cf. Theisen/Raßhofer, 2007, p. 1317 ff).

From a content perspective, the German Corporate Governance Code is divided into seven chapters. These look at the subject areas of shareholders and the annual general meeting, the cooperation of the executive and supervisory board, the executive board, the supervisory board, transparency as well as accounting and the statutory audit. A further differentiation is made in individual points with regard to legal provisions as well as regarding nationally and internationally recognized best practices for a good and responsible company management and company monitoring.

Attached to the digital enclosure to this study is the full text of German Corporate Governance Code dated 2009, 2010, 2012 and 2013 translated by the Commission of the German Corporate Governance Code into English.

### 3.2.3 *Content and Changes Made to the German Corporate Governance Code (2013) due to the Catalogue of Measures to Strengthen Companies' Integrity and to Protect Investors*

Firstly, for this study the relevant content of the German Corporate Governance Code and the changes that were made in the last decade based upon the suggestions made in Catalogue of Measures to Strengthen Companies'



Integrity and to Protect Investors from 2003 will be pointed out<sup>46</sup>. That means that individual points will be mentioned, its development presented and the quality of this development critically reviewed in relation to the goals of the DCGK as formulated in the foreword. What it said was: "Its purpose is to promote the trust of international and national investors, customers, employees and the general public in the management and supervision of listed German stock corporations. The Code clarifies the obligation of the Management Board and the Supervisory Board to ensure the continued existence of the enterprise and its sustainable creation of value in conformity with the principles of the social market economy (interest of the enterprise)" (English version of the DCGK, 2013, Foreword).

In the third point the 10-Point-Program deals with the "Further developed German Corporate Governance Code, especially relating to the transparency of share-based or incentive-based compensation (stock options) of board members"<sup>47</sup> (translated in context by the author).

To achieve further development relating to the named areas, further points are listed that are included in the recommendations of the Code and which could be laid down by the legislator.

Regarding the public disclosure of option programs, the proposal is to highlight the information pertaining to the possible volume of compensation of a planned option program prior to agreeing to the resolution at the annual general meeting through comparative calculations (cf. Catalogue of Measures, 2003, Point 3, p.3).

The current version of the Corporate Governance Code applies this proposal in different parts. In point 2.2.1 it is noted that with regard to the annual general meeting there is the option to take the decision to approve of the system of compensation for the board members (cf. DCGK, 2013). In point 4.2.5 it is stated among other things that: "A compensation report as part of the Management Report outlines the compensation system for Management Board members. The outline shall

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46 To ensure a better reading flow the following text with call out the Catalogue of Measures to Strengthen Companies' Integrity and to Protect Investors in its short form Catalogue of Measures or 10-Point-Program.

47 „Weiterentwicklung des Deutschen Corporate Governance Kodex, insbesondere zur Transparenz von aktienbasierten oder anreizorientierten Vergütungen (Aktioptionen) der Vorstände“.

be presented in a generally understandable way. The compensation report shall also include information on the nature of the fringe benefits provided by the company. In addition, for financial years starting after 31 December 2013, and for each Management Board member, the compensation report shall present:

- the benefits granted for the year under review including the fringe benefits, and including *the maximum and minimum achievable compensation* for variable compensation components
- ...

The model tables provided in the appendix shall be used to present this information” (English version of the DCGK, 2013, *emphasis added by author*). In respect of the model tables, it is stated that: “...the multi-year variable compensation granted in the year under review is broken down *into different plans* and the relevant periods of time are stated. For subscription rights and other share-based payments, the fair value of the compensation at the time it is granted is calculated and reported as previously. If the multi-year variable components comprise non-share-based payments, the target value or a comparable value for an “average probability scenario” must be stated at the time of confirmation (if available)” (English version of the DCGK, 2013, *emphasis added by author*). Additionally, under point 4.2.3 the statement is made that “the chairman of the supervisory board shall outline once to the general meeting the salient points of the compensation and then any changes thereto” (English version of the DCGK, 2013). These are not legal requirements but recommendations that were partially newly taken up in the DCGK.

In regard to the declaration of stock option programs, the Catalogue of Measures makes the proposal that the reporting company should declare the shareholdings, option rights and derivatives that members of the board own. The pertaining details can be made in the notes to the annual financial statement and in the notes to the consolidated financial statement – in the latter also insofar when the board members are not only members of the reporting company but also of an affiliate (cf. Catalogue of Measures, 2003, Point 3, p. 3). The Corporate Governance Code addresses this proposal albeit in weakened form. Under point 6.3, on the topic of transparency one can find the following recommendation: “Beyond the statutory obligation to report and disclose dealings in shares of the company without delay, the ownership of shares in the company or related financial instruments by Management Board and Supervisory Board members shall be reported if these

directly or indirectly exceed 1 % of the shares issued by the company. If the entire holdings of all members of the Management Board and Supervisory Board exceed 1 % of the shares issued by the company, these shall be reported separately for the Management Board and Supervisory Board in the Corporate Governance Report” (English version of the DCGK, 2013). As a result, there can be a situation whereby the full ownership of shares and derivatives of board members is not declared but only those who hold more than one per cent of the shares issued by the company. Supplementing this point, 7.1.5 states regarding the accounts that the consolidated financial statement should take note on the relationship with shareholders considered to be related parties pursuant to the applicable accounting regulations (cf. DCGK, 2013).

Regarding the “Declaration of Stock Option Programs in the Notes” one can find in the third point of the Catalogue of Measures the following proposal. A general description of the individual programs including key data might become possible. This includes in detail (cf. Catalogue of Measures, 2003, Point 3, p. 3 and 4):

- the subscription price and if applicable performance targets, the number of stock rights, the time period, the blocking period, the vesting conditions as well as the mathematical value of the rights at the time granted;
- the value of all accumulated commitments from programs in the period. If there is more than one program, then the information needs to be provided for each program separately;
- for each program the number of option rights and its average subscription price must be stated separately from all outstanding, available, during the year granted, exercised and expired rights;
- the total value of all option rights granted within the year for the purpose of remuneration is to be declared. The value of the option rights that were given to the members of the board are to be declared separately.

This suggestion was specifically taken onboard by the legislator and it added the following passage to the German Commercial Code (HGB) § 285 (other statutory disclosures) number 9, 9a: “In addition the notes must include: for the members of the board, the supervisory board, a council or a similar institution for each individual group of people, the received total remuneration (wages, profit-sharing, option rights and other share based remuneration, reimbursement of expenses, insurance premiums, commissions and fringe benefits of any kind) for the activities

performed in a fiscal year ... option rights and any other share-based rights must be declared stating the number and the value at the time of being granted; later changes in value that are based on a change in the conditions applying must be considered. For a listed company in addition to naming the person, the remuneration of each board member needs to be listed, divided according to non-result-based and result-based components as well as components with long-term incentive respectively ...<sup>48</sup> (translated in context by author).

The German Corporate Governance Code takes a stance on this under point 7.1.3 accounting standards and recommends: "The Corporate Governance Report shall contain information on stock option programmes and similar securities-based incentive systems of the company, unless this information is already provided in the Annual Financial Statements, the Consolidated Financial Statements or the compensation report." (English version of the DCGK, 2013).

Point 3 of the government's Catalogue of Measures lists further suggestions which could possibly become legislative measures relating to the remuneration of board members. Here it is stated that also maximum limits, the so-called cap, could be recommended (cf. Catalogue of Measures, Point 3, p. 4).

The German Corporate Governance Code recommends in point 4.2.3 (executive board) "...all compensation components must be appropriate, both individually and in total, and in particular must not encourage individuals to take unreasonable risks. The amount of compensation shall be capped, both overall and

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48 „Ferner sind im Anhang anzugeben: für die Mitglieder des Geschäftsführungsorgans, eines Aufsichtsrats, eines Beirats oder einer ähnlichen Einrichtung jeweils für jede Personengruppe die für die Tätigkeit im Geschäftsjahr gewährten Gesamtbezüge (Gehälter, Gewinnbeteiligungen, Bezugsrechte und sonstige aktienbasierte Vergütungen, Aufwandsentschädigungen, Versicherungsentgelte, Provisionen und Nebenleistungen jeder Art). ... Bezugsrechte und sonstige aktienbasierte Vergütungen sind mit ihrer Anzahl und dem beizulegenden Zeitwert zum Zeitpunkt ihrer Gewährung anzugeben; spätere Wertveränderungen, die auf einer Änderung der Ausübungsbedingungen beruhen, sind zu berücksichtigen. Bei einer börsennotierten Aktiengesellschaft sind zusätzlich unter Namensnennung die Bezüge jedes einzelnen Vorstandsmitglieds, aufgeteilt nach erfolgsunabhängigen und erfolgsbezogenen Komponenten sowie Komponenten mit langfristiger Anreizwirkung, gesondert anzugeben. ....“

for individual compensation components. The variable compensation components shall be related to demanding, relevant comparison parameters. Changing such performance targets or the comparison parameters retroactively shall be excluded. For pension schemes, the Supervisory Board shall establish the level of provision aimed for in each case – also considering the length of time for which the individual has been a Management Board member – and take into account the resulting annual and long-term expense for the company. In concluding Management Board contracts, care shall be taken to ensure that payments made to a Management Board member on premature termination of his/her contract, including fringe benefits, do not exceed the value of two years' compensation (*severance pay cap*) and compensate no more than the remaining term of the employment contract. If the employment contract is terminated for a serious cause for which the Management Board member is responsible, no payments are made to the Management Board member. The severance payment cap shall be calculated on the basis of the total compensation for the past full financial year and if appropriate also the expected total compensation for the current financial year. Payments promised in the event of premature termination of a Management Board member's contract due to a change of control shall not exceed 150 % of the *severance payment cap*" (English version of the DCGK, 2013, *emphasis added by author*).

The next aspect suggests that there is a better link of the performance targets to relative comparison parameters. They should not only be linked to a company's share price but also to sector indices etc. (cf. Catalogue of Measures, 2003, Point 3, p. 4).

There is no concrete reference made in response to this in the German Corporate Governance Code. In point 4.2.2 it is merely stated in regard to the executive board that: "...Criteria for determining the appropriateness of compensation are both the tasks of the individual member of the Management Board, his/her personal performance, the economic situation, the performance and outlook of the enterprise as well as the common level of the compensation taking into account the peer companies and the compensation structure in place in other areas of the company...". Further in point 4.2.3 it is stated that "... the compensation structure must be oriented toward sustainable growth of the enterprise. The monetary compensation elements shall comprise fixed and variable elements. The Supervisory Board must make sure that the variable compensation elements are in general based on a

multiyear assessment. Both positive and negative developments shall be taken into account when determining variable compensation components. All compensation components must be appropriate, both individually and in total, and in particular must not encourage to take unreasonable risks" (English version of the DCGK, 2013).

A further proposal is to make the declaration of individual's compensation obligatory for board members (cf. Catalogue of Measures, 2003, Point 3, p. 4). The legislator reacted to this suggestion and formulated for members of the board of listed public limited companies pursuant to the German Commercial Code (HGB) § 285 (9a) sentence 5 following legislative text: "listed companies must state separately, in addition, the names of and remuneration paid to the individual members of the executive board divided into non-result-based and result-based components as well as components with long-term incentive effect respectively"<sup>49</sup> (translated in context by the author). Furthermore § 286 (5) of the German Commercial Code (HGB) states that: "The disclosure required under § 285 No. 9 Letter a Sentence 5 to 8 should not be made if this was decided at the Annual General Meeting. A decision which can be taken for a maximum of five years requires a majority that constitutes at least three quarters of the share capital represented at the time of adopting the resolution"<sup>50</sup> (translated in context by the author). Also in the German Corporate Governance Code under point 4.2.4 one can find the following directive: "The total compensation of each one of the members of the Management Board is to be disclosed by name, divided into fixed and variable compensation components. The same applies to promises of benefits that are granted to a Management Board member in case of premature or statutory termination of the function of a Management Board member or that have been changed during the financial year. Disclosure is dispensed with if the General Meeting has passed a resolution to this

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49 „Bei einer börsennotierten Aktiengesellschaft sind zusätzlich unter Namensnennung die Bezüge jedes einzelnen Vorstandsmitgliedes, aufgeteilt nach erfolgsunabhängigen und erfolgsbezogenen Komponenten sowie Komponenten mit langfristiger Anreizwirkung, gesondert anzugeben.“

50 „Die in § 285 Nr. 9 Buchstabe a Satz 5 bis 8 verlangten Angaben unterbleiben, wenn die Hauptversammlung dies beschlossen hat. Ein Beschluss, der höchstens für fünf Jahre gefasst werden kann, bedarf einer Mehrheit, die mindestens drei Viertel des bei der Beschlussfassung vertretenen Grundkapitals umfasst.“

effect by three-quarters majority” (English version of the DCGK, 2013).

For all board members and executive board members of non-listed companies or other companies this regulation does not apply.

Furthermore, in point 4.2.5 it states that: “Disclosure shall be made in the Notes or the Management Report. A compensation report as part of the Management Report outlines the compensation system for Management Board members. The outline shall be presented in a generally understandable way. The compensation report shall also include information on the nature of the fringe benefits provided by the company” (English version of the DCGK, 2013). In 2013 the German Corporate Governance Code was amended to include the following recommendation: “In addition, for financial years starting after 31 December 2013, and for each Management Board member, the compensation report shall present:

- the benefits granted for the year under review including the fringe benefits, and including the maximum and minimum achievable compensation for variable compensation components;
- the allocation of fixed compensation, short-term variable compensation and long-term variable compensation in/for the year under review, broken down into the relevant reference years;
- for pension provisions and other benefits, the service cost in/for the year under review.

The model tables provided in the appendix shall be used to present this information” (English version of the DCGK, 2013).

The next proposal suggests that the applicability of the key points for stock option programs under § 193 (2) of the Stock Corporation Act is to be extended to include programs with convertible bonds (cf. Catalogue of Measures, 2003, Point 3, p. 4). This proposal was taken on-board in the Stock Corporation Act in the section referring to conditional increases in capital. In § 192 (1) and (2) it says that: “The general shareholders’ meeting can agree to an increase of share capital, that shall be implemented only to the extent that conversion or subscription rights (contingent capital increase) are applied to the new shares. The contingent capital increase should only be decided for the following reasons: 1. For the purpose of granting the right to issue or to convert the convertible bonds into ordinary bearer shares to the creditors; ...”<sup>51</sup> (translated in context by the author). And in § 193 (1) sentence

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51 „Die Hauptversammlung kann eine Erhöhung des Grundkapitals beschließen,

1 of the Stock Corporation Act: “The resolution on the conditional capital increase must be approved by a majority of at least three-quarters of the shares capital represented when the resolution is voted on”<sup>52</sup> (translated in context by the author).

Also the next proposed measure was incorporated into the legislative text. The program suggests an extension of § 87 (1) of the Stock Corporation Act. Incentive based compensation components should expressly be subject to the requirements for equitableness (cf. Catalogue of Measures, 2003, Point 3, p. 4). The current edition of the Stock Corporation Act under § 87 (1) states that the supervisory board has to ensure when determining the total amount of remuneration for each individual member of the executive board that it must be in reasonable proportion to the duties and performance of the executive board and the company’s situation and may not exceed the normal level of remuneration unless there are special reasons.

The next aspect looks at the supervisory board. The point here is: “Provision should be made that the notes of the annual financial statement and consolidated financial statement include the details of the payments made or advantages extended for services provided personally by the supervisory board members of a company, parent company or affiliate, in particular advisory or agency services”<sup>53</sup> (translated in context by the author) (Catalogue of Measures, 2003, Point 3, p. 4). This proposal was addressed by the German Corporate Governance Code. Under point 5.4.6 regarding the supervisory board the following statement regarding remuneration and services provided personally can be found: “Compensation of

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dienur soweit durchgeführt werden soll, wie von einem Umtausch- oder Bezugsrecht Gebrauch gemacht wird, das die Gesellschaft auf die neuen Aktien (Bezugsaktien) einräumt (bedingte Kapitalerhöhung). Die bedingte Kapitalerhöhung soll nur zu folgenden Zwecken beschlossen werden: 1. Zur Gewährung von Umtausch- oder Bezugsrechten an Gläubiger mit Wandelschuldverschreibungen;...“.

52 „Der Beschluss über die bedingte Kapitalerhöhung bedarf einer Mehrheit, die mindestens drei Viertel des bei der Beschlussfassung vertretenen Grundkapitals umfasst.“

53 „Es sollte vorgesehen werden, dass im Anhang zum Jahres- (Konzern-) Abschluss für die Mitglieder des Aufsichtsrats die von der Gesellschaft bzw. vom Mutterunternehmen und den Tochterunternehmen für persönlich erbrachte Leistungen, insbesondere Beratungs- und Vermittlungsleistungen, bezogenen Vergütungen oder Vorteile anzugeben sind“



the members of the Supervisory Board is specified by resolution of the General Meeting or in the Articles of Association. Also to be considered here shall be the exercising of the Chair and Deputy Chair positions in the Supervisory Board as well as the chair and membership committees. Members of the Supervisory Board receive compensation which is in an appropriate relation to their tasks and the situation of the company. If members of the Supervisory Board are promised performance-related compensation, it shall be oriented toward sustainable growth of the enterprise. The compensation of the members of the Supervisory Board shall be reported individually in the Notes or the Management Report, subdivided according to components. Also *payments made by the enterprise to the members of the Supervisory Board or advantages extended for services provided individually, in particular, advisory or agency services*, shall be listed separately on an individual basis" (English version of the DCGK, 2013; *emphasis added by author*). There is no legally binding codification supporting this recommendation. The enterprises can, therefore, deviate from these recommendations but are then obliged to declare this on an annual basis.

The last recommendation included in the third point of the Catalogue of Measures is aimed at testing whether the D & O insurance<sup>54</sup> (directors and officers liability insurance) of executive and supervisory board members should include deductibles mandatory by law (cf. Catalogue of Measures, 2003, Point 3, p. 4). Regarding this, there is a legal requirement pursuant to § 93 (2) sentence 3 of the Stock Corporation Act for the executive board in which is stated that, if a company takes out a D&O insurance for its executive board then they have to provide for a deductible of at least 10% of the loss up to at least the amount of one and a half times the fixed annual compensation of the respective executive board member.

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54 The directors- and officers liability insurance is a special form of financial loss insurance through which a company insures its board members against not only demands of the company itself (internal) but also against claims by third parties (external) for specific violations of due diligence. Depending on the form of insurance one can be insured against:

- Internal claims, i.e. company claims against its board members.
- Claims under private law.
- Claims under public law.
- Environmental and product liability cases (cf. Wirtschaftslexikon Gabler, 2011).

Regarding the supervisory board the Code under point 3.8 merely provides a recommendation that a similar deductible shall be agreed upon in any D&O policy for the supervisory board (cf. DCGK, 2013).

3.2.4 *Important Changes Made in the German Corporate Governance Code Dated 26.05.2010 Compared to the Version Dated 18.06.2009*

In order to better demonstrate the accentuation of the Federal Government's implementation of its Catalogue of Measures the changes made to the DCGK in 2010 shall be reviewed.

In the version dated 26 May 2010 there were changes made to the sections of shareholders and the annual general meeting, executive and supervisory board compared to the previous version dated 18 June 2009. A new suggestion was included whereby the general meeting can approve the authorization of the remuneration system for the members of the executive board (2.2.1). Relating to the convening of the shareholders' annual general meeting it also specifies that the convening of a meeting, as well as the forms required by law for a postal vote together with the agenda are made accessible on the company's internet site (2.3.1). The enterprise shall facilitate the personal exercising of shareholders' voting rights. It shall also assist the shareholders in using postal votes and proxies (2.3.3) (cf. DCGK, 2010, version including highlighted changes, Points 2.2.1; 2.3.1; 2.3.3).

The recommendations regarding the management board were extended under point 4.1.5 that states that when filling managerial positions in the company, the Executive Board shall take diversity into consideration and, in particular, aim for an appropriate consideration of women (cf. DCGK, 2010, Version with highlighted changes, Point 4.1.5). This topic is also a current topic in other countries, however, in the Federal Republic of Germany it holds a special interest as the former Minister of Family Affairs Kristina Schröder (CDU) and the former Minister for Employment Ursula von der Leyen (CDU) are discussing how to have senior management jobs in the hands of women with the executive boards of the companies listed on the DAX. In the thirty German companies listed on the DAX the quota of women was 3.7 per cent in 2011, i.e. only seven out of 189 management board positions are occupied by women. According to the coalition agreement of 27 November 2013, there will be a legal introduction of a gender equality code in executive boards and supervisory boards of companies at the beginning of the 18

th electoral period of the German federal parliament. Hereby especially companies listed on the stock exchange and companies obliged to worker participation are legally obliged to determine binding targets to increase the number of female employees in executive- and supervisory board and on top management level from 2015 on. The public must be informed about that in a given measure of transparency (cf. coalition agreement CDU, CSU and SPD, 2013, p. 102).

In point 5.1.2 the recommendation is made to the supervisory board to respect diversity and, in particular, to aim for an appropriate consideration of women. The point 5.4.1 regarding the composition of the supervisory board was completely revised. Here the following text can be found: "The Supervisory Board has to be composed in such a way that its members as a group possess the knowledge, ability and expert experience required to properly complete its tasks. The Supervisory Board shall specify concrete objectives regarding its composition which, whilst considering the specifics of the enterprise, take into account the international activities of the enterprise, potential conflicts of interest, an age limit to be specified for the members of the Supervisory Board and diversity. These concrete objectives shall, in particular, stipulate an appropriate degree of female representation" (English version of the DCGK, 2010, Version with highlighted changes).

In a press release of 4 May 2011 the commission DCGK appointed by the German Federal Ministry of Justice stated that German based companies listed on the DAX have already been actively dealing with this topic. In the recent past there have already been many more women nominated for activities in the supervisory board than previously. There are also further plans to have more women in these panels. As an example, twelve supervisory board positions were taken by women in the last one and a half years in the thirty DAX listed companies. This is a much higher number than in previous years. The commission assumed that, as part of the large wave of scheduled new elections in spring 2013, the number of women in the supervisory board will grow significantly (cf. Press release of the Government Commission DCKG, 2011). On 15 June 2013, a good two years later, the number of women in the supervisory boards of the 160 listed companies on the DAX, MDAX, SDAX and TecDAX was 17.2 per cent. Considering the number of board members it was a mere six per cent of females. In total the share of women in the board and supervisory boards is 11.6 per cent. The increase in women in board positions over the last two and a half years in the 160 companies belonging to the

above listed DAX groups is 5.1 percentage points (Status 15.06.2013) (cf. *Frauen in die Aufsichtsräte (FidAR)*, 2013, p. 3). The coalition agreement of 27 November 2013 also dealt with the topic of the percentage of women on supervisory boards. To this there is a statement that supervisory boards of companies listed at the stock exchange and companies obliged to full worker participation have to present a gender quote of at least 30 per cent from the year 2016 on. If the quote is not fulfilled the positions on the supervisory board designated for the underrepresented gender are not occupied (cf. coalition agreement CDU, CSU and SPD, 2013, p. 102).

Furthermore, point 5.4.1 states that the “Recommendations by the Supervisory Board to the competent election bodies shall take these objectives into account. The concrete objectives of the Supervisory Board and the status of the implementation shall be published in the Corporate Governance Report. The members of the Supervisory Board shall on their own take on the necessary training and further education measures required for their tasks. They shall be supported by the company appropriately” (English version of the DCGK, 2010, Version with highlighted changes, Point 5.4.1). There were also updates made pertaining to the number of supervisory board mandates or other similar roles. “Members of the Management Board of a listed company shall not accept more than a total of three Supervisory Board mandates in non-group listed companies or in supervisory bodies of companies with similar requirements” (English version of the DCGK, 2010, Version with highlighted changes, Point 5.4.5).

In 2011 the commission did not deem it necessary to make changes to the code. They generally assumed the principle to change as little as possible and as much as required by the code. Every adjustment has a significant impact on companies and one should allow them an appropriate measure of time to adapt to the already made changes (cf. Press release Regierungskommission DCKG, 2011). The German Corporate Governance Code was only changed and adapted in 2012.

Further, the Government Commission plans, in future, to strengthen the input of the stakeholders (employees, customers, suppliers etc.) in the work of the German Corporate Governance Code. In line with this, planned changes are to be published on their homepage and the interested public asked to provide their feedback within an appropriate measure of time. The feedback provided should then form part of the consultation process. The commission assumed that taking such a step would support improved transparency and participation. It hoped that such

action would improve the debates and lead to an improved acceptance of the Code in all economic activities (cf. Press release Regierungskommission DCKG, 2011). This was implemented with the adaptations to the Code in 2012.

### 3.2.5 *Further Important Regulations of the German Corporate Governance Code*

The Commission of the German Corporate Governance Code also addressed in its recommendations and suggestions circumstances that were not mentioned in the federal government's Catalogue of Measures. Conclusively, these points shall be reviewed.

The DCGK views the following aspects of a company as belonging to the roles and responsibilities of the management board: to develop the enterprise's strategy in coordination with the supervisory board and ensure its implementation and abidance to all provisions of law and the enterprise's internal policies as well as in conformity with § 91 (2) of the German Stock Corporation Act to ensure appropriate risk management and risk controlling in the enterprise (cf. DCGK, 2013, Points 4.1.2 to 4.1.4). These provisions are supplemented by the German Act to Modernize Accounting Law (BilMoG)<sup>55</sup>. Publicly traded corporations must describe the essential characteristics of their internal control and risk management system with regard to their accounting process. The focus is therefore on the process of accounting but also on the organisational as well as control and security structures that ensure that business facts and figures are valued correctly in the balance sheet. This assumes that it is made available to the relevant parties as part of the external accounting. As a company must report externally, the legislator assumes that this creates the incentive to implement working internal control systems and to ensure their effectiveness. In any case, the documentation of existing

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<sup>55</sup> The German Act to Modernize Accounting Law which came into effect in 2009 will be reviewed in more detail in chapter 3.3.2 as it is the largest balance rights reform since 1985. It is the result of many years of discussion on the further development of German accounting law and the convergence to international accounting principles. The BilMoG enables German companies to have a cost effective alternative to the complex international accounting principles. One of its goals is, as part of the realignment of the commercial balance sheet, to encompass the needs especially of small and medium sized companies.

processes has become more important through this. The key weaknesses of the internal control system forms part of the report presented by the independent auditor in the supervisory board's / audit committee's financial statements meeting (§171 (1) page 2 of the German Stock Corporation Act) (cf. KPMG, 2011a).

A mere recital of the legislative regulations can be found in the Code with regard to the point of conflicts of interest for members of the management board as part of the non-competition clause. Every form of side-line activities like, for example, taking over a supervisory board mandate in another corporation requires the approval of the supervisory board of the enterprise (cf. DCGK, 2013, Points 4.3.1 and 4.3.5). In addition the German Corporate Governance Code refers to the prohibition for members of the management board to accept advantages or grant advantages. Here the Code refers to several elements of an offence such as bribery, breach of trust or embezzlement. In his or her decisions he/she is bound by the enterprise's best interests and therefore the pursuance of personal interests is forbidden for members of the management board or for other employees. Every member of the management board shall disclose conflicts of interest to the supervisory board immediately and then inform the other members of the management board (cf. English version of the DCGK, 2013, Points 4.3.1 to 4.3.5; Boecker, 2010, p. 263, Footnote 1558).

"The task of the Supervisory Board is to advise regularly and supervise the Management Board in the management of the enterprise. It must be involved in decisions of fundamental importance to the enterprise" (English version of the DCGK, 2013, Point 5.1.1.). The supervisory board is the only body that has the power to appoint and dismiss members of the board (cf. English version of the DCGK, 2013, Point 5.1.2).

"Depending on the specifics of the enterprise and the number of its members, the Supervisory Board shall form committees with sufficient expertise. The respective committee chairmen report regularly to the Supervisory Board on the work of the committees" (English version of the DCKG, 2013, Point 5.3.1). In particular, the Supervisory Board shall establish an Audit Committee (5.3.2). This committee "handles the monitoring of the accounting process, the effectiveness of the internal control system, risk management system and internal audit system, the audit of the Annual Financial Statements, here in particular the independence of the auditor, the services rendered additionally by the auditor, the issuing of the

audit mandate to the auditor, the determination of auditing focal points and the fee agreement, and – unless another committee is entrusted therewith – compliance. The chairman of the Audit Committee shall have specialist knowledge and experience in the application of accounting principles and internal control processes. He should be independent and not be a former member of the Management Board of the company whose appointment ended less than two years ago” (English version of the DCKG, 2013, Point 5.3.2).

At least one independent member of the supervisory board or of the established Audit Committee, should this be the case, must have the relevant expertise in financial reporting or statutory auditing (§100 (5) of the German Stock Corporation Act). This means that companies must place a special focus on the qualifications of its members with regard to financial reporting / statutory auditing as intended by the German Act to Modernize Accounting Law (BilMoG) (cf. KPMG, 2011b).

With regard to the composition of the supervisory board the German Corporate Governance Code includes the following recommendations that go beyond the legal regulations:

“The supervisory board has to be composed in such a way that its members as a group possess the knowledge, ability and expert experience required to properly complete its tasks” (English version of the DCGK, 2013, Point 5.4.1). The supervisory board shall specify concrete objectives regarding its composition that are important for formulating the selection criteria for suitable candidates. Thereby the international activities of the enterprise, potential conflicts of interest, the age limit to be specified for the members of the supervisory board and an appropriate degree of female representation shall be taken into account. In addition, in its election recommendations to the General Meeting, the supervisory board shall disclose the personal and business relations of each individual candidate with the company, the executive bodies of the company and with a shareholder holding a material interest in the enterprise. In terms of this recommendation, shareholders holding a material interest are shareholders who directly or indirectly hold more than 10 per cent of the voting shares of the company (cf. English version of the DCGK, 2013, Point 5.4.1).

“The Supervisory Board shall include what it considers an adequate number of independent members. Within the meaning of this recommendation, a Supervisory Board member is not to be considered independent in particular if

he/she has personal or business relations with the company, its executive bodies, a controlling shareholder or an enterprise associated with the latter which may cause a substantial and not merely temporary conflict of interests. Not more than two former members of the Management Board shall be members of the Supervisory Board and Supervisory Board members shall not exercise directorships or similar positions or advisory tasks for important competitors of the enterprise" (English version of the DCGK, 2013, Point 5.4.2).

It is encouraged that the elections to the supervisory board shall be made on an individual basis. Proposed eligible candidates for the supervisory board chair shall be announced to the shareholders (cf. English version of the DCGK, 2013, Point 5.4.3).

The German Corporate Governance Code recommends that management board members may not become members of the supervisory board of the company within two years after the end of their appointment. This shall only be possible on an exceptional basis if they are appointed upon a motion presented by shareholders holding more than 25% of the voting rights in the company and shall be justified to the general meeting (cf. English version of the DCGK, 2013, Point 5.4.4).

Being a member of a supervisory board requires time in order to fulfil the task of surveillance properly. For this reason every member must take care that he/she has sufficient time to perform his/her mandate. When taking on the necessary training and further education measures the supervisory board members shall be supported by the company appropriately (cf. English version of the DCGK, 2013, Point 5.4.5).

It is important that each supervisory board meeting is always attended by all members. Exceptional regulations should only apply when ill or in other important family matters. The attending members are noted in the minutes in line with § 107 (2) sentence 2 of the German Stock Corporation Act. Pursuant to § 110 (3) sentence 1 of the German Stock Corporation Act listed companies must hold at least two supervisory board meetings per calendar half-year, i.e. four meeting per fiscal year. The German Corporate Governance Code recommends making a note in the report of the supervisory board if a member of the supervisory board took part in less than half of the meetings of the supervisory board (cf. English version of the DCGK, 2013, Point 5.4.7). It can be assumed that a frequently absent member of the supervisory board cannot properly fulfil his/her duties towards the enterprise (cf.



Boecker, 2010, p. 291).

The supervisory board members are bound by the enterprise's best interests (cf. English version of the DCGK, 2013, Point 5.5.1). "No member of the Supervisory Board may pursue personal interests in his/her decisions or use business opportunities intended for the enterprise for himself/herself. Each member of the Supervisory Board shall inform the Supervisory Board of any conflicts of interest, in particular those which may result from a consultant or directorship function with clients, suppliers, lenders or other third parties. In its report, the Supervisory Board shall inform the General Meeting of any conflicts of interest which have occurred together with their treatment" (English version of the DCGK, 2013, Point 5.5.1 to Point 5.5.3). The Code recommends that material conflicts of interest and those which are not merely temporary in respect of the person of a supervisory board member shall result in the termination of his/her mandate (cf. English version of the DCGK, 2013, Point 5.5.3).

Based on the monitoring functions of the supervisory board, the independence of its members is of immense importance. Just as important, though, is the requirement for clear and structured implementation of his/her activities. The German Corporate Governance Code tries to meet these expectations by further specifying the many legally codified requirements. In line with the in § 161 of the German Stock Corporation Act every company must make a mandatory declaration of compliance to the German Corporate Governance Code (declaration of compliance) whereby it must publish what recommendations of the Code it did not follow. Since 2009 the companies must also declare why they deviated from the recommendations of the Code. One can, therefore, speak of monitoring by the participants of the capital markets. The goal is to achieve a wider acceptance of the regulations of the German Corporate Governance Code and thereby also a more effective orientation of the overseeing boards (cf. Boecker, 2010. p. 292). With the German Act to Modernize Accounting Law (BilMoG) coming into effect, also the number of companies that need to make a declaration of compliance has increased. It does not only encompass listed corporations but also corporations that trade securities other than shares and that are admitted to trading on an organised market. Whilst a company previously had to make the declaration of compliance only accessible to the shareholders on an on-going basis, it now has to be published by the management and supervisory board on the homepage on an on-going basis (cf.

Bundesverband der Deutschen Industrie, 2009, p. 43).

In addition, a corporate governance statement (§ 289 (a) of the German Commercial Code) is to be disclosed. This so-called Corporate Governance Statement must include three key points. It includes firstly the declaration of compliance. Secondly, the corresponding relevant information on the key corporate governance processes that go beyond the legal requirements. There must be an indication made as to where this information can be publicly accessed. And thirdly, a description of the procedures of the management board and supervisory board as well as of the composition and modus operandi of their committees must form part of the Corporate Governance Statement (cf. KPMG, 2009). The corporate governance statement was previously not regulated by law and was included into the German Commercial Code through the German Act to Modernize Accounting Law (BilMoG)<sup>56</sup>.

### 3.2.6

#### *Consequences for Everyday Work*

Before assessing the proposals made in the Catalogue of Measures as well as their implementation in the German Corporate Governance Code, one must take into account that it is exclusively the willingness of companies to follow the recommendations and suggestions made that determines its effectiveness as long as they are not reflected in legislation.

In those cases where there has been an actual legal embodiment, one can assume an effective impact. This is, for example, the case with the so-called Act on the Disclosure of Executive Board Remuneration (VorstOG) that came into force in 2005. It stipulates that listed corporations must declare the compensation paid to members of the management board in the notes to the annual and consolidated financial statements (§§ 285 Sentence 1 No. 9a, 314 (1) No. 6a HGB). One can also rate positively the legal regulations on the directors- and officers liability insurance for members of the management board: “Should the company take out a D&O insurance to protect a member of its executive board against risks arising from his or her professional work then a deductible of at least 10 per cent of damages up to at least one and a half times the fixed remuneration of a board member must

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<sup>56</sup> The German Act to Modernize Accounting Law is reviewed in more detail in chapter 3.3.2.

be provided for<sup>57</sup> (translated in context by the author) (§ 93 (2) sentence 3 of the German Stock Corporation Act). Although this legislative measure, as such, can be assessed as positive there still remains the question whether the low deductible fulfils the deterrent function. These examples show, however, that at least the actions taken towards more transparency and to hinder fraudulent acts by deterrent means have fruited. The person who knows that being caught committing a crime will cost him or her dearly will act differently to a person who knows in advance that he/she does not need to fear punishment.

As to the suggestions and recommendations one must note – as shown above – that there is a slight difference. In contrast to the recommendations, departures from suggestions are permitted without needing to be declared. This differentiation is important in so far as deviating from a recommendation must be explained and thereby the danger of a recommendation going unnoticed is banned. One therefore speaks of a three-phased differentiation. The legal codification requires the fulfilment of the measure. The recommendation allows a deviation from the measure but this has to be justified. Suggestions, however, can be ignored without providing any form of rationale.

Because of this situation the German Corporate Governance Code is assessed as a “blunt weapon” (Hofmann, 2008, p. 369) or a “toothless self-regulation” (Zünd, 2005, p. 8). As a consequence there are calls for unambiguous legislation and penal provisions that enforce adherence to ethical processes. Investors need enforceable laws (cf. Hofmann, p. 369).

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57 “Schließt die Gesellschaft eine Versicherung zur Absicherung eines Vorstandsmitglieds gegen Risiken aus dessen beruflicher Tätigkeit für die Gesellschaft ab, ist ein Selbstbehalt von mindestens 10 Prozent des Schadens bis mindestens zur Höhe des Eineinhalbfachen der festen jährlichen Vergütung des Vorstandsmitglieds vorzusehen.”

### 3.3 FURTHER DEVELOPMENT OF ACCOUNTING STANDARDS AND ITS ADAPTION TO INTERNATIONAL ACCOUNTING PRINCIPLES

The EU standards for accounting are aimed at adapting the European accounting principles to the International Accounting Standards (IAS) and the International Financial Reporting Standards (IFRS). The decree passed in 2002 obliges member states to ensure that all parent companies which are orientated towards the capital market to complete their group accounts according to the IAS/IFRS standards as of 2005 or 2007. In line with point 4 of the Catalogue of Measures, issued by the German Federal Government, the adaptation of the German accounting principles towards international standards was implemented by the legislator in a two-stage process with the (German) Accounting Reform Act dated 15.12.2004 (BGBl volume 2004 part I no. 65, page 3166 ff) and the German Act to Modernize Accounting Law dated 26.05.2009 (BGBl volume 2009 part I no. 27, page 1102 ff).

#### 3.3.1 *The (German) Accounting Reform Act*

The content of the (German) Accounting Reform Act sets its priorities in the areas of accounting principles and the final audit<sup>58</sup>. Especially the accounting principle section should implement the adaptation of the German accounting principles towards the IAS-decree of 2002. Hereby, the primary goal is to ensure that member state options are exercised relating to the application of international accounting standards such as the IAS/IFRS in consolidated and separate financial statements. The scheme to adapt the German Commercial Code (HGB) to the IAS-decree forms the centre-piece of the act. In addition the (German) Accounting Reform Act implements the compulsory elements of the fair-value, modernization and threshold directive (cf. Hüttemann, 2004, p. 203; Wendlandt/Knorr, 2005, p. 53).

At this point, it should be noted that many of the encompassing changes made to the (German) Accounting Reform Act were changed again with the introduction of the (German) Act to Modernize Accounting Law. Consequently, some of the statutory provisions that are cited or explained in this section of the Accounting Reform Act in time no longer exist in the form cited at this point. Nevertheless, these legal changes within the Accounting Reform Act should be reviewed as part of this thesis, provided they were important steps in the path towards current

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<sup>58</sup> For details on the subject of the final audit refer to point 3.4

legislation.

### 3.3.1.1 *Exercising the Decision Rights for the Separate Financial Statement*

Member states, pursuant to article 5 of the IAS-decree, are authorised to allow or even insist upon the application of the IAS also to the separate financial statement. This affects capital market companies as well as other companies. As such, the German Federal Government announced in its Catalogue of Measures from 2003, that the admission of the IAS for the separate financial statement is proposed only in relation to its informational function, but would otherwise abide to the financial statement rules of the German Commercial Code (HGB). The separate financial statement does not just fulfil information purposes but is also the basis for measuring the distribution of dividends (cf. for example § 57 (3), § 58 (4) of the German Stock Corporation Act) and forms the basis for determining taxable earnings (cf. § 5 (1), sentence 1 of the German Income Tax Act). The reasoning behind the restrictive implementation as provided by the German Federal Government is as follows (cf. draft bill of the German Accounting Reform Act/Federal Ministry of Justice, 2003, p. 50/6 f):

- As the fair value notion is strongly emphasised within the IAS and therefore not yet realised profits have to be captured, an IAS-financial statement is hardly feasible as a basis for measuring the distribution of dividends. For the purpose of informational needs, this approach makes sense but it appears less appropriate to distribute not yet realised profit to the shareholder. As such, even the IASB note that the guidelines should only fulfil the purpose of providing information (cf. draft bill of the German Accounting Reform Act/Federal Ministry of Justice, 2003, p. 51/7).
- The upstream process for recognising gains, which does not fulfil the principle of a performance-related taxation, does not let the application of the IAS as a basis for taxation seem appropriate. A further crucially important factor is that the IAS is ruled by a private body, namely the IASB. The national legislator will hardly give up part of its legislative power relating to tax law and transfer its rights to a private body. Furthermore, the Federal Ministry of Finance needs planning security. For this reason, there is a vested interest to understand the foreseeable tax burden on the one hand and the State revenue on the other hand. Accounting according to the IAS principles, however, often leads to a

considerable fluctuation of results (cf. draft bill of the German Accounting Reform Act/Federal Ministry of Justice, 2003, p. 51/7).

- As decoupling the Tax from the Trade Balance by creating a separate Tax Accounting Law would mean an abrupt change to the current system, which in turn would put an un-proportionally high strain on companies, such measures should not be taken. In addition, it is not absolutely clear whether a separate Tax Accounting Law could be implemented at much lower cost (cf. draft bill of the German Accounting Reform Act/Federal Ministry of Justice, 2003, p. 53/9).

The implementation of voting rights occurs, pursuant to the German Accounting Reform Act, only on a voluntary basis and only for the purpose of disclosure (§ 325 (2a) and (2b) HGB). A company which publishes a separate financial statement for informational purposes pursuant to the IAS must still create an additional HGB-financial statement for corporate law and tax purposes. § 325 (2a) of the German Commercial Code (HGB) specifically states that the following provisions are to be made: sentence 1: instead of the obligatory publication of a German Commercial Code (HGB) separate financial statement, one can also publish a separate financial statement pursuant to international regulations (IAS/IFRS). Sentence 2 and § 325 (2b) of the German Commercial Code (HGB) designate the following five conditions:

- Full compliance with the International Accounting Standards.
- The management report must refer to the IAS separate financial statement in the required detail.
- An IAS separate financial statement auditor's certificate must be published instead of the German Commercial Code (HGB) separate financial statements auditor's certificate.
- In addition, the separate financial statement pursuant to the German Commercial Code (HGB) along with the corresponding auditor's certificate must be handed in to the Commercial Register.
- The proposal for the distribution of profits as well as the decision for the distribution of profits must also be published.

Sentence 3 and 4 obligate a company preparing their annual accounts according to IAS, to continue to use the following HGB norms analogical to § 315a (1) of the German Commercial Code (HGB), in particular, the regulations relating to the management report.

The legislator therefore views the application of the IAS for separate financial statements as a solution that provides companies with a high degree of flexibility and at the same time integrates itself into the systematization of the prevailing accounting and company law (cf. draft bill of the German Accounting Reform Act/ Federal Ministry of Justice, 2003, p. 53/9).

### 3.3.1.2

#### *Extended Detail of Notes*

Through the implementation of the fair value directive, changes to the details of the notes were made. Pursuant to § 285 number 18 as well as § 314 number 10 of the German Commercial Code (HGB) the type and extent of derivative financial instruments per category as well as their fair value are to be provided. Derivative financial instruments are artificially created constructs whose value changes based on changes to a fixed interest rate, share price, price or interest index, credit rating or credit index or a comparable variable component. They require no or only a small initial net investment and are settled at a future date. In addition, the valuation technique and, if available, the existing book value of the derivative as well as of the balance sheet item are to be provided for the statements made (cf. Wendlandt/Knorr, 2005, p. 54)<sup>59</sup>.

### 3.3.1.3

#### *Extended Management Report*

§ 289 (1) of the German Commercial Code (HGB) was designed in such a way that the company results must be explicitly stated and that a balanced and comprehensive analysis of the business performance and the situation of the company must be portrayed. The degree of detail of this analysis is dependent on the magnitude and complexity of the business field in which the company operates. This analysis must include the relevant financial performance indicators for the business field and these must be explained referencing the declared amounts and information as provided in the annual statement of accounts. The legislator justifies this with the rationale that the annual statement of accounts is in principle there for presentation reasons whereas the management report fulfils primarily

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<sup>59</sup> Based on the German Act to Modernize Accounting Law these paragraphs have already been changed. In addition, the requirements for the derivative financial instruments can now be found in § 285 number 19 HGB as well as § 314 number 11 HGB.

the purpose of analysis and elaboration of relevant key figures and issues (cf. draft bill of the German Accounting Reform Act, 2003, p. 63).

Furthermore, the § 289 (1) sentence 4 of the German Commercial Code (HGB) states that: "Moreover the management report must show the foreseeable development along with the assessment and explanation of key opportunities and risks; the relevant underlying assumptions must be disclosed"<sup>60</sup> (translated in context by the author). The annual results should be explained and commented on by the executive board. The main premises that the forward-looking statements are based upon are to be made transparent by the board. This was supposed to fulfil the goal to increase the standard of information relevant for decision-making within the management report and to allow target versus actual comparisons to take place (cf. draft bill of the German Accounting Reform Act, 2003, p. 62).

Pursuant to the § 289 (2), number 2 of the German Commercial Code (HGB) the management report should cater to "the risk management goals and methodologies of the company including its methods for securing all important types of transactions that are captured as part of the hedge accounting documentation, as well as the price, default and liquidity risks as well as the risks from cash flow volatility to which the company is exposed, interpreted in relation to the usage of financial instruments by the company and to its relevance for the situation or the foreseeable development of the company"<sup>61</sup> (translated in context by the author). This version implements the requirements of the fair value directive for reporting the usage of financial instruments. The methods used to hedge the risk are predominantly hedge transactions. With this, when hedge transactions are under-

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60 „Ferner ist im Lagebericht die voraussichtliche Entwicklung mit ihren wesentlichen Chancen und Risiken zu beurteilen und zu erläutern; zugrunde liegende Annahmen sind anzugeben“.

61 „die Risikomanagementziele und –methoden der Gesellschaft einschließlich ihrer Methoden zur Absicherung aller wichtigen Arten von Transaktionen, die im Rahmen der Bilanzierung von Sicherungsgeschäften erfasst werden, sowie die Preisänderungs-, Ausfall- und Liquiditätsrisiken sowie die Risiken aus Zahlungsstromschwankungen, denen die Gesellschaft ausgesetzt ist, jeweils in Bezug auf die Verwendung von Finanzinstrumenten durch die Gesellschaft und sofern dies für die Beurteilung der Lage oder der voraussichtlichen Entwicklung von Belang ist“



taken, the underlying systematization and the type and category of the various different hedges must be reported in detail (cf. draft bill of the German Accounting Reform Act, 2003, p. 63).

Also § 289 (3) of the German Commercial Code (HGB) was amended in order to implement the modernization directive. The reporting obligations of large limited liability companies (§ 267 (3) HGB) has been extended to include non-financial performance indicators, such as information relating to environmental and employee matters, as long as it is relevant for understanding the business development or the situation of the company. Small and medium sized limited liability companies are freed from this reporting requirement. The legislator observes in its explanatory statement that the above mentioned matters of environmental protection as well as employee matters should not form an exhaustive list and should therefore not entail a corresponding strategic objective. The management report should include also other non-financial information if it is important for the valuation of the business development, the current situation or the foreseeable development of the company. At this stage, it refers to the development of a core customers base, human capital, research and development as well as donations to charitable organisations and if applicable to sponsoring (cf. draft bill of the German Accounting Reform Act, 2003, p. 64).

#### 3.3.1.4 *Exercising the Decision Rights for the Group Accounts*

Article 5 of the IAS-decree allows Member States to decide if the IAS should also be applied or even prescribed for the group accounts of companies which have not issued securities on the market. In line with the announcement in the Catalogue of Measures of 2003, the legislator gave all companies a comprehensive right to decide if they want to apply the IAS for their group accounts (cf. draft bill of the German Accounting Reform Act/Federal Ministry of Justice, 2003, p. 49/5).

For group accounts of capital market oriented companies, the § 315a (1) HGB regulates that such companies must complete their group accounts in line with the IAS/IFRS. Nevertheless, some of the German Commercial Code (HGB) guidelines, especially those relating to the management report (§ 315 HGB), must also be adhered to. Also companies which have applied for a listed security to trade on a regulated market pursuant to § 2 (5) of the German Stock Corporation Act, must, based on § 315 a (2) of the German Commercial Code (HGB) complete their

accounting according to the IAS standard. Companies which are not capital market orientated are allowed to complete their group accounts pursuant to the IAS/IFRS standards.

According to Wendlandt and Knorr this gives such companies which would like to present their business partners with accounts which have been prepared according to international standards a guaranteed flexibility (cf. Wendlandt/Knorr, 2005, p. 55 f).

### 3.3.1.5 *Abolition of the Consolidation Prohibition Pursuant to § 295 HGB*

Before 31 December 2004 there were situations where a subsidiary, due to the different nature of its activities, was prohibited from being included into the group accounts. This regulation was removed from the German Commercial Code (HGB) as it was not internationally recognized. The different areas of activities of a company are catered for through segment reporting according to the international accounting standards (cf. Wendlandt/Knorr, 2005, p. 57).

### 3.3.1.6 *Extension of the Items Within the Consolidated Financial Statements*

§ 297 (1) of the German Commercial Code (HGB) was re-designed 1 January 2005; this states that: "The group accounts consist of the consolidated balance sheet, the consolidated income statement, the consolidated notes, the cash flow statement and the statement of changes in equity. It can be expanded to include segment reporting"<sup>62</sup> (translated in context by the author). The cash flow statement and the statement of changes in equity are therefore prescribed for all group accounts. The legislator justifies this on the grounds that both instruments are frequently used for analysis purposes. The segment reporting, which in some circumstances contains highly sensitive information, is therefore only an optional part of the group accounts. Capital market orientated companies that create their accounts according to the IAS/IFRS automatically underlie the duty of segment reporting (cf. Wendlandt/Knorr, 2005, p. 56).

### 3.3.1.7 *Evaluation*

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62 „Der Konzernabschluss besteht aus der Konzernbilanz, der Konzern-Gewinn- und-Verlustrechnung, dem Konzernanhang, der Kapitalflussrechnung und dem Eigenkapitalspiegel. Er kann um eine Segmentberichterstattung erweitert werden.“

The dispute over the development of accounting principles has come to very opposing results. Ernst assumes that the International Financial Reporting Standards (IAS/IFRS) are the accounting standards of the present-day and as well of the future. The only open question is whether it is the only method for making all companies happy. According to his opinion, the current system should be maintained and then constantly updated. The German Commercial Code (HGB) should be developed further, reformed and adapted to current circumstances and conditions; one could not abolish the German Commercial Code (HGB) (cf. Ernst in Freidank, 2005, p. 4).

According to the “External Corporate Accounting”<sup>63</sup> working group (literally translated by the author); the German Commercial Codes’ (HGB) financial statement should include the distribution of profits, the taxation and a minimum of information, but not more than that. People requiring more information should refer to the IAS/IFRS (cf. Ernst in Freidank, 2005, p. 4 f).

Ernst raises the point that, in relation to this, the view also exists that the IFRS in its current form has no strong future. This type of market evaluation already existed 150 years ago and was stopped for good reason. As such the “IFRS-spook”<sup>64</sup> (literally translated by the author) will pass just as quickly. Proposals that originate from this direction are therefore directed towards further developing individual sections of the German Commercial Code (HGB) – while fully keeping the important corner pillars (core points) unchanged (cf. Ernst in Freidank, 2005, p. 5).

Peemöller highlights the fact that the financial statements pursuant to IAS/IFRS provide a vast amount of information with which one can form a good view of the economic situation of the company. According to him, this vast amount of information should be used and not discounted as “Information Overflow” (cf. Peemöller in Freidank, 2005, p. 97).

The overall analysis, according to Hofmann, sees the changes made to the Accounting Reform Act (BilReG) as appropriate for improving the meaningfulness of management reports. A more detailed view of a company results in a higher quality of financial communication and, as such, strengthens investor protection. However, Hofmann points out that in relation to the actual reporting praxis, there

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63 „Externe Unternehmensrechnung“

64 „IFRS-Spuk“

is skepticism whether it is really possible to develop the management report to become a “second pillar” along with the annual financial statement (cf. Hofmann, 2008, p. 284). This is supported by the fact that the application of the IAS/IFRS is seen less enthusiastically in present times compared to when it was published as part of the fundamental EU Regulation in 2002. An important reason for this is the lack of clarity of the set of regulations of the IAS/IFRS, that with its current scope of much more than 2000 pages is also still in a dynamic development evolution. A continuously growing and therefore for investors even more incomprehensible company reporting in turn works against investor protection. The critical analysis of the down-side Küting states appropriately as follows: “We were all blinded by the statement that, once the international accounting standard is implemented, all things will improve”<sup>65</sup> (translated by author in context) (cited in Hofmann, 2008, p. 281).

Ernst reports on the internationally supported expert hearing in May 2005, where the following trend towards the assessment of the IFRS became clear: The IFRS in its current form is good for large companies but by far not so good for small and medium-sized companies. A further development of the German Commercial Code (HGB) should be welcomed but not a uniform accounting process pursuant to IFRS that is applicable for all companies per se (cf. Ernst in Freidank, 2005, p. 6).

Following the views cited in various publications, it can be said that in relation to large companies, the application of IAS/IFRS is an improvement in the comparability of accounting on an international level. In Germany analysts are used to proceeding, according to the German Commercial Code (HGB). A changeover in accounting practices for the annual financial statements pursuant to IAS/IFRS therefore requires a high level of willingness to change existing habits und face new requirements. In comparison, in Great Britain where companies complete their accounts mainly pursuant to UK-GAPP and IFRS, one must take into account that the tendency exists to portray companies in as positive a light as possible. Whereas in Germany, merchants traditionally follow the principle of caution. In relation to the application of IAS/IFRS one must also take into account that it does not only provide the possibility of decision rights but that this also means that bottom-line, all positions that exist at a certain point in time must be shown in its current value

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65 „Wir sind alle geblendet worden, als gesagt wurde, wenn die internationale Bilanzierung kommt, wird alles besser.“

(for example, pursuant to IAS/IFRS all parts of an airplane – fuselage, nozzles, interior – must be individually written-off). The determining factor here is that key parts, with varying useful life, of a single asset are written-off differently (cf. IAS 16.43). In contrast, pursuant to the German Commercial Code (HGB) the plane would be written-off as one (§ 253 (3) HGB, in connection with § 255 (1) HGB). A (small) German company that does not have to create their accounts pursuant to IAS/IFRS but chooses to do so, will in all likelihood portray their annual financial statement in a better light than it actually is. The reason for this is the improved leeway of scope for portraying the accounts if accounting pursuant to IAS/IFRS.

As such, one can conclude that for recognizing the actual commercial viability of a company, the ability of the person analyzing the annual financial statement is the deciding factor. Specific positions of the annual financial statement pursuant to IAS/IFRS must be, as a minimum requirement, present in the statement of the financial position within the accounts (cf. IAS 1.54). The extension of these minimum requirements – i.e. the segmentation of these items – can occur either in the balance sheet or the notes (cf. IAS 1.54). A qualified reader of balance sheets will take a close look at the structure of these items – especially of their segmentation – within the annual financial statement.

In relation to the possibility of discovering balance sheet manipulations one should note that with increasing complexity of the annual financial statement also the difficulty increases to discover manipulated items. Especially small and medium-sized companies have the possibility to hide inaccuracies when accounting pursuant to IAS/IFRS, as its addressees are mainly small credit institutions and taxation authorities. Their employees normally do not have the competencies required to uncover cunningly hidden balance sheet violations.

### 3.3.2 *The German Act to Modernize Accounting Law (BilMoG)*

Whilst the German Federal Government announced in 2003 in its Catalogue of Measures its aim to modernise the German Commercial Code (HGB) and in a first step started to do this when the German Accounting Reform Act came into force in 2004, the actual submission of the announced draft bill addressing these issues was constantly deferred; it was finally published in November 2007. The draft bill of the German Act to Modernize Accounting Law triggered a flood of comments which were partly considered in the revised draft bill dated 21 May

2008. On 26 March 2009 the German Act to Modernize Accounting Law was approved by the German Federal Parliament (Bundestag) and came into effect on 29 May 2009. The primary goal of the German Act to Modernize Accounting Law – according to the Federal Ministry of Justice – was to advance the German accounting principles so as to become a lasting and fully-fledged alternative to the international accounting standards (IFRS). It should be a simpler and more cost-effective alternative that would provide especially small and medium-sized companies with the option of using modern accounting principles without having to apply the IFRS. During this process, the German Commercial Code (HGB) was “cleansed” from outdated decision rights and the reverse authoritativeness principle of the tax law upon the commercial code was abolished. In addition, the German Act to Modernize Accounting Law wanted to implement a deregulation in order to free companies from unnecessary costs. Also in future the trade balance will play an important role for the assessment of distributions and for the determination of taxable income (cf. BDI, 2009, p. 6). The remainder of this chapter, based on the focus on accounting fraud, will initially refer to the changes which have no potential impact on stopping account manipulations or which even nurture accounting manipulations. Following this, there will be a short description of further statutory updates through the German Act to Modernize Accounting Law.

The modernization of the German Commercial Law led to measures of cost relief. The German Act to Modernize Accounting Law supports the reduction of bureaucratic costs by freeing sole traders from the duty of bookkeeping and accounting obligations according to the commercial law. In § 241a of the German Commercial Code (HGB) it states in relation to the release from the duty of bookkeeping and for preparing the inventory that: “Sole traders who at the time of the financial reporting dates of two consecutive business years, have not more than 500,000 euros turnover and 50,000 euros annual surplus do not need to apply § 238 to 241 of the German Commercial Code (HGB)<sup>66</sup>. In the case of start-ups the legal requirements already apply when the values do not exceed the values of the block 1 at the time of the start-ups first financial reports<sup>67</sup> (translated in context

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66 This relates to the release from the duty to do bookkeeping and for preparing the inventory.

67 „Einzelkaufleute, die an den Abschlusstichtagen von zwei aufeinander folgenden Geschäftsjahren nicht mehr als 500.000 Euro Umsatzerlöse und 50.000 Euro

by the author). Pursuant to § 242 (4) of the German Commercial Code (HGB) the parties affected do not require a financial statement – consisting of a balance sheet and the profit and loss account – to be prepared in accordance with the German Commercial Code (cf. BDI, 2009, p. 7).

Bittmann's view on the de-coupling of the bookkeeping and accounting requirements from the (full) merchant status (§ 241a HGB) is of "deep systematic concern"<sup>68</sup> (literally translated by the author). The explosiveness of the fact that retail traders are freed from the need to bookkeep or prepare inventory if their turnover is below 500,000 euros and their profit below 50,000 euros is self-explanatory. He raises serious questions in relation to the possibility of manipulating the accounts. This is, on the one side, the question how are threshold values determined especially relating to when they are exceeded. Bittmann fears that such regulations will entice entrepreneurs to manipulate their profit assessment to be below the threshold, especially since there is no documentation requirement for the rationale provided. Another question raised by Bittmann is then how legitimate the Accounting and Balance Sheet Criminal Law remains. § 331 of the German Commercial Code (HGB) as well as § 283 b (3) and 283 (1), number 5 and 7 of the German Criminal Code base their penal code mainly on the identity of the qualification of a merchant on the one hand and the bookkeeping and accounting obligation on the other hand (cf. Bittmann, 2008, p. 444 f). One must agree with Bittmann when he states that a merchant who does not have the appropriate level of information can hardly manage a business effectively. If a merchant does not do exact bookkeeping, then he cannot know what the current financial status of the company is. He cannot, for example, based on missing calculations assess if he can accept a specific contract at the offered price. He is not in the position to define his assets and his liabilities and as such cannot assess his capital resources. In addition, he can neither calculate his customer nor creditor repayment periods and does not know how often the goods in his warehouse are handled. Without an appropriate level of bookkeeping, it is not possible to lead a solid operation.

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Jahresüberschuss aufweisen, brauchen die §§ 238 bis 241 HGB nicht anzuwenden. Im Fall der Neugründung treten die Rechtsfolgen schon ein, wenn die Werte des Satzes 1 am ersten Abschlussstichtag nach der Neugründung nicht überschritten werden.“

68 „stärksten systematischen Bedenken“

Annual financial statement: A fundamental part of the German Act to Modernize Accounting Law is the modernization of the recognition and measurement provision for all merchants. In addition, there are supplementary requirements for corporate enterprises which encompass not only a convergence towards international financial reporting standards but also the adoption of European requirements (cf. BDI, 2009, p. 8).

For self-created intangible assets § 248 (2) the German Commercial Code (HGB) foresees a restricted option to capitalize these. Should one make use of the option to capitalize then one must, pursuant to § 285 number 22 of the German Commercial Code (HGB), declare in the notes the full year amount of research and development costs as well as the value of the self-created intangible assets. For trademarks, print titles, publishing rights, customer lists or comparable intangible assets which have not been purchased, there is a capitalization prohibition pursuant to § 248 (2), sentence 2 of the German Commercial Code (HGB). The reason for this capitalization prohibition is that the production costs for the previously mentioned intangible assets cannot be clearly isolated from the expenditures for the development of the company as a whole – this refers to the self-created business and company value (cf. BDI, 2009, p. 12).

Bittmann views this restrictive capitalization prohibition of trademarks, print titles, publishing rights, customer lists or comparable intangible assets as a big issue for the person applying the law. The legislator does not provide more detail what such or comparable items are. What, for example, is the view on patents, know-how or ideas? Should these items be categorized as exceptions then what could still be classified as a capitalized internally generated intangible asset? At least the rationale for the law provides some interpretation support. According to this, those self-created intangible assets can be capitalized where a cost of production can reliably be determined (cf. Bittmann, 2008, p. 443).

Pursuant to § 255 (2a) of the German Commercial Code (HGB) “production costs of intangible assets are costs created during its development”<sup>69</sup> (translated in context by the author). Development costs are not allowed to be included in the production costs pursuant to § 255 (2), sentence 4 of the German Commercial Code

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<sup>69</sup> „Herstellungskosten eines selbst geschaffenen immateriellen Vermögensgegenstandes des Anlagevermögens die bei dessen Entwicklung anfallenden Aufwendungen“



(HGB). Only such expenditures are allowed to be capitalized that occur during the development phase. For this purpose, one can find a legal definition in § 255 (2a), sentence 2 and 3 of the German Commercial Code (HGB) of what research and development is. It is stated that; “a development is the application of research results or of new knowledge used for further development of goods or processes or the advancement of goods or processes by making significant changes. Research is the independent and planned search for new scientific or technical insights or experiences of a general nature and to which no statement can be made as to their technical applicability or economic chances for success.”<sup>70</sup> (translated in context by the author). It is not possible to reliably separate research and development and as a result one is not allowed to capitalize development costs pursuant to § 255 (2a), sentence 4 of the German Commercial Code (HGB) (cf. BDI, 2009, p. 12 f). Also in relation to this Bittmann critically states that for all practical purposes one can often not effectively distinguish between research and development costs. The point in time when the research phase of a project is finished and it goes into the phase of development cannot always be reliably determined. This in turn offers the possibility of manipulation by capturing the costs as not to be capitalized research costs or as deductible development costs. According to Bittmann, the changes made to § 255 (2a), sentence 4 of the German Commercial Code (HGB), whereby it is not allowed by law to capitalize development costs if they cannot be clearly differentiated from the research costs, does not change anything relating to the actual opportunities to manipulate (cf. Bittmann, 2008, p. 442 f).

For reasons of creditor protection there is a payout block for corporate enterprises. Pursuant to § 268 (8), sentence 1 of the German Commercial Code (HGB) profits up to the amount capitalized are only allowed to be paid out if the amount of available reserves remaining after the pay-out plus any profits carried forward and minus losses carried forward and minus accruals formed for deferred taxes

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70 „Entwicklung ist die Anwendung von Forschungsergebnissen oder von anderem Wissen für die Neuentwicklung von Gütern oder Verfahren oder die Weiterentwicklung von Gütern oder Verfahren mittels wesentlicher Änderungen. Forschung ist die eigenständige und planmäßige Suche nach neuen wissenschaftlichen oder technischen Erkenntnissen oder Erfahrungen allgemeiner Art, über deren technische Verwertbarkeit und wirtschaftliche Erfolgsaussichten grundsätzlich keine Aussagen gemacht werden können“.

is at least equal to this amount (cf. BDI, 2009, p. 13). As such the amount of payout blocked relating to self-created intangible assets is not based on the full amount of capitalized assets but is formed based upon the difference between the book value of self-created intangible assets and the related deferred tax assets (cf. Küting et al., 2011, p. 3). Also according to Bittmann this payout block leads to the situation where the available distributable profits only consist of the surplus minus the capitalized self-created intangible assets and further blocked assets. The impact on the Criminal Law is not uniform but has to be assessed on a case-by-case basis. This can be seen in the following example: For making an assessment whether being over-indebted pursuant to § 263 of the German Criminal Code or a delay in filing for an insolvency pursuant to § 15a of the Insolvency Statute exists, the self-created intangible assets only recently have to be considered as assets. Depending on the situation, this can definitely lead to a major move in the timing of becoming insolvent. The time of insolvency will clearly occur at a later point in time. Consequently, there is a contrast between this regulation and the goals of the Insolvency Statute. This is aimed at initiating insolvency proceeding as early as possible in the interest of improving the chances for recovery (cf. Bittmann, 2008, p. 442).

A completely different effect has been made through the abolition of § 269 of the German Commercial Code. In order to help with the balance sheets this paragraph also allowed the capitalization of expenses relating to start-ups and expansions, whereby these were also with a payout block. But since the German Act to Modernize Accounting Law came into force it is forbidden to capitalize start-up and expansion investments. The delay in the timing of the over-indebtedness is therefore lessened by the fact that this form of capitalization is forbidden (cf. Bittmann, 2008, p. 442).

The purchased (derivative) goodwill is a short-term useable asset which has to be capitalized pursuant to § 246 (1), sentence 4 of the German Commercial Code (HGB). It has to be amortized over the planned useful life. The erstwhile permitted fixed-rate amortization over four years under § 255 (4) of the German Commercial Code is now obsolete. If a company wants to capitalize a purchased goodwill over a planned period of more than five years, they must provide the rationale in the notes as to why the goodwill should be used for a period of more than five years (cf. BDI, 2009, p. 9). In addition § 253 (5), sentence 2 of the German Commercial Code prescribes that the lower amount stated for a purchased goodwill has to be

upheld. This restrictive directive is based upon the rationale that an occurring reversal after an asset is written down is related to the business and operating activities of a company and is therefore self-created. And that the self-created goodwill is not to be capitalized today or in the future (cf. Ernst/Seidler, 2007, p. 2558). From a taxation point of view, the purchased goodwill can be activated as an asset, as is current praxis. As a result, it is possible to have a discrepancy between commercial and tax balance sheets resulting from the different rules of write-downs. From a tax perspective, purchased goodwill must be amortized over a standard useful life of fifteen years. If, based on this directive, the situation should occur where the goodwill from a commercial law perspective has a shorter useful life than the term used in the balance sheet for taxation purposes, then one must possibly form deferred tax assets which must be commercially carried forward. In addition, the future commercial capitalization of goodwill can have an effect on the commercial equity ratio (cf. BDI, 2009, p. 9).

The duty to capitalize purchased derivative goodwill is viewed critically by Bittmann. In his opinion there is a scope of assessment when taking over companies that affects the value of the derivative goodwill, which in turn provides the opportunity to manipulate. Similar concern was already raised by Bittmann in regard to the capitalization of intangible assets. It is also questionable that self-created goodwill should not be capitalized. If, for example, three years after takeover one finds an item of goodwill, then it must be clarified to which percentage it is derived and to which percentage it is self-created. This appears to be a difficult issue to solve for the person developing the accounts. At this point, Bittmann raises the question how one should proceed when the overall value of the goodwill does not decrease, but the derivative goodwill must be value-corrected due to continuous reduction of its value whereby at the same time the self-created value of the goodwill increases by the same amount. Bittmann gives rise to concern that, given such complex scenarios, it is hardly possible to generally quantify the planned useful life (cf. Bittmann, 2008, p. 443).

Another aspect is that the capitalization of the derivative goodwill potentially leads to the over-indebtedness occurring at a later point in time and this therefore makes a mockery of the Insolvency Statute (cf. Bittmann, 2008, p. 443). A company which is in a state of crisis must, when creating the annual financial statements documentations, check if there is a case for over-indebtedness.

According to the definition of insolvency which prevailed until 2008, the assets had to outweigh the debts. If this was not the case, then you were over-indebted pursuant to the Insolvency Statute. From 2008 to the end of 2013 there was an interim arrangement whereby, if you had a positive prognosis for the company, you were not over-indebted pursuant to the Insolvency Statute (§ 19 InsO). This regulation was then indefinitely extended with the introduction of the Financial Market Stabilization Act and is thereby valid for an unlimited period of time. Should a company, however, become over-indebted without a positive prognosis, the goal of the Insolvency Statute is to bring forward an application of insolvency (cf. Steffen, 2001, p. 7; Nickert, 2012, p. 1; German Federal Ministry of Justice (press report), 2012, Neue Rechtsbehelfsbelehrung und Entfristung des Überschuldungsbegriffs beschlossen).

Pursuant to § 253 (1), sentence 2 of the German Commercial Code (HGB) provisions should be valued according to prudent commercial assessment of the required amount payable. Thus the valuation of provisions must take into account future price and cost relations at the time the obligation is to be settled. By contrast, the § 6 (1), number 3a, letter f of the Income Tax Act explicitly points out that for the purpose of determining taxable net income when assessing provisions, the conditions prevailing on the reporting date are essential. For this reason future price and cost increases are not allowed to be considered. In the commercial balance sheet this can lead to a situation where, for the purpose of differentiation, deferred tax assets are established and have to be carried forward in the balance sheet (cf. BDI, 2009, p. 16).

Provisions must generally be discounted taking into account the individual evaluation principle. This applies for financial liabilities as well as for the obligation to supply goods. § 253 (2), sentence 1 of the German Commercial Code (HGB) states that provisions maturing in more than one year must be discounted using the average market interest rate of the past seven years, according to their remaining maturities. By applying a market interest rate, the individual credit risk of the debtor is not considered within the interest rate. An average market interest rate of the past seven years is used in order to absorb elements of randomness in the interest rate development. The required discount rates pursuant to § 253 (2), sentences 4 and 5 of the German Commercial Code (HGB) are established by the German federal bank in line with legal regulations and are published on a monthly basis

(cf. BDI, 2009, p. 16).

For pension provisions, special regulations were introduced. Here no specific actuarial method of calculation is required. Pursuant to § 285, number 24 of the German Commercial Code (HGB) the actuarial method of calculation applied must be described in the notes and the basic assumptions of the calculation must be explained. When discounting pension provisions, one must generally apply, same as for all other provisions, the average market interest rate of the past seven years as determined by the German federal bank. However, pursuant to § 253 (2), sentence 2 and 3 of the German Commercial Code (HGB), there is a simplification rule. According to this, pension provisions can be generally discounted with the average market interest rate of the past seven years which results from the assumed residual term of 15 years. This is a right that can be decided by the reporting entity (cf. BDI, 2009, p. 17).

Bittmann views the total procedure applied for valuating provisions pursuant to the German Act to Modernize Accounting Law slightly more critically. According to him, the German Act to Modernize Accounting Law provides two changes which go in opposing directions. He points out that, on the one hand, pursuant to § 253 (1), sentence 2 of the German Commercial Code (HGB) a valuation of provisions by reasonable commercial assessment on the basis of the amount payable has come into effect replacing the previous rule of the current valuation cut-off-date principle. This leads to the situation where future price increases have to be projected and taken into account. This process provides the reporting entity with significant leeway in which to operate. This rule is even more stringent when establishing the pension provisions. Here one must not only take into account future wage increases but also the individual career development of employees. Bittmann is right to question whether this is reliably do-able. These adjustable components provide easy ways to manipulate balance sheets. These requirements will generally lead to a situation where increases in provisions will be made. But the reporting entity can determine the extent of provisions being made variably depending on the prevailing economic situation and objectives. On the other hand, pursuant to § 253 (2) of the German Commercial Code there is a compulsory requirement to discount the provisions made. This reduces the value of these provisions (cf. Bittmann, 2008, p. 443 f.). The aspects highlighted by Bittmann clarify that this provides a creative leeway in which one can conceal accounting fraud.

According to Bittmann with the German Act to Modernize Accounting Law coming into effect one can expect to see the amounts of passivating provisions increasing. This can generally lead to a pre-emption of the time companies apply for insolvency in the form of an earlier occurrence of over-indebtedness and thereby stands in contrast to the compulsory requirement to capitalize self-created intangible assets and the derivative goodwill. However, it will probably rarely happen that these counteracting trends actually occur within one company. All in all, the valuation of the provisions can be viewed as being closer to reality compared to the former valuation methods (cf. Bittmann, 2008, p. 444).

Pursuant to § 340e of the German Commercial Code, credit institutions must capture the financial assets held for trading at fair value as recorded income. This regulation was initially to apply for all companies independent of their structure or legal form. The legislator distanced itself though from this directive due to the financial crisis. It was viewed as appropriate to limit the valuation to the banks' trading books. A final definition of the term financial instruments is not planned as the market tends to be very fast-paced in this sector and there are constantly new creations being made. As such, one should assume a wide basis of application, so that also all types of derivative financial instruments are included. The amount provided at fair value must have a so-called risk-discount applied to it. The risk-discount is established based upon the internal risk handling pursuant to banking regulatory specifications (value at risk). Pursuant to § 340e of the German Commercial Code a reclassification of financial instruments is prohibited unless unusual circumstances, in particular severe impairments to the free transferability of the financial instruments, lead to a stop in the intention to trade by the credit institution. Pursuant to § 340g of the German Commercial Code credit institutions are allowed to include the position "funds for general banking risks" on the liabilities side of the balance sheet to protect against general banking risks as long as it is, after prudent commercial assessment, required due to the special risks of the particular credit institutions business sector. Pursuant to § 340e (4) of the German Commercial Code, this fund for general banking risks must have, in each business year, an amount of at least 10 per cent of the net earnings of the trading book added and this must be recognised separately. This position is only allowed to be liquidated to compensate the net amount of the trading portfolio. Or in the situation when the value is higher than 50 per cent of the average last five years net revenue of the trading portfolio (cf. BDI, 2009, p. 18 f).

If a market value of a financial instrument exists then the valuation is admittedly relatively simple. However, the explosive nature of this valuation process can be seen in the mortgage bank and fiscal crisis which to date still has not been entirely overcome. Banks and insurance companies had and still have to undergo massive value adjustments of their financial instruments (cf. Bittmann, 2008, p. 444). The German *Commerzbank*, for example, lost in the period from January 2008 till December 2011 more than 80 per cent of its share value. This is not just a result of the financial instruments purchased by the *Commerzbank* for trading purposes. But the financial instruments were part of the reason for the decline in value of the high street bank. For hypothetically major price falls it can, for example, happen that with a real-time valuation there is a faster reduction of hidden reserves as when there is a not such a real-time valuation. If there is no market value of the financial instruments, the valuation is much harder to complete. Then the so-called general commercial measurement methods must be applied. Also pursuant to § 254 of the German Commercial Code another option is to create valuation units, whereby one is allowed to deviate from the principle of individual valuation. The correct valuation of financial instruments purchased for trading purposes is becoming increasingly more difficult due to the lack of straightforwardness and accounting fraud can probably, if wanted, be more easily carried out.

After having reviewed changes made to the accounting principles, taking into consideration the question whether they are of interest in providing possibilities to stop accounting fraud, the next section will briefly outline additional legal amendments triggered by the German Act to Modernize Accounting Law. Based on the wide spectrum of the German Act to Modernize Accounting Law, the following outline will focus on major changes only. Areas which offer the possibility of manipulation of balance sheets will be highlighted accordingly. The basis for this outline is the publication of the Federation of German Industry (BDI) (cf. BDI - Bundesverband der Deutschen Industrie and Ernst & Young, German Act to Modernize Accounting Law, 2009):

Annual financial statement: Valuation requirements for all merchants:

1. Economic attribution: "The principle of the economic attribution of assets is clearly and explicitly stated in the law – no changes to the current legal situation

are planned. Debts need to be included in the balance sheets of the debtor<sup>71</sup> (translated in context by the author) (§ 246 (1), sentences 2 and 3 HGB).

2. Balancing of the debts against the planned assets: balancing decree of debts against plan assets. The approach is the present value with a pay-out and payment stop (§ 246 (2), sentence 2 and 3 HGB; § 253 (1), sentence 4 HGB; § 268 (8) HGB).
3. Creation of special items with a reserve component: prohibited inclusion as a liability for special items with a reserve component.
4. Provision for expenses: prohibited inclusion as a liability for expense provisions which are not considered for tax purposes.

Annual financial statement: Measurement requirements for all merchants:

1. Write-downs: Prohibition for unscheduled write-downs of fixed assets with only a temporary decrease in value. This does not apply to financial investments (§ 253 (3), sentence 4 HGB). Value fluctuation write-downs of current assets are prohibited. Write-downs within the framework of reasonable commercial judgment are prohibited. The execution of write-downs only for tax admissible purposes is prohibited.
2. Reinstatement of the original value: "Reinstatement of original value decree, except for goodwill"<sup>72</sup> (translated in context by the author) (§ 253 (5) HGB).
3. Valuation units: "Duty to create valuation units becomes defined by law"<sup>73</sup> (translated in context by the author) (§ 254 HGB).
4. Production costs: Minimum level is the direct costs, material and production overheads as well as the amortization of non-current assets (as long as they are related to the production). It is prohibited to include distribution and research costs (§ 255 (2) HGB).
5. Simplified valuation methods: The simplified valuation method is now only applicable to the valuation of the weighted average, LIFO (last in first out) or

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71 „Der Grundsatz der wirtschaftlichen Zurechnung von Vermögensgegenständen wird ausdrücklich im Gesetz verankert – keine Änderung der bestehenden Rechtslage beabsichtigt. Schulden sind in die Bilanz des Schuldners aufzunehmen“

72 "Wertaufholungsgebot, außer bei Geschäfts- oder Firmenwert".

73 "Pflicht zur Bildung von Bewertungseinheiten wird gesetzlich verankert".



FIFO (first in first out) (§ 256 sentence 1 HGB).

Annual financial statement: Additional requirements for limited liability companies:

1. Cash flow statement and equity statement: "Preparation of the cash flow statement and equity statement also for the purpose of a separate financial statement as long as the capital market oriented limited liability company does not prepare group accounts"<sup>74</sup> (translated in context to the author) (§ 264 (1), sentence 2 HGB).
2. Legally required method of itemization: Adding new positions, such as self-created intangible assets, deferred tax assets and liabilities, reserves for reinvestments, active difference resulting from asset offsetting (§ 266 (2) and (3) HGB).
3. Threshold values: Through the new regulation the old threshold values for small limited liability companies, medium sized limited liability companies and large limited liability companies were increased by 20 percent (§ 267 (1), (2), and (3) HGB).
4. Not called-in open deposits and own shares: These must be clearly distinguishable from the position "subscribed share capital" (§ 272 (1), sentence 3 and (1a) and (1b) HGB).
5. Notes: Type and usage as well as risks and advantages of the off-balance-sheet transactions must be provided if they are required for the assessment of the financial situation (§ 285 (3) HGB). All companies must provide details of the auditor fees for the calculated total fees of the business year (§ 285 (17) HGB).<sup>75</sup> Non-market typical business with companies or people with which there is a close relationship must be declared. For market typical business providing this information is voluntary (§ 285 (21) HGB). This raises the question whether it is so simple to differentiate between market typical and market untypical

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<sup>74</sup> "Aufstellung von Kapitalflussrechnung und Eigenkapitalpiegel auch für Zwecke des Einzelabschlusses, sofern kapitalmarktorientierte Kapitalgesellschaft keinen Konzernabschluss aufstellt".

<sup>75</sup> This will be explained in more detail in the next point relating to the publication of royalty information.

business. Under certain circumstances this creates a certain leeway so that certain business, which one does not want to declare, is not declared as it is declared as market typical business. The suspicion of certain possibilities to manipulate is obvious.

Management report: Regarding the regulations of the management report the German Act to Modernize Accounting Law has unconditionally taken-over the European legal requirements without requesting additional reporting duties. The legislator demands the duty to explain all key characteristics of the accounting related internal control and risk management system (§ 289 (5) HGB). It should be noted that not the complete internal control and risk management system is described but only that part of the system relating to the accounts. The reason for this is that information relating to the non accounting part could get publically known, which in turn would conflict with the to-be-protected interests of the company. The legislator does not provide regulations for the establishment nor for the nature of the content of the internal control and risk management system. There is also no requirement to detail its effectiveness. The legislator hereby makes only a half-hearted attempt, as a system without detailed requirements relating to the nature of its content cannot be effective.

In addition, the legislator requests a separate declaration of Corporate Governance in the management report or on the company's homepage which contains the statement of compliance, details on management practices and a description of the way in which the executive board and supervisory board behaves (§ 289a HGB).<sup>76</sup>

The changes made to the annual financial statement and the group management report will not be further reviewed in this paper due to the requirement to restrict its scope. Additional information can be found in the Federation of German Industry (BDI) printed matter number 425 dated April 2009 (see also the list of literature). The changes made to the German Act to Modernize Accounting Law in relation to Corporate Governance have already been described in chapter 3.2. The changes to the final audit will be described in much detail in the next chapter 3.4.

In the summer of 2006 a written questionnaire was issued to approx. 4,000 German companies by Köhler and Martin in close collaboration with the auditing

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<sup>76</sup> Further information relating to this topic can be found in chapter 3.2.5, last paragraph.

firm Deloitte & Touche. The goal of this study was to gauge the view of companies as to how they assess the reform proposals being made at that point in time, which were to be selectively applied by the German Act to Modernize Accounting Law. The companies who participated in this study can be generally classified as mittelstand. After the deadline had expired, 290 questionnaires which could be evaluated had been returned by supervisory boards and managing directors. Due to the low number of questionnaires returned, there was no claim to representativeness of the questionnaire results. After the analysis of the study was completed, one came to following results: Five of the total thirty-five proposals were rejected rather than welcomed by the companies who participated in the questionnaire. A particularly strong resistance was established in relation to three proposals relating to the abolition of recognition and valuation options within the annual financial statement. This included specifically the prohibited inclusion as a liability for provisions of required maintenance expenses that are to be deferred to the following nine months of the next business year (§ 249 (1), sentence 3 HGB, which was abolished when the German Act to Modernize Accounting Law came into effect); the prohibition to include as a liability the provision for operating expenses (§ 249 (2) HGB, which was also abolished when the German Act to Modernize Accounting Law came into effect); and the prohibition to consider low values of current assets based on the expected value fluctuations in the immediate future (§ 253 (3), sentence 3 HGB, which was also abolished when the German Act to Modernize Accounting Law came into effect). All three recognition and valuation options, whose abolition was against the wishes of the companies questioned, were abolished in 2009 when the German Act to Modernize Accounting Law came into effect. In respect of the abolition of decision rights within the group accounts relating to the change proposals made to the obligation to include inappropriately high costs of information collection (§ 296 (1), number 2 HGB) and the extension of the obligation to consolidate also special purpose entities, whose opportunities and risks mainly relate to the parent group and are not required for a participation (new: § 290 (1) in conjunction with (2), number 4 HGB), were more or less rejected. Regarding the inclusion of inappropriately high costs for information collection within the group accounts (§ 296 (1), number 2 HGB), there was no change made by the German Act to Modernize Accounting Law. Here the decision right still exists. However, the treatment of special purpose entities within the group accounts was changed according to the proposals made by the German Act to Modernize Accounting Law. Pursuant to § 290 (2), number

4 of the German Commercial Code (HGB) there is a case of a controlling influence exerted by the parent company “if, after economic evaluation, it carries the majority of the burden of risks and opportunities that are required in order to fulfill a closely limited and clearly defined objective of the parent company (special purpose entity).”<sup>77</sup> (translated in context by the author) (cf. Köhler/Marten/Schlereth, 2006, p. 2301 ff).

Only such proposals were rejected by companies which were based on the elimination of rights of choice. The rights of choice provided companies with significant leeway in the way in which they could portray their assets, liabilities and financial position, even compared to appropriate IFRS regulations. Of these five rights of choice four were abolished and only one was maintained. All in all there was a relatively high agreement in reply to the 35 questions regarding the formulated possibilities to further develop the German Commercial Code, these were then implemented as part of the German Act to Modernize Accounting Law in 2009 (cf. Köhler/Marten/Schlereth, 2006, p. 2302 ff).

The introduction of the German Act to Modernize Accounting Law (BilMoG) changed the German Accounting Law considerably. It applies to firms of all sizes and legal forms. A survey of 211 companies in December 2010 by the audit firm pwc showed that, at that time, only 24 percent of the companies polled had implemented the German Act to Modernize Accounting Law. For 66 percent of the polled companies the implementation was still underway and 10 percent had not even started with its implementation. As such, it is not fully possible to ascertain how considerable the effect of the BilMoG-changes will be. The opinions as to what the effect of the German Act to Modernize Accounting Law will be on the systems used in accounting and for the annual financial statement are varied. A small majority of mid-sized companies view the impact of the German Act to Modernize Accounting Law on the closing processes and systems as more or less irrelevant. Only in relation to municipal undertakings does this result look different. Here 47 percent perceive the changes to the closing processes and systems through the German Act to Modernize Accounting Law as substantial and only 43 percent as more or less irrelevant. Ten percent have not yet formed an opinion. The major

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<sup>77</sup> „wenn es bei wirtschaftlicher Betrachtung die Mehrheit der Risiken und Chancen eines Unternehmens trägt, das zur Erreichung eines eng begrenzten und genau definierten Ziels des Mutterunternehmens dient (Zweckgesellschaft).“

changes to the annual financial statement through the German Act to Modernize Accounting Law can be seen by companies in the area of general provisions and provisions for pensions (cf. pwc, 2011b, p. 2 ff).

The introduction of the German Act to Modernize Accounting Law led to changes in the requirements of internal processes and documentation. In addition, the new requirements (accounting rules) have and will change the structure of balance sheets and of the profit and loss accounts. The additional note and management report particulars will impact company communication because the now numerously required publication of particulars (key performance indicators) means that companies will have to become more transparent towards the public (cf. BDI, 2009, p. 47).

The German Act to Modernize Accounting Law has taken a step in the right direction. The goal to provide a more simple and more cost effective alternative which should provide especially small and medium sized companies with the opportunity to make use of modern accounting principles without having to apply the IFRS, has been realized. As such the German Act to Modernize Accounting Law is to be rated positively. That these – as demonstrated by Bittmann – include aspects which can support balance sheet manipulations is undisputed. Here it has weaknesses that also existed previously and which could not be eliminated by the German Act to Modernize Accounting Law. A stricter approach to stopping balance sheet manipulations would have been desirable. In view of preserving the existence of small and medium sized companies one can altogether positively highlight the fact that the German Act to Modernize Accounting Law can in any case lead to the strengthening of such companies.

### 3.4 STRENGTHENING THE ROLE OF THE INDEPENDENT AUDITOR

People who manage someone else's money are already obliged under civil law regulations to be accountable towards the holding parties for revenues and expenditures. The obligated party has to provide careful and complete details pertaining to all revenue. The legislator prescribes for each individual type of company what the individual financial reporting must look like. When a limited company reaches a certain size then the company requires the attestation of an independent auditor (§ 316 HGB). The criteria by which the size of a company is classed is defined within § 267 of the German Commercial Code (HGB).

The independent auditor, pursuant to § 318 (1), sentence 1 of the German Commercial Code (HGB) is elected by the shareholders. Then the independent auditor is commissioned under the law of obligations by the supervisory board. If there is no supervisory board, then the independent auditor is commissioned under the law of obligations by the legal representatives. The tasks of an independent auditor are defined formally by the law. It has a monitoring obligation. Its control and confirmation function is specified through §§ 316 ff of the German Commercial Code (HGB) and through the provisions of the Public Accountants Act (WPO) in conjunction with § 259 of the German Civil Law Code (BGB). As such, the annual financial statement must adhere to the statutory regulations as well as to the additional provisions of the partnership agreement or bylaws. The findings of the audit of the annual financial statement must be captured in the management report and an accurate insight into the situation of the company has to be ensured. The independent auditor has to report about the nature and extent of the audit as well as about the results with due clarity (§ 321 (1), sentence 1 HGB) and must provide an audit certificate summarizing the results of the audit (§ 322 (1), sentence 1 HGB). The rights of the independent auditor to fulfil their tasks are defined through § 320 of the German Commercial Code (HGB), which defines the obligation of the company to provide information as well as the independent auditor's right to inspect and obtain information (cf. Budde/Steuber in Wollmert et al., 2003, p. 135 f). It can be noted, therefore, that the independent auditor has the task within the system of accounting, auditing and disclosure to carefully test whether the annual financial statement which has to be developed by the management and for which it is accountable, has been made according to statutory regulations and in line with the Statute. With this the auditor also has the function of being

a warner against potential crisis situations. The public, the shareholders and the creditors must be able to rely on the auditor's well-qualified work and the quality of the published attestation (cf. Munoz, 2008, p. 20).

The public's trust in the accounting and quality of judgement of the auditors has dropped drastically due to major accounting scandals. The fact that companies which had received unrestricted attestation later came under public criticism for the annual financial accounts and the independent auditors report pushed this topic into the focus of public attention. Decisions made by financial analysts, investors and creditors are strongly influenced by the audited annual financial statements and the audit certificate. Despite being certified, false information can subsequently have dire consequences. Since 2002 there has therefore been an unprecedented amount of discussion after the introduction of the statutory audit over the need for reforms in this sector (cf. Baetge/Matena in Wollmert et al, 2003, p. 181 f).

The reaction of the German Federal Government to the increasingly important need to reform was duly appropriated with the 10-Point-Program of measures, with the intent to strengthen the role of the independent auditor. This included full transparency of all services rendered by the independent auditor towards the supervisory board and the detail of their actions in the independent auditor report. Further measures relate to the assurance of autonomy of the contracted services rendered by the auditor as well as provisions regarding personal interrelations and financial dependence of the auditor, but also relating to changing auditors, the publication of fees received, the extension of liability and the strengthening of the statutory audit profession.

#### *3.4.1 The Principle of Independence*

The original task of an independent audit is to provide a trustworthy judgement regarding the formal and tangible correctness of the published annual financial statement. The independent audit is an important step in securing and ensuring trustworthiness of the published annual financial statement and therefore forms part of the protection for users of the annual financial statements. Objectivity and professional integrity are the most important prerequisites of an independent auditor so that their judgement can be trusted by all parties alike. An independent auditor is viewed as being objective if they make their judgements independently

from all influences (independence of mind). In addition, their judgment is seen as trustworthy if the public is convinced of their independence (independence of appearance). The continuous accounting scandals have heavily shaken not only the independence of mind but also the independence of appearance (cf. Baetge/Matena in Wollmert et al, 2003, p. 183 f).

In order to gain back the public's trust in the independence of the independent auditor, it seems necessary to go back to the original, actual function of the independent auditor. The original understanding of what the role of the independent auditor is was initially not a service provided to companies but a review and confirmation of the formal and tangible correctness of the annual financial statement with the goal of informing company shareholders and the financial markets about the results of the audit. That this requires a certain basic inner attitude of the independent auditor goes without saying. The problem is that such a basic attitude, whose main goal is to stay independent, cannot be forced or commanded (cf. Baetge/Matena in Wollmert et al, 2003, p. 184).

In addition to this problem, there is also the issue that the public gains from the activity of the auditor but does not pay for it; the financial compensation is made by the company being scrutinized. As such, strictly speaking even the most virtuous auditor, who is proud of his inner independence, is externally never completely independent of the company being scrutinized. The problem how an auditor can retain his inner independency despite the unavoidable economic dependency that is systemically preconditioned remains structurally insoluble and an ethically moral challenge that each new generation of auditors must face (cf. Hagel, 2002, p. 1356).

Pursuant to § 43 (1) of the Public Accountants Act, the financial auditor has, in any event, to exercise their profession independently, conscientiously, discreetly and autonomously. They have to refuse their services if pursuant to § 49 of the Public Accountants Act, they are rendered for undertaking an unlawful action or there is a concern of bias for the execution of a service provided. Pursuant to § 21 (2) of the statutes of the German Chamber of Public Accountants regarding the rights and duties of exercising the professions of a financial auditor and a chartered accountant, that person is seen as unbiased: Firstly, "who makes judgements without being influenced by non-objective considerations. Secondly, the un-biasedness can be compromised in particular through own interests (§ 23), self-auditing (§ 23a),



representation of interests (§ 23b), as well as close personal relationships (§ 24). Thirdly, the existence of such circumstances does not lead to an impairment of unbiasedness if the circumstances themselves for making judgments are obviously insignificant or, combined with safeguards (§ 22), are on the whole insignificant. Fourthly, circumstances referred to in Sentence 2 may arise in particular outside of business, financial or personal relationships<sup>78</sup> (translated in context by the author).

Pursuant to § 21 (3) sentence 1 of the Statutes of the German Chamber of Public Accountants about the rights and duties when pursuing the profession of a financial auditor and of a chartered accountant, there is a case for suspected bias where “circumstances as defined in Section 2 Sentence 2 occur, which in the view of a judicious third party may be deemed sufficient to influence judgement in a non-objective way. Secondly, suspected bias does not exist in cases where the threat to un-biasedness as defined in Section 2 Sentence 3 is insignificant<sup>79</sup> (translated in context by the author). When completing the statutory independent audit according to §§ 316 ff of the HGB the general standard pursuant to § 318 (3) of the HGB also applies. These state that a financial auditor cannot be an independent auditor if there is a case for suspected bias. According to Veltins a “case for suspected bias<sup>80</sup> (translated in context by the author) can have various reasons but can be justified, in particular, by business, financial and personal types of relationships. Hereby, it is not relevant whether the auditor is actually objectively biased. Decisive for a case of suspected bias is the view of a rational and objective third

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78 „wer sich sein Urteil unbeeinflusst von unsachgemäßen Erwägungen bildet. 2 Die Unbefangenheit kann insbesondere durch Eigeninteressen (§ 23), Selbstprüfung (§ 23a), Interessenvertretung (§ 23b) sowie persönliche Vertrautheit (§ 24) beeinträchtigt werden. 3 Das Vorliegen solcher Umstände führt nicht zu einer Beeinträchtigung der Unbefangenheit, wenn die Umstände selbst für die Urteilsbildung offensichtlich unwesentlich sind oder zusammen mit Schutzmaßnahmen (§ 22) insgesamt unbedeutend sind. 4 Umstände nach Satz 2 können sich insbesondere aus Beziehungen geschäftlicher, finanzieller oder persönlicher Art ergeben“.

79 „wenn Umstände im Sinne von Absatz 2 Satz 2 gegeben sind, die aus Sicht eines verständigen Dritten geeignet sind, die Urteilsbildung unsachgemäß zu beeinflussen. 2 Besorgnis der Befangenheit liegt nicht vor, sofern die Gefährdung der Unbefangenheit nach Absatz 2 Satz 3 unbedeutend ist“

80 „Besorgnis zur Befangenheit“

party (cf. Veltins, 2004, p. 448). In addition, § 319 of the German Commercial Code (HGB) lays out reasons for an exclusion. When these are applicable, then the biasedness of an auditor is deemed irrefutable. However, whether there is a case for biasedness must always be decided on a case-by-case basis by the courts.

#### 3.4.2

#### *International Auditing Standard*

In May 2009 with the introduction of § 317 (5) of the German Commercial Code (HGB), the legal basis was formed for the direct application of international auditing standards (ISA) for carrying out statutory audits as adopted in EU law. The ISA can only be adopted into European law after a formal process of the EU Commission has been completed and thereby becomes legally binding for Member States. The process is titled as the so-called comitology procedure. The International Auditing and Assurance Standards Board (IAASB), responsible for the development and adoption of ISA, subjected the ISA to a “clarity review”. In this process the level of liability of the individual regulations was firmed up and the terminology of the standards were standardized. Now it is up to the European Commission to approve the adoption of the ISA into the Community legislation (cf. BDI, 2009, p. 44). In the meantime though, many but not all of the German Auditing Standards (IDW PS) have been adjusted to ISA’s. Therefore, the process is not yet fully completed.

For the publication of professional notifications that regulate amongst other things the responsibility of the auditor to discover accounting fraud, several institutions come into consideration. On an international playing field, the International Federation of Accountants (IFAC) as a private sector umbrella association for auditing professions is responsible. Under its control, one finds the International Auditing and Assurance Standards Board (IAASB). The IAASB is an independent committee that, following a fixed process, develops and adopts the internationally applicable International Standards on Auditing (ISA) (cf. Research Paper of the IDW, 2004, p. 1281). Currently the ISAs are directed at the Member Organisations which are then tasked to implement these into national auditing standards. These national auditing standards are called IDW Prüfungsstandards (IDW Auditing Standards – IDW PS) in Germany. The goal is to develop a “common auditing language” in Europe. That is why the International Standards of Auditing (ISA) should be integrated into European jurisdiction. The ISA is to be understood as a

set of regulations that can be adapted to an individual situation and to which the proportionality principle applies (cf. Heininger, 2010, p. 15 and 23).

The uniform introduction of ISA as a directly applicable law for all Member States of the European Union would have been preferable as it would have helped to avoid balance sheet manipulations. All independent auditors would have to apply the same regulations throughout Europe. Auditors who review companies in different EU member States would know exactly what standards of auditing and regulations apply as they are the same across the EU. Due to the uniform EU regulations, it would also be easier to ensure that companies which have affiliates in different EU Member States are following the same regulation.

#### 3.4.3 *The Declaration of Compliance and Corporate Governance Statement*

Both statements are based on the adoption of the changes made to the Audit Directive and, based on the similarity of content, they will be reviewed together. In the declaration of compliance (statement on the Corporate Governance Code) companies pursuant to § 161 (1), sentence 1 of the German Stock Corporation Act must publish and explain any deviations to the recommendations of the German Corporate Governance Code. The number of companies that have to submit a Declaration of Compliance has been extended. When the German Act to modernize Accounting Law (BilMoG) came into force not only publicly listed companies had to submit a Declaration of Compliance but also according to § 161 (1), sentence 2 of the German Stock Corporation Act, companies listed on the stock exchange that deal with other papers apart from shares – for example debt securities – on another organized market and at the same time whose issued shares are being traded on their own initiative on a multilateral trading facility pursuant to § 2 (3), sentence 1 number 8 of the Securities Trading Act. Thereby the number of companies which have to submit a Declaration of Compliance is identical to those which have to submit a Corporate Governance Statement (§ 289a of the German Commercial Code). The Declaration of Compliance has to be part of the Corporate Governance Statement and to be published by the Management Board and Supervisory Board on the Company's homepage pursuant to § 161 (2) of the German Stock Corporation Act (cf. BDI, 2009, p. 43).

Pursuant to § 317 (2), sentence 3 of the German Commercial Code (HGB) the Corporate Governance Statement is excluded from the examination proceedings.

It is also not subject to examination proceedings if the company makes use of its right of choice to include it in its Management Report and not to simply publish it on the company's homepage. Based on this procedure, it is possible to have a Management Report consisting of parts which are subject to examination and parts which are freed from examination proceedings. In order to avoid misunderstandings, the independent auditor must make note of the fact that the Corporate Governance Statement was not part of the independent audit proceedings in the introductory section of the audit certificate (cf. BDI, 2009 p. 44).

#### 3.4.4 *The Responsibilities of the Group Auditor*

Pursuant to § 317 (3), sentence 2 of the German Commercial Code (HGB) the group auditor must check the work and documentation of other audits should other auditors have completed checks of annual financial statements of affiliated companies. The area of responsibility of the group auditor is not changed by this as they already de lege lata carry the full responsibility for the qualified audit certificate on the group's consolidated financial statement. Up to 2009, the group auditor could limit their auditing tasks to the verification that legal prerequisites exist if other auditors had already checked the annual financial statements of companies that should be included in the Group's annual financial statement. This is now no longer possible (cf. BDI, 2009, p. 45). This regulation is also to be welcomed with regard to preventing and discovering accounting fraud. Through this regulatory change all individual financial statements of subsidiaries, if audited by an auditor other than the group auditor, are subject to in-depth scrutiny by two separate persons. The four-eye principle leads to an improvement of control options. In cases where there is a case of fraud by means of a collusion of company management and the auditor, these would be forced to include a second auditor. This would lead to an extension of the group of confidants which in turn increases the danger of the offence being discovered.

#### 3.4.5 *Separation of Independent Audits and Consultation*

Through the so-called "low-balling"<sup>81</sup> which refers to a practice whereby

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81 This model was first described in the chapter on auditing by Linda de Angelo (cf. De Angelo, 1981, p. 113-127).

the fee of the prevailing auditor is undercut by the offer of another auditor, many auditing firms were put in a position where the costs of the independent auditing process were no longer covered. This harmful type of competition results from the special structure of the auditing sector. In contrast to other professions, it is near to impossible to manage the business through the reputation of an auditor. Baetge and Matena demonstrate the difficulty of the sector with an illustrative example: A patient being treated by a doctor can ascertain the performance of the doctor by whether his health has improved. The actual customer of the independent auditor is the owner of the corporation and not the company's management as is often falsely presumed. The shareholder, however, can often not make a statement about the quality of the work the auditor performed as the shareholder has not got the possibility to directly view and control the work of the independent auditor. Mostly a lack of quality of the independent auditor's work only comes to the shareholders' attention if the independent auditor makes a false attestation over the formal and tangible correctness of the published annual financial statement. This then comes to light when a company files for insolvency in the following year despite of having received an unconditional audit certificate (cf. Baetge/Matena in Wollmert et al, 2003, p. 185).

Through the enormous price competition in the sector of annual financial statement audits, there has been a vast extension of the services offered to companies audited by a financial auditor. The costs of the auditing services which cannot be covered are subsidized by other services (cf. Baetge/Matena in Wollmert et al, 2003, p. 185). However, between 2001 and 2005 due to the worldwide high number of cases of accounting fraud detected, many auditing firms either listed their consulting firms on the stock exchange or sold them off. The reason for this was the fear that the Securities and Exchange Commission could force them to rigorously differentiate their auditing from their consultancy business. KPMG listed its consulting company on the stock exchange, Ernst & Young sold its consulting company to Capgemini for 11.5 billion euros, and pwc sold its consulting department to IBM for 3.5 billion dollars. But after the legislator then did not enforce a strict distinction between auditing and consulting after all, the auditing firms attempted to enter this lucrative market again. Due to the high profit margins that can be achieved in the consulting sector, this process of re-entering the market was not done gradually but as fast as possible (cf. Fink, 2005, p. k01). This is why nowadays many auditing companies are once again consulting conglomerates with multiple

service offerings. There is still a cross-subsidization of auditing services as the margins that can be attained through consulting services are much higher than the margins that can be attained through auditing. Therefore the danger exists, that by providing auditing services as well as audit related consultation to the same company, the auditor loses his independency and becomes a servant of two masters. On the one hand, he has to pursue the role of independent auditor in representing the interests of the shareholders and creditors and, on the other hand, due to his offered consultation services he has to fulfill the wishes of the company's management. As the consultation services offer higher profit margins, it can lead to a situation where the auditor is not orientated towards the expectations of the investors and shareholders but rather towards the demands and provisions of the company's management. Baetge and Matena call this web of relationships of independent auditors, the shareholders and the company's management a constructional flaw. The auditors, on the one hand, must scrutinize the actions of the company's management whilst, on the other hand, for the consultation services the auditor must be the provider and the company's management is the customer and the so-called customer is king. Baetge and Martena see two possibilities of correcting this constructional flaw. One must clearly separate the auditing from simultaneous consulting services. If this does not happen, then an external auditor rotation and an official scale of fees for services by auditors could at least substantially reduce the issue of dependency (cf. Baetge/Matena in Wollmert et al, 2003, p. 185 f).

A further advocate of a distinct separation between independent auditors and simultaneous consulting within the same company is Riecke. In his view the criminal acts of some auditors point to a cultural decline. The era of computers has dramatically changed the way in which the auditing sector works. The income of the hourly paid auditors has come under increasing pressure. The auditing firms have reacted to this by increasing their portfolio of services offered. By taking over consulting activities relating to tax, organizational and strategic questions, they have doubled their income over the last ten years. As overly-strict bookkeeping could endanger their lucrative consulting orders, the auditors have become dependent on companies. This conflict is made worse due to the fact that the companies' management is under extreme pressure to achieve growing share prices and therefore try to get the most out of their numbers. Riecke brings up the Enron-Andersen scandal to demonstrate this. Here the auditing firm Andersen was evidently also, at the same time, an accomplice to accounting fraud. In his

assessment Riecker also refers to the former boss of the US central bank Volcker who is a strong advocate for a fundamental change of this sector. The auditors must separate themselves from providing consultation services in order to avoid any conflict of interest. In addition, Volcker requests that companies should be obliged to change their auditor after five years at the latest. Only by doing this could the trust of investors in auditors be re-built (cf. Riecke, 2002, p. 9 f).

A strict opponent of the request to separate the services of auditing and consultation is Ring. He views the general problem as being such that the auditors *per se* – meaning independently of whether they provide other services – are facing growing competition. This has resulted in the situation that independent audits are sometimes offered at a fee that can hardly cover costs if the audit is performed according to the regulations that apply. Ring sees as the logical consequence that the effort made in the audit – with corresponding consequences for the quality of the independent audit – orientates itself to the fees that are paid. He also doubts that consultation orders really have a significant impact on the quality of the independent audit or that through low balling the auditing fees can be “bought”. Such tendencies are contrary to market mechanisms and economic incentives. His view is that a separation of consulting and auditing would damage the quality of the independent audit. When completing their audit, the auditor must have a high certainty of judgment. To be able to do this an in-depth background knowledge of the customer in question is needed that includes detailed knowledge about the characteristics of the business activity, the economic and legal environment in which the company and the sector operates which the auditor can only have if they also do consultation work for the company. According to Rings, it is more important to work on appropriate and targeted measures that avoid negative repercussions on the quality of the audit. Only by doing this, can one avoid an inevitable iteration of the crisis of confidence (cf. Ring, 2002, p. 1348 f).

According to Bauer the question, whether simultaneous audit and consultancy services endanger the independency of the auditor could not be proven as having a negative inter-dependency either on a scientifically empirical nor a scientifically theoretical basis (cf. Bauer, 2004, p. 184). Quick comes to a similar result. He found that most empirical studies cannot prove that there is a negative impact of consulting services on the actual independency of the auditor (cf. Quick, 2006, p. 56).

In Bauer’s view, a statutory requirement to disclose the auditing and

consulting fees would be sufficient to solve the issue. By doing this, the interested public has the necessary transparency and could form its own view on whether potential conflicts of interest exist. Bauer thinks that this way the balance can be made between the positive economic effects through the simultaneous demand of consulting services with the auditing firm and the negative effects under certain circumstances, of a possible limited independency of the auditing firm on a transparent open market (cf. Bauer, 2004, p. 184).

Furthermore, Bauer states the auditor is consulted by third parties when fulfilling auditing as well as consulting orders. Here the regulatory body of a company, for example, the supervisory board as contracting authority of the audit, needs to ensure that they obligate an independent auditor. If certain consultancy services are not compatible with simultaneous audit activities, then the auditor should be kept away from such assignments (cf. Bauer, 2004, p. 184).

One must note, in contrast to Bauer's opinion, that the supervisory board has a high interest in attaining the most favourable audit result possible. This is not just because the remuneration of the board but also of the supervisory board is closely tied to the results and the success of a company. In addition, studies by Loebbecke / Eining / Willingham<sup>82</sup> (1989) and Terlinde (2005) underline that also the supervisory board is, in a not insignificant number of cases, involved as primarily responsible offender.<sup>83</sup>

The German regulations regarding the compatibility of simultaneous auditing and consulting services provided by the independent auditor make the following provisions after the German Accounting Reform Act and the German Act to Modernize Accounting Law (BilMoG) came into effect: Pursuant to § 319 (3), number 3 a "financial auditor or chartered accountant is especially not eligible as an independent auditor if he or a person he is working with has provided in addition to the auditing services with or for the company to be audited in the year of the audit taking place or up to the point in time when the audit certificate is issued:

- a) has provided support with the bookkeeping or services related to the annual financial statement,
- b) has taken part in a responsible position in the administrative audit of the client,

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82 10 per cent of offenders were members of the Supervisory Board or according to the US system part of the Board of Directors.

83 See point 2.3.3 of this paper.



- c) has provided management services or financial services to the client or
  - d) has provided actuarial or assessment services that have a significant impact on the annual financial statement to be audited,
- provided these activities are of no minor nature<sup>84</sup> (translated in context by the author).

In addition, there are further special reasons for exclusion for companies of special public interest. In relation to this point, pursuant to § 319a (1), number 2 and number 3 of the German Commercial Code “a financial auditor is in addition to the points mentioned in § 319 (2) and (3) also to be excluded from the financial audit of a company which is capital market orientated within the meaning of § 264 d if he

- 2. has provided, in the financial year to be audited, in addition to auditing services, legal or tax services which go beyond simply pointing out alternative arrangements and which directly and not insignificantly influence the depiction of the situation of assets, finances and earnings in the year the annual financial statement is to be audited,
- 3. during the financial year under review has been involved, in addition to his auditing services, in the development, installation and introduction of financial reporting information systems, providing these activities are not of secondary

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84 „Wirtschaftsprüfer oder vereidigter Buchprüfer insbesondere von der Abschlussprüfung ausgeschlossen, wenn er oder eine Person, mit der er seinen Beruf ausübt, über die Prüfungstätigkeit hinaus bei der zu prüfenden oder für die zu prüfende Kapitalgesellschaft in dem zu prüfenden Geschäftsjahr oder bis zur Erteilung des Bestätigungsvermerks

- a) bei der Führung der Bücher oder der Aufstellung des zu prüfenden Jahresabschlusses mitgewirkt hat,
- b) bei der Durchführung der internen Revision in verantwortlicher Position mitgewirkt hat,
- c) Unternehmensleistungs- oder Finanzdienstleistungen erbracht hat oder
- d) eigenständige versicherungsmathematische oder Bewertungsleistungen erbracht hat, die sich auf den zu prüfenden Jahresabschluss nicht nur unwesentlich auswirken,

sofern diese Tätigkeiten nicht von untergeordneter Bedeutung sind.“

importance...<sup>85</sup> (translated in context by the author)

The regulations made by the German legislation are a step in the right direction as the regulations affecting commerce were considerably reinforced in regard to the separation of simultaneous auditing and consulting. However, many of these regulations are extremely imprecisely and vaguely formulated so that they provide companies with a wide creative leeway. For example, in § 319a (1), number 2 it is stated: "... which directly and not insignificantly influence the depiction of the situation of assets, finances and earnings in the year of the annual financial statement to be audited." However, what a direct and not insignificant effect exactly depicts is not explained in more detail. The same applies to point 3 in the same paragraph: "...providing these activities are not of secondary importance". When are services rendered of secondary importance? Also in this case the question remains unanswered by the law.

#### 3.4.6 *Appointing the External Auditor and Reporting of the Auditor*

Since the Corporate Sector and Supervision Transparency Act (KonTraG) came into force in 1998 the supervisory board, after having previously elected the auditors in the Annual General Meeting (§ 119 (1), number 4 of the German Stock Corporation Act), award the audit agreement to the auditors (§ 111 (2), sentence 3 of the German Stock Corporation Act). This regulation is intended to ensure a higher degree of independency of the auditor from the executive board. Pursuant to point

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85 „ein Wirtschaftsprüfer ist über die in § 319 Abs. 2 und 3 genannten Gründe hinaus auch dann von der Abschlussprüfung eines Unternehmens, das kapitalmarktorientiert im Sinne des § 264 d ist, ausgeschlossen, wenn er

2. in dem zu prüfenden Geschäftsjahr über die Prüfungstätigkeit hinaus Rechts- oder Steuerberatungsleistungen erbracht hat, die über das Aufzeigen von Gestaltungsalternativen hinausgehen und die sich auf die Darstellung der Vermögens-, Finanz- und Ertragslage in dem zu prüfendem Jahresabschluss unmittelbar und nicht nur unwesentlich auswirken,

3. über die Prüfungstätigkeit hinaus in dem zu prüfenden Geschäftsjahr an der Entwicklung, Einrichtung und Einführung von Rechnungslegungsinformationssystemen mitgewirkt hat, sofern diese Tätigkeit nicht von untergeordneter Bedeutung ist....“

5.3.2 of the German Corporate Governance Code (the “Code”): „The Supervisory Board shall set up an Audit Committee which, in particular, handles the monitoring of the accounting process, the effectiveness of the internal control system, risk management system and internal audit system, the audit of the Annual Financial Statements, here in particular the independence of the auditor, the services rendered additionally by the auditor, the issuing of the audit mandate to the auditor, the determination of auditing focal points and the fee agreement, and – unless another committee is entrusted therewith - compliance”<sup>86</sup> (English version of the DCGK, 2013, p. 10).

In line with point 7.2.1 of the German Corporate Governance Code, the Supervisory Board and the Audit Committee shall attain a statement from the proposed auditor before an auditor is proposed for election as independent auditor in the General Shareholders’ Meeting “whether, and where applicable, which business, financial, personal and other relationships exist between the auditor and its executive bodies and head auditors on the one hand, and the enterprise and the members of its executive bodies on the other hand, that could call its independence into question. This statement shall include the extent to which other services were performed for the enterprise in the past year, especially in the field of consultancy, or which are contracted for the following year”<sup>87</sup> (English version of the DCGK,

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86 „Der Aufsichtsrat soll einen Prüfungsausschuss (Audit Committee) einrichten, der sich insbesondere mit der Überwachung des Rechnungslegungsprozesses, der Wirksamkeit des internen Kontrollsystems und des internen Revisionssystems, der Abschlussprüfung, hier insbesondere der Unabhängigkeit des Abschlussprüfers, der vom Abschlussprüfer zusätzlich erbrachten Leistungen, der Erteilung des Prüfungsauftrages an den Abschlussprüfer, der Bestimmung von Prüfungsschwerpunkten und der Honorarvereinbarung sowie – falls kein anderer Ausschuss damit betraut ist – der Compliance, befasst“

87 „ob und gegebenenfalls welche geschäftlichen, finanziellen, persönlichen oder sonstigen Beziehungen zwischen dem Prüfer und seinen Organen und Prüfungsleitern einerseits und dem Unternehmen und seinen Organen andererseits bestehen, die Zweifel an seiner Unabhängigkeit begründen können. Die Erklärung soll sich auch darauf erstrecken, in welchem Umfang im vorausgegangenen Geschäftsjahr andere Leistungen für das Unternehmen, insbesondere auf dem Beratungssektor, erbracht wurden bzw. für das folgende Jahr vertraglich

2013, p. 14). This point in the German Corporate Governance Code highlights the fact that it places emphasis on the independency of the auditor and that it has evidently realized that problems can arise when simultaneously auditing and consulting services are carried out.

Through the introduction of the German Act to Modernize Accounting Law (BilMoG), companies are faced with the following changes relating to their choice of auditor. If a company has an Audit Committee, then the proposal of the supervisory board submitted to the Annual General Meeting for the election of the auditor pursuant to § 124 (2), sentence 2 of the German Stock Corporation Act be based upon the recommendation of the Audit Committee. This requirement is inherently consistent as the Auditing Committee intensively shares information with the auditors on an ongoing basis. The legislator stresses, when explaining its reasons, that the supervisory board holds the right in exceptional cases to deviate from the proposal made by the Audit Committee. A deviation from the proposal made by the Audit Committee must, however, be explained in detail by the supervisory board prior to the Annual General Meeting (cf. BDI, 2009, p. 42).

In relation to the selection of the members of the Audit Committee, the second last revision of the German Corporate Governance Code (DCGK) in 2012 made the following changes. Before the second last revision, the criteria for the independency of the corporation's management were legally hardly realized through the requirements made in the DCGK. The German Corporate Governance Code only suggested that no former company board member whose term ended less than two years prior to a proposed nomination, should be allowed to become a member of the Audit Committee (cf. DCGK, 2010, p. 7). But as this was merely a suggestion and was not binding, the implementation was very questionable. Since the version of 2012, the German Corporate Governance Code has recommended that at least the chairman of the Audit Committee has to be independent and cannot be a former member of the management board of the company whose appointment ended less than two years ago (cf. DCGK, 2012, p. 10). One must still critically note though that a time span of two years is not really sufficient to ensure that one achieves the desired distance.

According to German law, the supervisory boards of public companies are the receivers of the independent audit report ever since the introduction of the

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Corporate Sector and Supervision Transparency Act (KonTraG) (§ 321 (5), sentence 2 HGB in connection with § 111 (2), sentence 3 of the German Stock Corporation Act). At the same time, the same law stipulates that the board has to be given the opportunity to comment on the audit report before it is handed over to the supervisory board (§ 321 (5), sentence 2 HGB). The possibility to make comments on the audit report can, in some cases, be used by the board to remove unwanted observations, reports and comments from the report in advance. In order to avoid this, the board should not receive a draft but finalized and signed audit report. The board can then provide its own individual observations separately but together with the audit report signed by the auditor to the supervisory board (cf. Baetge/Matena in Wollmert et al, 2003, p. 194).

After the Corporate Sector and Supervision Transparency Act (KonTraG) came into force, the reporting duty of the independent auditor was repeatedly revised and newly regulated by the German Act to Modernize Accounting Law (BilMoG). Pursuant to § 171 (1), sentences 2 and 3 of the German Stock Corporation Act, the auditor reports to the plenary Supervisory Board or to the Audit Committee at the final review meeting of the Supervisory Board. The supervisory obligations of the auditor were extended with the German Act to Modernize Accounting Law (BilMoG) and the reporting duties were newly regulated. The independent auditor is required to report about the key results of his audit. When doing this, he must also report about any key weaknesses of the accounting-related internal control and risk management systems identified. In addition, he must bear witness as to whether circumstances exist which led him to believe that he was biased. There is an additional information requirement as to what services were provided to the company in addition to the auditing. All in all, the transparency of the relationship between the supervisory board and the auditor needs to be increased (cf. BDI, 2009, p. 43). This, for example, also can be seen by the fact that the supervisory board has the option to have specific parts of the accounts or of the audit report explained to them in detail with additional extensive background material provided (cf. Peemöller in Förschle/Peemöller, 2004, p. 31).

#### 3.4.7

#### *External Versus Internal Auditor Rotation*

In Germany, the internal auditor rotation was introduced with the Corporate Sector and Supervision Transparency Act (KonTraG) in 1998 and changed in the

following years with the German Accounting Reform Act in 2004 and the German Act to Modernize Accounting Law (BilMoG) in 2009. Pursuant to § 319a (1), sentence 1 number 4 of the German Commercial Code (HGB), an auditor is not eligible as independent auditor of a company that is capital market orientated pursuant to § 264d if he “was responsible in seven or more cases for the independent audit of a company; this does not apply if, since his last participation in the company’s audit, two or more years have passed”<sup>88</sup> (translated in context by the author). Furthermore, sentences 4 and 5 state that this regulation is applicable to auditing firms in the following way: That they are not allowed to be the independent auditor if they employ an auditor while conducting the independent audit of a company who, as responsible audit partner in line with the above mentioned regulations, is not permitted to be an auditor (cf. § 319a (1), sentence 4 HGB). “The audit partner is the one who signs the audit certification pursuant to § 322 or who has been elected as an auditor of an auditing firm to hold the main responsibility for carrying out the statutory audit”<sup>89</sup> (§ 319a (1), sentence 5 of the German Commercial Code (HGB)) (translated in context by the author). This also applies, pursuant to § 319a (2), sentence 2 of the German Commercial Code (HGB), for the audit partners in connection with the group audit that have been elected as primarily responsible for the independent audit of a significant subsidiary (cf. BDI, 2009, p. 45).

The request to have an external auditor rotation was rejected by the legislator because of the danger of losing audit quality after a change in the auditing firm. Critics point out that the legislator has not provided proof for this reasoning (cf. Ruhnke, 2000, p. 91 f; Niehus, 2003, p. 1638). It is held against the legislator that common practice refutes this argument as there are successfully completed audits after which the independent auditor was exchanged. Ballwieser and Dobler however note that, in this case, there is also no proof of the quality of such audits. They emphasize, however, that if it is about increasing public confidence of the

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88 „für die Abschlussprüfung bei dem Unternehmen bereits in sieben oder mehr Fällen verantwortlich war; dies gilt nicht, wenn seit seiner letzten Beteiligung an der Prüfung des Jahresabschlusses zwei oder mehr Jahre vergangen sind“

89 „Verantwortlicher Prüfungspartner ist, wer den Bestätigungsvermerk nach § 322 unterzeichnet oder als Wirtschaftsprüfer von einer Wirtschaftsprüfungsgesellschaft als für die Durchführung einer Abschlussprüfung vorrangig verantwortlich bestimmt worden ist“

independency of the independent auditor and hence about the credibility of the accounts, then external rotation seems to be more appropriate than a shortening of existing internal rotation cycles. Even if by doing this the number of auditors that need to be replaced is increased, there remains a connection between the client and the auditing firm that could give rise to cause for concern regarding partiality (cf. Ballwieser/Dobler, 2003, p. 463 f). Baetge and Matena endorse a change of the external auditor every five to six years, whereby the auditing contract should be placed for the whole period of five or six years, so that the auditor has plenty of time to ensure a follow-on order. As a result of the long contract period, the auditor is under no pressure to fear that a difference in opinion with the board regarding an audit result could lead to a premature loss of the contract. In order to reduce the cost associated with regular rotation, Baetge and Matena suggest that the auditing firms make agreements in which the former auditor is obliged to provide the new auditor with all audit documentation (cf. Baetge/Matena in Wollmert et al, 2003, p. 195 f). With regard to this proposal, Ballwieser and Dobler note critically that this plan has limitations due to the need for the client to give their approval. The former auditor could have reasons why he/she does not want to provide all information in order to protect his/her own interests. In addition, an audit which is based mainly on the knowledge gained by the predecessor could in turn lead to the unwanted issue of organizational blindness (cf. Ballwieser/Dobler, 2003, p. 464).

Haller and Reitbauer assume that new auditors will also apply their own audit priorities, concepts and methods which in turn changes the horizon of the audit. When evaluating the effectiveness of the reasons provided in favor of a binding external rotation, they state one should however not forget that the danger of organizational blindness or of too much trust between auditors and company management can also be reduced by a regular change in the members of the auditing team, especially of the audit leader for the purpose of internal rotation. They further raise the concern that a "rotation", in practical terms, can also be understood in such a way that a mandate can be exchanged in an agreed timing interval (possibly even shorter than the legally prescribed timing) between two of the same auditors. In such a case, the auditor would be part of a kind of "joint venture" with a varying time of being on the job. This would mean they could fulfill the legal requirements of the external rotation but at the same time would undermine the advantages of an external rotation in relation to organizational blindness and independency (cf. Haller/Reitbauer, 2002, p. 2233). Keeping in mind the possible

advantages of external rotation, Haller and Reitbauer looked at the rotation regulations which exist in Austria alone and investigated a series of negative effects and based on this background, came to the conclusion that it would be unwise for the Austrian legislator to hold on to its "isolated solution".

Weißberger voices the concern that, with a forced external rotation, too little money and know-how would be invested in newly acquired mandates (cf. Weißberger, 1997, p. 2319). At the beginning of an auditing assignment, the independent auditor must invest more auditing and information gathering time in order to gain sufficient knowledge about the company which is to be audited. That is why the costs of an audit are higher in the first two years than in the years to come. With constant audit fees the auditing firms could, in some cases, be in a position where they have a negative contribution margin. One could counteract this, if a legislative requirement for external rotation is introduced, with higher audit fees in the first two years of a mandate. Baetge and Matena assume that this would be a supplementary fee of 25 per cent (cf. Baetge/Matena in Wollmert et al, 2003, p. 197 f). Some opponents of the external rotation system raise the point that the auditors require several years to work their way into a new company. In response to this it should be mentioned that such an auditor should not be permitted in the first place as such an auditor would never be in a position to certify their first audit report (cf. Munoz, 2008, p. 28).

In contrast to Schruff, Peemöller and Hofmann are of the opinion that an external rotation is an appropriate instrument for strengthening the trust in the integrity of the independent audit and in the fight against fraudulent accounting. Schruff, on the other hand, assumes that the introduction of external rotation would provide criminal balance sheet manipulators a minimum two-year advantage. This is because: An auditor could not immediately have the required knowledge about the accounting practices of the new mandate when accepting the contract to complete a proper assessment. They need two to three years to familiarize themselves until they have the same base of knowledge that their predecessor had. In the initial years, there is an increased risk for making auditing mistakes (cf. Peemöller/Hofmann, 2005, p. 199).<sup>90</sup> One can, however, argue that, should there really be a distinct case of a danger of independency, then the exchange of individual

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90 Further argumentation as the pro and cons of an external auditor rotation can be found in Peemöller/Hofmann, 2005, p. 199 and Ballwieser/Dobler, 2003, p. 464.



team members cannot be avoided through replacing individual employees. The new employees could be quickly instructed by the management of the auditing firm and by the colleagues already involved in the audit and therefore apply the same processes and methods as their predecessors (cf. Munoz, 2008, p. 29).

Ultimately, Döring's proposal should be followed since he still sees the best form of control as auditors competing against each other. An obligatory change of an auditor and the whole auditing firm – and not just of a single audit team – should, in his opinion, occur every five years. Such action would not just retroactively help to uncover organizational blindness and entanglements between the auditor and the management but also help to prevent this from happening at all (cf. Döring, 2002, p. 1). Based on the developments of the last few years where one has seen an increasing amount of fraudulent acts occurring in accounting (cf. KPMG, 2010, p. 9), external rotation, whereby a new auditor must familiarize himself with the company every five years, should not be viewed as a disadvantage but should be seen as an advantage in relation to stopping balance sheet manipulations from occurring.

A good example for the uncertainty created among shareholders is the general meeting of shareholders of the Deutschen Lufthansa AG in May 2012. The last agenda point was the election of the independent auditor and of the auditor for the consolidated financial statement as well as of the auditor for the examination of the interim reports for the 2012 business year. The directors and supervisory board nominated the continuation of work with pwc. The shareholders raised a countermotion for an exchange of the auditing firm. The reason given was the long period of time of over seven years while noting that a change would protect the company from organizational blindness. In addition, the shareholders had a reason to assume that pwc was not dutifully checking the false accounting policies of the company in relation to the provisions for frequent flier miles and was thereby not fulfilling the accounting policies as stipulated by the German commercial law (cf. Lufthansa Group, 2012a, Internet resource). The countermotion was rejected in the annual general meeting but the details of the results of the vote were not provided by the Deutschen Lufthansa AG on its website. What is relevant for the issues that are being discussed here is the fact that at this annual general meeting, attended by approximately 2600 shareholders, the agenda comprising of seven points also included the motion for external rotation (cf. Lufthansa Group, 2012b, Internet resource).

## 3.4.8

*Public Disclosure of Fees*

With the introduction of the Accounting Reform Act (BilReG), capital market orientated companies are obliged to publish the value of independent auditor fees for the business year and provide a detailed breakdown in the following four categories; independent audit, other confirmation services or audit work, tax advisory services and other services. This legal requirement was revised and changed with the introduction of the German Act to Modernize Accounting Law (BilMoG) in 2009. In the current version it states in § 285, sentence 1, number 17 of the German Commercial Code (HGB) that in the annex the total billed fees of the independent auditor for the fiscal year must be provided as well as “broken down into fees for auditing services, other confirmation services, tax consultancy services and other services, to the extent that the disclosures are not contained in the consolidated financial statements in which a company is already included”<sup>91</sup> (translated in context by the author). The regulatory requirements for the consolidated notes can be found in § 314 (1) number 9 of the German Commercial Code (HGB). The changes made by the German Act to Modernize Accounting Law (BilMoG) relate to the previous financial disclosure requirements that were limited to companies that belong to an organised market as laid down by § 2 (5) of the Securities Exchange Act. Since the German Act to Modernize Accounting Law (BilMoG) came into force, the obligation to publish the breakdown of fees has been extended to all companies. The transparency created by the public disclosure of final auditor fees was received well by the public and strengthened the independence in appearance. But a further problem surfaced. Through the publication of fees, it was possible for the companies’ governing bodies to make comparisons. For example, whether the appointed auditor is getting a higher or lower fee compared to auditors of other companies. When receiving a high fee the auditor is in danger of having his fees lowered. But the opposite can also occur, meaning that an auditor with a comparatively low fee can receive an increase as the required quality of the audit appears not to be guaranteed at such a low price (cf. Nonnenmacher, 2003, p. 477). In order to keep the auditor fees within a reasonable limit, it could be necessary to legally regulate the

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91 „aufgeschlüsselt in das Honorar für die Abschlussprüfungsleistungen, andere Bestätigungsleistungen, Steuerberatungsleistungen und sonstige Leistungen, soweit die Angaben nicht in einem das Unternehmen einbeziehenden Konzernabschluss enthalten sind“

maximum allowance of fees for the independent audit and other services provided. Such a stringent regulation would, however, strongly limit the independency of companies as it sometimes happens that a company requests special services from the auditing firm, such as placing a capital increase on the market or help with the introduction of the euro in 2002 or in 2000 with managing the changeover of computer systems (cf. Nonnenmacher, 2003, p. 477).

The new legislation for disclosure and breakdown of the audit fees should definitely be welcomed as one must assume that the higher the fees for non-auditing services are, the higher the dependency of an auditor on the company's management is likely to be. Through the obligation of disclosure, one can see what the ratio is between auditing services and non-auditing services and whether the ratio of fees changes over time in the one or other direction.

In order to answer the question how the various services of the auditor are distributed across the four categories Lenz, Möller and Höhn conducted a study with companies from the stock market segments DAX, MDAX, TecDAX and SDAX. They made the following findings: The first category of "independent auditing services" achieved 66.3 per cent of the average portion of the total fees. The second category "other confirmation services" was 12.2 per cent of the average portion of total fees. The third category of "tax consultancy services" was only 7.6 per cent of the average portion of fees. And the fourth and last category "other services" contained 13.9 per cent of the average portion of fees. All in all, one can note that the results of this study demonstrate that the reporting of the auditor's fees to companies is very heterogeneous. If one divides the independent auditor fees for each one million euros of total assets over the four stock market segments under consideration then companies listed on the SDAX and TecDAX pay over 800 euros in auditing fees per one million of total assets, the MDAX companies pay 386 euros per one million euros of total assets and the DAX companies pay only 214 euros per one million euros of total assets. One must take into account though, that companies listed on the DAX have the highest amount of total assets followed by companies listed on the MDAX. The portion of fees for the independent audits amounts to two-thirds of the total fees and as such the importance of other confirmation services, tax consultancy services and other services can be considered to be relatively moderate. A not insignificant amount of the companies who participated in the survey do not give these types of orders to independent auditors

at all. The tightened regulations of the German Accounting Reform Act and the following German Act to Modernize Accounting Law (BilMoG) have surely been part of this development (cf. Lenz/Möller/Höhn, 2006, p. 1793).

### 3.4.9

#### *Extension of Liability*

After the many accounting scandals of the past 20th and new 21st century, there were not just calls for increasing the liability of company board members as the people responsible for the company but also for increasing the liability of the independent auditor for false certification. According to current law the independent auditor is liable to the company pursuant to § 323 (1) sentence 3 of the German Commercial Code (HGB) which states that “who with intent or with gross negligence violates his duties is obligated to compensate the corporation and if an affiliated company was damaged also this company for the resulting damage”<sup>92</sup> (translated in context by the author). The auditor is only liable towards investors who placed their trust in the information provided by the auditor pursuant to the terms of the general tort law §§ 826 BGB and 823 BGB in connection with the Protection Act. The general liability in tort involves a set of problems for the investors which are difficult to solve. On the one hand, the investor must portray and prove in the case of an audit certificate with false content that the auditor being sued knew of this and at least wanted to conditionally deliberately damage investors. And on the other hand, the investor must prove that he purchased the security papers based on the fact that he trusted the correctness of the audit certificate. It is hardly possible for an investor to prove this. For this reason claims made by investors regularly fail (cf. Baums/Fischer, 2003, p. 14).<sup>93</sup> In the case *Refugium AG* in which a false annual financial statement was published with an unqualified audit certificate, the District Court in Bonn dismissed the case amongst other reasons because the damaged shareholder could not convincingly present when and from which source he had received the annual financial statement and where he had attained the specific knowledge for analyzing it [LG (regional court) Bonn, 15.05.2001 - 11 O 181/00]. Ultimately the difficulties which the investors are faced with are comparable with

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92 „Wer vorsätzlich oder fahrlässig seine Pflichten verletzt, ist der Kapitalgesellschaft, und wenn ein verbundenes Unternehmen geschädigt worden ist, auch diesem, zum Ersatz des daraus entstandenen Schadens verpflichtet.“

93 See point 3.1.2.3 and 3.1.2.4 of this paper

those when they sue board or supervisory board members of a corporation. In order to reduce this problem and to be able to make the independent auditor more liable, Baums and Fischer propose to make changes to the §§ 37c to 37g of the Securities Trading Act. Pursuant to § 37d of the Securities Trading Act the changes to the liability of the independent auditor would then read:

“Who as an independent auditor of an issuer of securities pursuant to § 20a (1) sentence 2 willfully or with gross negligence contributes to making false statements according to §20a (1), especially if he issues an incorrect audit certificate for the group accounts or in the absence of a group account for the annual financial statement or provides an incorrect interim report over the audit review is liable pursuant to § 37c. This § 37c (4) is also applicable to independent auditors who are not natural persons”<sup>94</sup> (translated in context by the author) (Baums/Fischer, 2003, p. 19). In § 37c (4) of the Securities Trading Act it would then state that the liability of a natural person that acted in a grossly negligent way to pay damages would be limited to one million euros (cf. Baums/Fischer, 2003, p. 18 f). With this proposal, Baums and Fischer want to make sure that the independent auditors are liable towards investors if they publish incorrect annual financial statement certificates. Their proposals are in line with the intent of the Act Governing Liability for Capital market Information which was to be introduced in 2004 but was then subsequently recalled.<sup>95</sup>

The liability and sanctions against managers and auditors is more diligent and harder in other countries which can be seen, for example, in the US. According to the Sarbanes-Oxley-Act (SOA), managers that against their better knowledge make false statements regarding assets, liabilities, financial position and profit or loss are faced with monetary fines of up to 5 million US dollars and prison terms of

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94 „Wer als Abschlussprüfer des Emittenten eines Wertpapiers im Sinne des § 20a Absatz 1 Satz 2 vorsätzlich oder grob fahrlässig an unrichtigen Angaben im Sinne des § 20a Absatz 1 mitwirkt, insbesondere indem er einen inhaltlich unrichtigen Bestätigungsvermerk zum Konzernabschluss oder, in Ermangelung eines Konzernabschlusses, zum Jahresabschluss erteilt oder eine inhaltlich unrichtige Bescheinigung über die prüferische Durchsicht eines Zwischenberichts ausstellt, haftet entsprechend § 37c. § 37c Absatz 4 ist auch auf Abschlussprüfer, die nicht natürliche Personen sind, anzuwenden“

95 See point 3.1.2.5 of this paper.

up to 20 years. In addition, indemnity payments can be frozen and the repayment of variable salaries achieved from stock option plans can be requested. For independent auditors there is a catalogue of sanctions that foresees monetary punishments of up to 15 million US dollars (cf. Ballwieser/Dobler, 2003, p. 460). Nonnenmacher asks himself if and to what extent the liability as it exists, for example, in the US helps to strengthen the independent audit. According to current legislation, the liability of an auditor towards a company is limited to one million euros per audit pursuant to § 323 (2) of the German Commercial Code (HGB). For the audit of a stock company whose shares are admitted to trading on a regulated market, the liability is limited to the obligation to compensate for persons who have acted in a grossly negligent way to 4 million euros per audit. As already stated, a liability towards third parties can only be considered for tort claims and in exceptional cases based on a contract containing protection. According to Nonnenbacher, the application of the various proposals regarding the extension of the civil liability of an auditor can be measured by whether the proposed changes can contribute to an improved quality of the independent audit and to strengthening the trust in the audited annual financial statements. One must consider that the damage caused to investors through an incorrect audit can only be calculated based on the evaluation of more or less plausible assumptions as the share price is influenced by many different factors. Should the situation occur where damages need to be compensated for then this must be provided to all the shareholders suing in the same way. It is also difficult to calculate the factually correct and proportionally correct share of the damage caused in relation to the responsibility of the board and supervisory board for the liability of an auditor for investor damages occurred. At the end of the day, the board and supervisory board are the leader and head of the company. They hold the power within the company and carry the responsibility for a correct corporate reporting. The independent auditor has only the task of checking the correctness of this information. The actual fraudulent behavior, i.e. the manipulation and forging of the annual financial statement occurs, with few exceptions, at the top management level (cf. Nonnenmacher, 2003, p. 478).

#### 3.4.10

#### *Changes to the Professional Supervision*

An intact and nationally as well as internationally recognized auditor oversight system is not just very important for the profession but also for the German

economy. The Chamber of Public Accountants (WPK) is responsible for the overseeing of accountant societies, chartered accountants and for auditing companies. Its responsibility also encompasses the system of external quality control. Up until 2004 they were in turn monitored by the – in 2001 introduced – advisory board for quality control which was made up of members who were not members of this profession. That up to 2004 they were also already obligated to public authorities' procurement is reflected in the organizational form of a public sector entity and its being placed under the legal supervision of the Federal Ministry of Economy. Although this supervisory system was shaped by detailed legislative regulation it still showed some weaknesses. This led to the situation where it was criticized by the public as a pure model of self-regulation (cf. Marten, 2006, p. 1123 f). In parallel there was and today still is the special professional jurisdiction.<sup>96</sup>

The legislator reacted to this situation by introducing the Independent Auditor Supervision Act (APAG) that came into force in January 2005. With the introduction of this act the first meaningful supplement and further development of already existing structures was created. Marten summarizes this chosen path under the catchphrase "monitored self-regulation". The Chamber of Public Accountants (WPK) is now also subject to close monitoring of its overseeing function through a new, from the profession unrelated, committee: under the oversight

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<sup>96</sup> Pursuant to § 68 (1) of the Public Accountants Act (WPO) professional law proceedings can be brought to the division for audit affairs of the Regional Court in Berlin and following sanctions can be imposed against an auditor: In case of a warning the court accepts the committed breach of duty but at the same time issues a strong warning of reoccurrence. In the case of an admonition the breach of duty is already considered to be significant. A fine pursuant to § 68 (1) number 1 of the Public Accountants Act (WPO) can be imposed to up to 500,000 euros. In case of a temporary suspension the professional person is not allowed to pursue his profession for a limited amount of time. This prohibition can be from certain types of activity or a complete employment ban from the profession. In case of a final exclusion from the profession there must have been a case for a grave breach of duty in conjunction with a high level of guiltiness by the professional. Elements of an offence are in this case often embezzlement, fraud, breach of trust and falsification of documents (cf. Marten/Köhler/Paulitschek, 2006, p. 27)

of the Auditors' Supervision Commission (APAK).

The Auditors' supervision Commission (APAK) consists of six to ten honorary members. They are not allowed to have been a member of the Chamber of Public Accountants (WPK) for five years prior to their appointment. Before being appointed, they should have been experts in the area of accounting, finance, economy, science or law. They are appointed by the Federal Minister of Economy and Technology. Furthermore, they are independent and not subject to directives (cf. Heiniger/Bertram, 2004, p. 1738; Marten/Köhler/Paulitschek, 2006, p. 28).

The APAK's role is to oversee all areas that in a broad sense belong to the system of professional supervision. To this, amongst other tasks belong (cf. Baetge/Lienau, 2004, p. 2280):

- overseeing the quality control of the independent audit
- the public profession related supervision of the tasks of the Chamber of Public Accountants (WPK)
- cooperation with relevant institutions of other Member States.

The APAK can be understood as a further development of the commission for quality control. Their area of responsibility as external monitoring instance is extended to encompass all areas that in a broad sense can be part of the system of professional supervision. Thereby their supervision responsibilities relate to the whole array of activities which the Chamber of Public Accountants (WPK) directly exercises in its role of public administration. In addition, the role of the APAK is not solely limited to tasks of pure system control. The APAK is directly involved in the system of professional supervision in which it has the full powers to make decisions as to how specific individual matters of professional supervision should be handled. This also includes the right to participate in Chamber of Public Accountants (WPK) meetings, to have access rights to information and to inspection and can request representatives of the Chamber of Public Accountants (WPK) to participate in their meetings. The Chamber of Public Accountants (WPK) is also explicitly obligated to report in a timely and appropriate form to requests from the APAK regarding individual matters for supervisory purposes. The APAK can reject decisions made by the Chamber of Public Accountants (WPK) and request them to re-review based on reasons provided and if not corrected can annul the decision. With these regulations, the legislation has reacted to the public pressure that the professional association should not be allowed to decide upon measures of



professional supervision. The public and international recognition of professional supervision in relation to the independent auditor has thereby had its main obstacles removed. The professionally unrelated APAK is the actual professional supervision organ, whilst the Chamber of Public Accountants (WPK) is subordinated to it and therefore does not play a critical role but rather a role of execution and of laying the groundwork (cf. Heininger/Bertram, 2004, p. 1739; Baetge/Lienau, 2004, p. 2279; Marten, 2006, p. 1124).

With the introduction of the Independent Auditor Supervision Act (APAG), the German Federal Government, in line with the 10-Point-Program from 2003, implemented an independent commission for the supervision similar to that of the American regulatory authority Public Company Accounting Oversight Board (PCAOB). Through the extensive responsibilities of the supervisory commission, the public has access to a more transparent resolution or punishment of breaches of duty by auditors. However, Baetge and Lienau rightly give rise to concern that the possibilities of the Auditors' Supervision Commission are also tightly constrained. The reason for this is the fact that the commission consists of only a limited number of members who are also supposed to be working on a voluntary basis. Finding the appropriate people for this honorary post who are or were actively engaged in accounting, finance, economy, science or law and who five years prior to their appointment were not a personal member of the Chamber of Public Accountants (WPK) may be difficult (cf. Baetge/Lienau, 2004, p. 2281).

A complete recognition of the German supervisory system will be hard to achieve without considering a set of tools similar to those in America. The willingness of the PCAOB to pass on own inspections for German auditing firms, however, presupposes this. As the prevailing quality control system in Germany did not meet the requirements of the PCAOB and the EU-Commission did not view the German supervisory system as totally conforming to the requirements of the 8th directive, the legislator prompted a further bill. The Professional Supervision Act that came into force in September 2003 was targeted at closing the remaining gaps (cf. Marten, 2006, p. 1124).

The Professional Supervision Act created the new instrument for special random as well as scheduled inspections. According to the mandate of the PCAOB, the special random inspections relate solely to the auditors of capital market orientated companies. One can monitor all professional duties which need to be completed in

line with the legal annual financial statement audit. The randomly selected auditors that are required to undergo special investigations cannot plead professional confidentiality obligation towards the company. This ensures that the Chamber of Public Accountants (WPK) gets access to documented internal documents of the company being audited. To protect the interests of the company, this information is only allowed to be used for professional supervisory proceedings against the auditor (prohibition of use). Auditors are generally obliged to provide information, files and other documentation that is relevant for the assessment of a supervisory or appeal proceeding to the Chamber of Public Accountants (WPK) upon demand. If a professional refuses to cooperate, then employees of the Chamber of Public Accountants (WPK) are allowed to access the grounds and business premises of the professional affected during normal business hours. They are allowed to view documents and make copies in order to start and complete the required investigation (cf. Marten, 2006, p. 1125; Marten/Köhler/Paulitschek, 2006, p. 28). The rights of the Chamber of Public Accountants (WPK) were extended to allow them to start independent investigations in cases of medium severity. In connection with this, the sanction possibilities were extended in so far as that they can, for example, impose a written complaint connected with a fine of up to 50,000 euros (cf. Hofmann, 2008, p. 320). In parallel there is, in addition to this, the special professional jurisdiction that can impose fines up to 500,000 euros, temporary suspensions or also an independent disbarment for breaches of duty.<sup>97</sup> Possibilities to sanction fraudulent behaviour are therefore sufficiently provided for.

Even though the new statutory framework conditions are initially targeted at capital market orientated companies and their independent auditors, criticism has been voiced that the changes relating to the professional practice are often disproportionate and impractical for medium sized auditing firms. In contrast, the legislator assumes that the balance of legislation also caters for the requirements of smaller firms. In an investigation in 2011 that looked at the effects of the normative changes on medium sized auditing firms, Haßlinger noted a significant impact. This includes, for example, the newly introduced external quality control that carries significant organisational and auditing costs. Haßlinger states that the normative changes tend to incur additional costs. As a result of this, the cost-benefit-ratio

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<sup>97</sup> The possible measures were already described in detail at the beginning of this paper under point 10 (see footnote 96).

of conducting such business in general and of conducting the independent audit in particular has worsened. The intensity of the impact can be seen in relation to the size of the firm and to the scope of activity. Smaller firms and firms with a low scope of activity are partially more impacted than larger firms with a high scope of activity. Based on the given developments, Haßlinger concludes that it will be increasingly harder, especially for smaller auditing firms to fulfil the increasing functional, professional and mandate requested requirements. As a consequence of international harmonisation tendencies, further changes in the professional framework would further exacerbate the situation. In this context especially, the set-up of the professional supervision would play an important role in the future. The legislative activities would continue to lead to an increased versatility of the auditing sector. Based on the current state and the foreseeable developments one cannot assume that there will be a noticeable reduction of burden for medium sized firms in this competitive environment. Auditing firms which place their focus on strategic work could possibly have an advantage according to Haßlinger (cf. Haßlinger, 2011, p. 781 f).

#### 3.4.11

#### *Conclusion*

The goal of the reform measures, in relation to the strengthening of the role of the independent auditor, was to rebuild the trust in the quality of the expertise of independent auditors which had been lost through the large accounting scandals. This was to be achieved through the complete transparency of all services provided by the independent auditor, the ensuring of his independency, the auditor rotation, the public disclosure of fees, the extension of their liability as well as the strengthening of the professional supervision. In conclusion, one can summarize that the legislator has strengthened the role of the auditor through the reform measures implemented but not to the extent which would have been needed to achieve its designated purpose. As such, for example, the increasing expansion of the product range harbours significant problems for the legally required independency of the independent auditor because – as illustrated – the high profit margins in the consultancy business have led to a cross-subsidisation of the auditing services. By not enforcing a clear distinction between auditing and consulting, the danger that the auditor can lose his independence due to his dual responsibility of auditing and consulting has not been averted. In its ruling regarding the basic

compatibility of auditing and consultancy, the Second Civil Senate of the Federal Court of Justice (BGHZ 135, 260; confirmed through BGHZ 153, 32 and BGH WM 2004, p. 1491 (1493) f) pointed out the criteria for a functional decision-making competence. Munoz correctly points out that time will tell whether the instrument of functional decision-making is really suitable to balance the sensible compatibility of auditing and consultancy with the protection of independency. The functional right to make decisions allows the auditor to show alternatives in the preparation of the annual financial accounts; it does not, however, allow him to make decisions for the client. Consulting services conducted by the auditor beyond those of portraying the alternative scenarios would be impermissible participation when compiling the annual financial statement. At the point in time when a client makes his own independent decision, the auditor is testing not his own decision but that of the client. Munoz raises the concern that proving whether an auditor has overstepped his authority as an auditor is difficult to do. He strengthens this point with the comment that support from the supervisory board to solve whether or not the auditor was involved at an inadmissible level in the creation of the annual financial statement cannot be expected. According to Munoz, whether the tool of functional responsibility is really applicable for balancing auditing and consultancy services with an effective assurance of independency is also dependant on how the jurisdiction will in future apply the blanket clause of the § 319 (2) of the German Commercial Code (HGB). According to this, an auditor should be excluded if there are objective reasons, especially those of business, financial or personal nature, that raise cause for concern of independency. For determining whether there is a case for a conflict of interest, it will always have to be reviewed on a case-by-case basis. Thereby the legislator has passed a part of its responsibility over to the courts. Munoz assumes that also in future one will have to rely, on the one hand, on the fact that the named company board members act pursuant to § 318 (3) sentence 1 of the German Commercial Code (HGB) will become involved as soon as they become aware of reasons that could support a concern that the auditor has a conflict of interest. And on the other hand one must place trust in the honesty of the auditor. Munoz views the fact that several leading auditing firms have stopped their association with law firms in Germany as giving reason for hope – assuming that this is done not just to keep up appearances (cf. Munoz, 2008, p. 30 ff).

At the end of the day, the legislator's chosen solution in relation to the independency of the auditor appears to be unsatisfactory. Likewise the decision to only

have an internal rotation appears unsatisfactory. A compulsory exchange of the complete auditing firm and not just of an individual auditing team could not only help to stop organisational blindness and interrelations between auditors and the company's management team but could also help to avoid this from even occurring. The argumentation that an auditor requires a two-year period to be fully up to speed can be counteracted that exactly this period of adjustment provides the opportunity for a new, neutral view of the company.

One concluding criticism is that the auditor cannot properly fulfil his required advisory and warning function as his rights to scrutinize company activity and to obtain information are really quite limited. In relation to this point, Budde and Steuber have demanded that auditors should be given all the rights necessary in order to provide them with the ability to access all required information and to dig into the realms of the supervisory board members (cf. Budde/Steuber in Wollmert et al., 2003, p. 142).

### 3.5 MONITORING THE LEGALITY OF SPECIFIC COMPANY ACCOUNTING BY AN INDEPENDENT SOURCE (“ENFORCEMENT”)

Business asymmetries and corporate collapses, errors in the accounts of large, multi-national corporations and accounting fraud have led the European Commission to make the future strategic approach to accounting a subject of discussion. This happened already on 13 June 2000 with a communication to the Council and to the European Parliament. Whilst other industrial nations have had institutions responsible for the monitoring of reporting of information of listed companies in place for many years<sup>98</sup>, Germany lacks such controlling institutions. The German system for enforcing the accounting regulations has been primarily the audit by the independent auditor and the Supervisory Board. The need to improve the German enforcement system is indisputable and well known in public discussions and in particular by all parties with a vested interest in company accounting; the specific implementation, however, was controversially discussed. Nevertheless there was overwhelming consensus regarding the fact that external financial reporting within the context of corporate governance plays a very important role for a functioning and efficient capital market. This was declared as indispensable for the international competitiveness of the German capital market. Whilst there was agreement over the need for a German enforcement institution, views differed notably on questions whether such institutions should be established on a national or European level and whether they should be privately or publicly organised (cf. Naumann/Tielmann in Wollmert et al., 2003, p. 161; Vater, 2004, p.3). These questions were answered on 15 December 2004 with the German Federal Parliament passing the bill on the German Law on Financial Reporting Compliance (BilKoG) which came into force on 1 July 2005 (BGBl Volume 2004 Part I No. 69, Page 3408 ff). This act introduced a two-stage enforcement procedure, in the first stage organized under private law and by the Federal Ministry of Justice and in agreement with the Federal Ministry of Finance recognized German Financial Reporting Enforcement Panel (DPR or FREP) applying §§ 342b – 342e

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<sup>98</sup> The Security and Exchange Commission (SEC) in the United States of America, the Commission Nazionale de le Societa e la Borsa in Italy as well as the Autorité des Marchés Financiers in France are completely organized by the state. The Financial Reporting Review Panel in Great Britain is a privately organised institution (cf. Hofmann, 2008, p. 323).

of the German Commercial Code (HGB) comes into play. In the second stage the German Financial Supervisory Authority (BaFin) acts pursuant to §§ 37a – 37u of the German Securities Trading Act (WpHG) which has sovereign rights. The process is structured in such a way that in the first phase of enforcement most cases are taken care of and closed by the DPR. With this regulation the German legislator has opted for a broad control under private law (cf. Scheffler, 2007, p. 209).

As such, the German Law on Financial Reporting Compliance (BilKoG) complies only in part with the opinion of the work group for external company accounting of the Schalenbach-Association for Business Administration (AKEU) which had proposed a purely official system (cf. AKEU, 2004, p. 329). Reasons for a state solution were amongst other things the extensive rights of information and presentation, a comprehensive sanctioning toolbox, a true enforcement of resolving found and not mutually agreed accounting violations as well as the unlimited acceptance and authority of a state-owned enforcement institution (cf. Peemöller/Hofmann, 2005, p. 231).<sup>99</sup>

The BilKoG implements the requirements of point six of the government's Catalogue of Measures to Strengthen Companies' Integrity and to Protect Investors from 2003 onwards (cf. Maßnahmenkatalog der Bundesregierung zur Stärkung der Unternehmensintegrität und des Anlegerschutzes, 2003, p. 9 f). The goal of this act is to prevent irregularities within the accounts and to renew and strengthen investors trust in the capital market.

### 3.5.1 *The German Financial Reporting Enforcement Panel (DPR/FREP)*

In May 2004, economic organisations such as the Federation of German Industry (BDI), the Bank Association, the Chamber of Public Accountants (WPK) and the German Trade Union Association (DGB) founded an association called the DPR e.V. that was to takeover the sponsorship for the independent inspection authority. By the acknowledgement agreement dated 30 March 2005 this authority was instituted as establishment by the enforcement panel of the German Federal Ministry of Justice (BMJ) pursuant to § 324b of the German Commercial Code (HGB). The association's Nomination Committee selects the (currently 15)

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<sup>99</sup> Further arguments for and also against a State solution can be found in Peemöller/Hofmann, 2005, p. 231.

members of the enforcement panel who are appointed with the agreement of the German Federal Ministry of Justice and the German Federal Ministry of Finance (BMF). The members of the enforcement panel are all full-time personnel and must conduct their jobs in a professional, independent and neutral manner. A prerequisite for this is that they have in-depth knowledge about the capital market with regard to accounting standards. At the head stand the president and vice-president (cf. Scheffler, 2007, p. 209). There is a framework agreement with 9 auditing firms that arranges a fast supply of further professionals on a fee basis when required. In 2008 the number of accredited people was approximately 180 (cf. Hofmann, 2008, p. 326)

The German Financial Reporting Enforcement Panel oversees the legality of the accounting of listed companies<sup>100</sup>. It checks whether the last submitted annual financial statement and management report and the last consolidated financial statements and consolidated management report of a company are in line with legal requirements. The legal requirements also encompass the standard accounting principles and other legally allowed accounting standards. These are, amongst others, the international accounting standards such as the IFRS and the US-GAAP. Rules of procedure as published on the FREP/DPR website regulate its approach. Organisation and execution of the inspection process as well as the required independence and responsibilities of the people part of the inspection process are also regulated here (cf. Scheffler, 2007, p. 210).

The FREP/DPR only audits if the company to be inspected agrees to support the audit. In this case the legal representatives of the company are obliged to provide correct and complete information and to provide the corresponding documentation. If a company refuses to participate, then this is reported by the FREP/DPR to the BaFin. The BaFin can then instigate their own inspection without having to fulfil any further requirements (cf. Hofmann, 2008, p. 326).

An audit is instigated when there is a reason (examination with cause). There is a reason for cause when there are concrete indications for a violation of the accounts. Indications for erroneous accounting that would support an examination with cause could be tips from concerned people, for example, from shareholders or

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100 In 2005 of the over 1200 companies that use the capital markets and were admitted to trading on a German stock exchange approximately 250 companies were also admitted on a foreign stock exchange (cf. Scheffler 2007, p. 210).



creditors but also from third parties or press reports. These kinds of tips, however, have so far only very rarely been submitted to the independent audit body. Most of the examinations with cause undertaken have been based on own research made by the FREP/DPR (cf. Scheffler, 2006, p. 16; Scheffler in Freidank/Altes, 2007, p. 211).

If the reviews of the published annual financial statements show possible violations against accounting standards, the Chamber of Public Accountants informs the enforcement panel. If there are indications for major breaches, the enforcement panel initiates an examination with cause. Normally the examination with cause encompasses only a review of the facts related to the specific issues raised. The enforcement panel, however, can extend the scope of the audit if it finds further indications of accounting standard breaches during its audit (cf. Scheffler, 2006, p. 16; Scheffler in Freidank/Altes, 2007, p. 211).

With regard to the sample checks, the FREP/DPR developed general principles covering the process for the selection of sample checks and implemented these on 5 September 2005 after attaining the approval of the Federal Ministry of Justice and the Federal Ministry of Finance. The goal is to sample audit every company admitted to the stock exchange over a certain period of time. As such, companies listed on the larger stock exchanges DAX, MDAX, TecDAX and SDAX should be audited every four to five years. The remaining capital market orientated companies should be audited every eight to ten years. Companies that were audited must additionally assume that they will be audited again in the following year. The sample check selection consists of a statistical random selection and a risk oriented approach. The enforcement panel selects 15 to 20 per cent of the sample checks based on risk criteria. This aims at capturing current and critical accounting standard problems or also critical company situations without companies showing indications for erroneous accounting. This includes factors such as first time admittance to the stock exchange, critical developments of an industry sector or of a company as well as changes of the business sector in which a company operates or changes to a company's organizational structure. The sample check audit is not a full audit pursuant to § 317 of the German Commercial Code (HGB). Accounting and risk management are not audited. The audit is restricted to the selected fields of concern. The focus is on criteria for success or risky situations that are fundamentally important for the economic situation and business development of the companies involved. In other words, it is about information which is critical for the decision

making of the people being addressed by the accounts (cf. Scheffler, 2006, p. 16; Scheffler in Freidank/Altes, 2007, p. 211 f).

In order to complete the audit, the enforcement panel requests for each examination with cause as well as for each sample audit that the company to be audited sends financial statements or consolidated financial statements together with the management reports as well as the corresponding audit reports of the independent auditor. Hereby the independent auditor's audit reports are the key files used to determine the focus of the audit. Also any interim reports that were published after the reporting date are requested. The audit of the DPR is focused on individual items or end-of-year items as well as selected accounting problems. The focus of the audit is determined autonomously by the auditor in charge of the case. The scope of the individual audit depends on the capacity of the enforcement panel. The capacity of the enforcement panel is determined, on the one hand, by the goal to audit all capital market orientated companies and, on the other hand, by the available budget. The audit of the DPR has to therefore focus on individual key items. As a consequence this means that the scope of the legal annual financial statement audits is significantly wider than the audit through the DPR (cf. Gahlen/Schäfer, 2006, p. 1620). The results of the DPR audits have to be documented in an audit report stating whether the accounts are in line with the applicable accounting standards or whether they are erroneous (§ 342b (5) HGB). Mistakes in the accounts are declared as breaches against the individually applicable legal requirements, accounting standards, binding interpretations or standard accounting principles. The accounts are seen as erroneous if these breaches individually or in their totality are significant. However, mistakes are not only significant if they affect the results or show end-of-year items falsely (cf. Scheffler, 2006, p. 17 f; Scheffler in Freidank/Altes, 2007, p. 212 f). But also when a mistake which does not impact the results, for example, the non-publication of unpleasant information such as the compensation of the Board of Executives, purchase prices in relation to company take-overs or the risk reporting in the management report can influence the economic decision making of the addressees of the accounts and is therefore also a reason for a case of erroneous accounts. Facts which lead to a suspected crime in relation to the accounts of a company are furthermore reported by the DPR to the responsible authorities for further persecution. Facts that suggest that auditors have neglected their professional duties are reported to the Chamber of Public Accountants (§ 342b (8) HGB) (cf. Gahlen/Schäfer, 2006, p. 1621 f). People entrusted

with the audits have to maintain the confidentiality over the company and business secrets as well as the company knowledge attained during the audit (§ 342c HGB). This does not apply when there is an obligation to testify towards investigating authorities relating to tax-related crimes (cf. Scheffler, 2006, p. 18 f; Scheffler in Freidank/Altes, 2007, p. 213 f).

After completing the audit, the DPR informs the company of the results whereby the DPR needs to provide an explanation to the company of the mistakes found by the DPR. Should such a case occur, then the DPR request the audited company's agreement, within a reasonable deadline, to the audit findings. The auditing process is closed with a notice of the president of the DPR to the BaFin. This includes the audit results and in case of erroneous accounts with the information whether the company has agreed to the auditing results (cf. Gahlen/Schäfer, 2006, p. 1620).

If a company agrees with the auditing results, then it is up to the BaFin to decide whether the findings must be published. If the company does not agree with the audit findings, then the BaFin decides whether there is a case of erroneous accounting or not. Erroneous accounting is thus supposed to have sanctions imposed by the company publishing the identified mistakes and the relevant parts of the explanation. In addition, established mistakes can lead to the invalidity of the annual financial statement if they specifically do not fulfill the rules for protecting creditors (§ 256 German Stock Corporation Act) (Scheffler in Freidank/Altes, 2007, p. 214).

Based on the activity reports of the DPR from 2010 and 2011, the following can be summarized: In 2010 the DPR completed 118 audits and in 2011 110 audits. Of these audits, 106 and 90 were sample checks in 2010 and in 2011 respectively. Thereby both years comply with the ground rules of the sample check audit process set by DPR whereby all index listed companies are audited every four to five years and all other capital market orientated companies every eight to ten years. Overall the number of companies that are subject to the German enforcement regulations has reduced by more than thirty per cent between 2005 and 2011. Apart from the sample checks, there were six examinations with cause and fourteen audits conducted upon requests by the BaFin (cf. Activity Report FREP, 2011, p. 3; Activity Report FREP, 2012, p. 3). In 2011 the average error rate was twenty-five per cent and as such on the same level as the last average four years. The error rates are,

as can be expected, significantly higher in the examinations with cause (100 per cent) and the audits upon request (64 per cent) as with the sample check audits (13 per cent). After establishing erroneous accounts, the DPR seeks to speak with the affected company whereby the company is asked if they agree with the findings. The quota of agreements continues to be on a high level with eighty-one per cent in 2011. All cases found with accounting mistakes are forwarded by the DPR to the BaFin, whereby the cases without the affected company's agreement are subject to a second audit conducted by the BaFin themselves (cf. Activity Report FREP, 2012, p. 4 ff).

In 2011 the most frequently found mistakes in the accounts were:

- Mistakes in the details of reports,
- Mistakes in accounting company acquisitions and disposals,
- Mistakes in general information provided in the notes,
- Mistakes with the realization of income,
- Mistakes with the disclosure and details of financial instruments and
- Mistakes with the cash flow statement.

The reasons for the mistakes were, on the one hand, insufficient disclosures in the management report and notes. Here it was mainly the case of wrongly portrayed potential effects of the financial and economic crisis on the company. On the other hand, the reasons for mistakes were the immense scope and the difficulties with applying the IFRS accounting principles to the financial statements (cf. Activity Report FREP, 2012, p. 7 f).

Detection of accounting fraud by the DPR: Although the DPR only had a budget of six million euros and was staffed only with a president, vice president and fifteen full-time auditors to complete the auditing procedures for 873 companies in 2011 (cf. BaFin, 2012, p. 230), it was possible to uncover at least two major cases of accounting fraud. The DPR uncovered in the case of the Landesbank Sachsen AG (Sachsen LB) that, in the 2006 financial statement, billions-worth of speculation with US credit papers were incompletely portrayed. In 2007 the Sachsen LB could only be saved through an emergency sale of the bank to the Landesbank Baden-Württemberg. In August 2008, based on investigations by the Federal Criminal Police Office and the Public Prosecutors Office in Leipzig, offices and apartments of five former directors of the bank were searched. After analysis of the confiscated documents, three former directors and three senior managers were charged

in 2011. The defendants were either accused of incorrect portrayal of the annual financial statements and embezzlement, or aiding and abetting. During the investigation, the investigators found settlements of accounts running into hundreds of millions of euros whose origin could not be traced. The amounts between 142.7 million euros and 155.6 million euros were found between 2003 and 2006 in the Deutsche Bundesbank but also as cash reserves or credit balances with central banks and also as receivables from customers. Value adjustments running into hundreds of million euros would have been a disaster. In addition, the Sachsen LB paid performance-based compensation which meant for the three directors premium payments between 68,000 and 142,000 euros in 2003 and 60,000 and 134,000 euros in 2004. The State guaranteed for losses of up to a total of 2.75 billion euros. Up until September 2011 the State transferred approximately 170 million euros to creditors of the Sachsen LB (cf. *Der Spiegel*, 2008, Issue 32; *Der Spiegel*, 2011, Issue 37; *Mitteldeutscher Rundfunk*, 2011a, *Mitteldeutscher Rundfunk*, 2011b; internet resources).

In 2008 the DPR discovered that the reputable auditing firm Pricewaterhouse Cooper (pwc) had signed-off the 2006 annual financial report of the Sachsen LB which had to be sold under distress and in which the risks of the speculation with US credit instruments worth billions of euros were incompletely portrayed. Investigations into this company were also initiated (cf. *Der Spiegel*, 2008, Issue 32; internet resources).

The second large case of accounting fraud was uncovered by the DPR in 2007. This involved the Tec-Dax listed Hamburg-based "Conergy" company dealing in photovoltaic systems. Until October 2007, the company Conergy was viewed as a prospering showpiece company on the capital market. But on 25 October 2007 the former Board of Directors unexpectedly issued a profit warning based on delays in delivery of solar modules which could lead to substantial losses in sales for the third quarter. After this disastrous notification, the share price of Conergy suddenly collapsed. As recently as March 2007, the former Board of Directors had sold substantial company share packages and had made tens of millions of euros. In 2007, BaFin requested the DPR to include Conergy in its auditing processes. The DPR found that Conergy had in multiple cases breached accounting standards in 2006 and 2007 so they could show higher results. These findings were passed on to the Public Prosecutor of Hamburg. Investigations into the company were initiated

and in 2009 24 offices and apartments were searched and evidence collected. In 2011 the Hamburg prosecutor's office brought charges against six former board members of Conergy for suspected market manipulation, accounting fraud as well as forbidden insider trading. It was suspected that there was a deliberate case of manipulation of the accounts as otherwise the company would have had to announce a loss of two million euros. The former supervisory board had confirmed the financial accounts; as well as the auditing firm who had issued an unqualified audit report. The Public Prosecutor's office initiated an investigation into the auditing firm (cf. Spiegel Online, 2011; Der Westen, 2011; Rotter Rechtsanwälte, 2010; internet resources).

As there have been no rulings in either case, these examples should merely highlight the fact that the enforcement establishment DPR is able to find mistakes in the accounts and has thereby proven its worthiness.

### 3.5.2 *The Federal Financial Supervisory Authority (BaFin)*

The BaFin requests the DPR to instigate an audit if they have substantial indications that there has been a breach of accounting rules (§ 37p (2) Securities Trading Act). The BaFin as such only gets active if

- (1) The company refuses to participate in the audit by the DPR (§ 37p (1) number 1 Securities Trading Act)
- (2) The audited company does not agree with the auditing results presented by the DPR (§ 37p (1) number 1 Securities Trading Act)
- (3) There are serious doubts about the correctness of the DPR audit results or about the conformity of the audit conducted by the DPR (§ 37p (1) number 2 Securities Trading Act).

If both DPR and BaFin conclude that the accounts are faulty, then the BaFin asks the affected company if there are serious grounds that would justify why, on an exceptional basis, one should not publicize the errors found (§ 37q (2) sentence 3 Trading Securities Act).

Forgoing publication of faulty accounts based on the justified interest of the company affected should be an exception. The clear goal of the enforcement-procedure is to strengthen the trust of the investors in the capital market. For this reason the interests of the investors and of the capital market should weigh more heavily

than the interests of affected companies (cf. Gahlen/Schäfer, 2006, p. 1621).

Should there be a case of no forgoing publication of the errors found, then the BaFin requests the company to promptly publish the mistakes found as well as all substantial parts of the reasoning in the electronic Federal Gazette as well as in either a multiregional stock exchange gazette or an electronic data dissemination system. If the audits conducted by the BaFin show no grounds for objection, then it informs the affected company of its findings (cf. Scheffler, 2006, p. 19). In 2010 the BaFin completed a total of thirty audits, whereby in twenty-four cases they found mistakes and ordered a subsequent injunction to publish the mistakes found: Therefore, the BaFin ordered all companies with errors found to publically disclose these errors. Also there were fewer cases than in previous years when companies presented reasons against a publication of the errors found. In only one case did the BaFin have to enforce the correct publication of the errors through administrative enforcement. A faster process of publicizing errors found was supported by the ruling of the higher regional court Frankfurt am Main (OLG Frankfurt, 31.08.2010 – WpÜG 3/10) whereby the publication of the errors was ruled as part of the next step in the process of finding errors and downplaying, relativizing or even inaccurate additions or making comments relating to the error publications is not in the interest of the information requirements of the capital markets and is therefore forbidden. Already in 2009 the higher regional court Frankfurt am Main (OLG Frankfurt, 22.01.2009 - WpÜG 1/08, WpÜG 3/08) had noted that the publication of the errors found was the main element of assertion in the enforcement process (cf. Federal Financial Supervisory Authority (BaFin), 2011, p. 228 ff).

In a case where a publication of errors is requested by order of the BaFin, then this has various possible consequences (cf. Gahlen/Schäfer, 2006, p. 1622 f):

- Through the disclosure in different media a wider public is informed about the fact that a certain company has significant errors in its annual financial statement. Thereby the company is proverbially in the pillory. The people addressed and people participating in the capital market can now decide if, in their view, the uncovered mistakes are essential and if it is therefore worth imposing sanctions.
- One can assume a preventative effect on other companies. The quality of the annual financial statements of companies listed on the capital markets is very likely to improve as the companies will try to avoid negative public perception

through the publication of mistakes found in its accounts.

- Ultimately, after a publication of found errors is made it is, however, up to the participants of the capital market to decide if and how they will impose sanctions on the affected company. The DPR and BaFin have no further means to influence the company once they have ordered and enforced the publication of the errors found. Should potential investors find that the mistakes made by the company are worthy of imposing sanctions, then they can react by refusing to buy the shares of the affected company. If many investors react in the same way, then this can lead to share prices falling which in turn can also impact the income of executive and supervisory boards especially those parts of the salary which are stock-performance related.
- Separate financial statements with substantial mistakes can be null and void pursuant to § 256 of the Stock Corporation Act. This only applies, however, for separate financial statements pursuant to the German Commercial Code (HGB) and not for consolidated financial statements. Published error reports if they affect a separate financial statement pursuant to the German Commercial Code (HGB) can lead to shareholders raising an action for annulment. Reasons for an action for annulment can be mistakes in the valuation of positions in the affected separate financial statement or the infringement of creditor safeguards or a breach against regulations over the structure of the annual financial statement.
- In the Annual General Meeting the executives or individual members can be refused the ratification of actions based on the found errors in the accounts. This does not have any direct legal consequences but can under circumstances lead to the career end of one or more affected board members or damage their reputation. Also the Supervisory Board must answer to the shareholders in the Annual General Meeting. The Annual General Meeting appoints and dismisses the Supervisory Board. If the majority finds that the Supervisory Board should have noticed the uncovered errors as part of its auditing activity then the voting capital (shareholders) can refuse to ratify the Supervisory Board or individual members of the Supervisory Board and thereby enforce the disqualification of a member for the upcoming reelection. The independent auditor is also appointed at the Annual General Meeting. Also here the Annual General Meeting can impose sanctions upon the work of the current auditor by appointing a different independent auditor.



## 3.5.3

*An Evaluation of the German Enforcement System*

The role of the German enforcement system pursuant to § 342b (2) of the German Commercial Code (HGB) is to audit the annual financial statements and management reports and the consolidated financial statements and management reports of companies listed on the capital markets. All these accounts were already audited by independent auditors pursuant to §§ 316ff of the German Commercial Code (HGB). DPR and BaFin should neither replace these legally required independent audits nor repeat them. Rather the enforcement process was established to look into selected audit areas or individual accounting questions. As such, the enforcement process should help through its preventive effect to secure and strengthen the independent audits. The preventive character is created by the fact that not only based on concrete evidence for a breach against accounting standards or upon request by the Federal Financial Supervisory Authority (BaFin) audits are made but also randomly selected without any due reason (cf. Borcherding/Kleen in Freidank, 2005, p. 174). The question rises whether there is even a sufficient probability of detecting mistakes through the enforcement process. Here it would appear that it is of great importance that the DPR and BaFin are put in a position where they can gain knowledge over irregularities and breaches. As soon as the BaFin or the DPR see first signs of conspicuities, they should start the process of gathering further targeted information about the company, the management and the market environment. Audits based on due reason are always preferable to randomly selected audits without due reason as the probability of detecting mistakes is much higher. Random audits have more of a proactive nature as the probability of detecting faulty accounts is fairly low. The DPR has restricted headcount and financial resources. Apart from the available resources, the probability of detecting mistakes or irregularities is influenced by the applied selection procedure. If a company is subjected to a random audit, then it is possible that under certain circumstances the company is subjected to a further audit in the following year. As such, there is a risk for all capital market orientated companies to be audited again in the following year to ensure that the preventive effect of the possibility of being audited is maintained (cf. Hofmann, 2008, p. 340 f; Baetge/Thiele/Matena, 2004, p. 212 f).

The probability of detecting accounting manipulations is not just dependent on the amount of cases analysed but also by the intensity in which each individual

financial statement is investigated. As the annual financial statements are only posted to the DPR for analysis and the DPR does not get actively involved on site, it can only ascertain whether the documents provided are complete and do not contradict each other. But it can only complete a very limited analysis on whether the real facts have been appropriately portrayed. Wilful and grossly negligent incorrect balance sheets can hardly be recognised. Accounting fraud which the independent auditor was not able to discover will not be detectable by the DPR or the BaFin as the accounting documents submitted show, especially in these cases, no clues for violations. If the DPR wants to detect such fraudulent accounting practices, then it needs to distance itself from the superficial reviews of the documentation and invest more in an in-depth audit of the company whereby additional company internal documents are needed. In order to make the most use of the capacity of the enforcement team, the audit scope must be limited in lieu of the audit depth. Here it seems appropriate that the DPR limits its proactive audits to a very closely defined audit scope which is defined internally and which changes each year. In addition, the employees of the DPR should be able to complete a business analysis and have extensive knowledge of management and financial accounting. One can assume that proactive audits have a preventative effect but this effect should not be overemphasized. Accounting manipulations will only rarely be detected by the enforcement team (cf. Baetge/Thiele/Matena, 2004, p. 213 f).

In order to deter or prevent perpetrators from undertaking accounting manipulations, the DPR would have to be able to implement sanctions against the companies. This is, however, not given and only the BaFin has limited abilities to sanction by informing the public of the accounting irregularities discovered. Further possibilities to influence the situation are, however, not provided. At this point one must ask the question if this is enough to “deter black sheep” or if it would not be more appropriate to introduce harsher penalties?<sup>101</sup> Finally, the enforcement establishment and its employees should also be independent. Financial independency is achieved by distributing the costs of the accounting controls pursuant to § 17d of the law of supervision of financial service. Pursuant to the stipulations in § 17d (1) sentence 1 and (4) of the law of supervision of financial service, the apportioning

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101 This was a question raised by Gerke to the BaFin President Sanio on the German Business Management Day in 2005, cited by Hofmann, 2008, p. 342.

of the costs of the Federal Institute and the Audit Authority are only the expenses incurred by the Federal Institute and the Audit Authority for a fiscal year. The allocated amount pursuant to § 3 of the law of supervision of financial service is the portion of apportionable costs that a contribution-liable company has to make. It is calculated based on § 6 of the law of supervision of financial service on the amount of all accrued inland stock exchange turnover of securities of a contribution-liable company in a fiscal year and is pursuant to § 7 of the law of supervision of financial service between a minimum of 250 euros and a maximum of 40,000 euros. The personal independency of members of the enforcement establishment is to be guaranteed through § 342b of the German Commercial Code (HGB).

Hofmann views the DPR with an annual budget of 5 million euros (2008) as facing a Herculean task. He points out that, according to the 2005 annual statement, only the auditing fees of the independent auditors of Daimler Chrysler AG alone amounted to 42 million euros and that of the E.ON AG to 26 million euros (cf. Hofmann, 2008, p. 343). Also with an annual budget of 7.8 million euros (2011) for the two stage enforcement – 6 million euros of which was for the DPR – the enforcement panel is faced with a huge task to generate appropriate auditing quality and intensity. That the DPR can partly carry-out this task successfully can be seen in the cases where it was able to detect irregularities of the accounts and accounting fraud.

However, the point raised by Baetge, Thiele and Matena is not unfounded that there is only a limited possibility to assess if real facts are appropriately shown in the accounts if one can only access the documents provided by the companies. In such cases it is hardly possible to detect wilful or grossly negligent inaccuracies of the accounts. But especially wilful breaches of accounting principles that were not found by the independent auditor will not be found by the enforcement panel as the accounts especially in these cases did not include any indications of the breach of law (cf. Baetge/Thiele/Matena, 2004, p. 213).

Nevertheless, all in all one must agree with Hofmann when he states that the German creation of the enforcement establishment is a step in the right direction as securing the correctness of reliable accounting is not only in the hands of the supervisory board and independent auditor. One must also agree with his point that it will take years to build up the reputation of the German enforcement establishment (cf. Hofmann, 2008, p. 343). Hereby one should note though that the detection

of the cases Sachsen LB and Conergy has already helped significantly.

Finally, one should note two complementary aspects. They highlight what the directional development is of the enforcement system in Germany as well as on a European level.

Since November 2009 companies have the option to provide the DPR in written form with individual pre-clearance requests in relation to specific accounting problems. The questions must relate to a given, clearly defined matter and must be provided in written form. In addition, the company must provide their own proposal on how to resolve the issue and add the view of the independent auditor to this specific question. On behalf of the companies, the option of pre-clearance is, however, only sparsely used. In 2010 there were 6 cases of specific pre-clearance requests to the DPR, whereas in 2011 there was just one (cf. Activity Report FREP, 2011, p. 11; Activity Report FREP, 2012, p. 12).

Based upon the European financial market reforms, some changes were made effective 1 January 2011 to the enforcement of accounts. The European Securities and Markets Authority (ESMA) replaced the Committee of European Regulators (CESR) which was active on a consultant basis and responsible for the coordination of the enforcement of accounts in the European Union as the European Securities and Markets Authority. It was also given additional rights. The role of the ESMA is to develop binding technical standards for the preparation and delivery of the enforcement audits which are to replace the previous non-binding CESR standards (cf. Activity Report FREP, 2011, p. 13; Activity Report FREP, 2012, p. 13). A potential problem could be the aforementioned fact that strongly differing enforcement structures across Europe exist. In Italy and France, for example, there is an exclusive state solution, in Germany a combined privately-owned and state institution and in Great Britain an exclusively privately-owned system. The different systems are subject to national law that lead to different processes and requirements of the control of financial statements. In order to achieve a greater European convergence also in this case, a working group was formed which includes also the DPR and the BaFin (cf. Activity Report FREP, 2011, p. 13). One should take note that in Great Britain the experience of the Financial Reporting Review Panel (FRRP) has shown that in over eighty per cent of all cases mistakes were able to be corrected by mutual agreement. The strategy pursued is to find a formal balance that counters any potential tensions between the auditing institution and the company in question.

This is to nurture the willingness to cooperate during and especially after the audit has been conducted to correct the mistakes found by the auditing institution (cf. Hommelhoff/Mattheus, 2004, p. 94). This approach only works if the accounting errors and manipulations did not occur deliberately. Companies who deliberately manipulate numbers can be expected to undertake every possible action to ensure that its acts are not uncovered. One cannot assume that they will really work with the DPR in the required way. They might pretend to be collaborating but not contribute towards anything that might uncover their manipulations.

### 3.6 ELECTRONIC PUBLICATION OF A COMPANY'S ACCOUNTS

Prior to 1 January 2007, many companies in Germany did not adequately fulfil the required publication requirements. According to statistical data less than five per cent of the companies required to declare their annual financial statements regularly fulfilled their declaration obligations pursuant to § 325 of the German Commercial Code. The reason for this behaviour was seen mainly in the fact that non-compliance led to a mere sanctioning of the body authorised to represent a limited shares company<sup>102</sup> (managers of a private limited company (GmbH), executive boards of a corporation) in form of a fine that in line with § 335 sentence 8 of the German Commercial Code was not allowed to exceed 10,000 Deutsche Mark (cf. Weyand, 2007, p. 935; Hofmann, 2008, p. 343). The registry court, however, only intervened up until 2000 if a member or creditor of a company and the central works council, or if they did not exist, then the works council of the corporation requested this (§ 335 sentence 2 of the German Commercial Code). In 2000 the law pertaining to limited liability partnerships (KapCoRiLiG) decided when the registry court, upon request, had to intervene. Ebenroth, Boujong and Joost explain in their comments on the German Commercial Code that in this way the very restricted target population that could potentially raise an application was annulled; this means everyone is now permitted to raise applications (cf. Ebenroth/Boujong/Joost, 2001, § 335a, Rn. 1). The process of penalty payments was changed to a process of administrative fines. In line with § 335 (a) of the German Commercial Code executive board members and managers of a corporation are liable to pay an administrative fine if they do not meet their obligation to publically declare the annual financial statement, the management report, the corporate financial statement, the corporate management report and other documents pertaining to the accounts in line with § 325 of the German Commercial Code. The administrative fine was set at a minimum 2,500 euros and as a maximum 25,000 euros (§ 335 (a) sentence 4 of the German Commercial Code). Schmittmann stresses that the key is that the administrative fines are not imposed against the corporation but

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102 The person to whom the penalty payment process applies is always a natural person and not a legal person. In accordance with § 335 sentence 1 of the German Commercial Code the circle of addressees is specifically limited to the members of the representative organs (executive board and management members) of the respective corporation (cf. Glanegger et al., 1999, p. 838).

personally against a member of management. The executive board or management member affected is, therefore, personally liable to pay the fine (cf. Schmittmann, 2004, p. 1064). One should also take note of the fact that the registry court only takes action upon receipt of a corresponding application, which can now be made by everyone (§ 335 (a) sentence 3 HGB). The legal changes made up to that time did not, however, lead to a significant increase in the publication quota (cf. Hofmann, 2008, p. 343). The German legislator had to react as other European countries – for example Great Britain – already had a long standing tradition of extensive obligations in regard to the electronic publication in business registers (cf. Weyand, 2007, p. 935). On 1 January 2007 the German Act on Electronic Commercial and Co-operative Registers and the Company Register (EHUG) came into force. This law enabled worldwide electronic access to all key corporate information. It led to three significant changes in Germany:

1. The changeover to an electronically operating system of the companies, cooperatives and partnerships registers.
2. Accounting information is now not published in the Commercial Register but in the electronic federal gazette.
3. The creation of a business register.

Of significant importance for everyday application is that in future it will no longer be possible, without repercussions, to ignore the legal obligation to publish. In the following section, the key changes of the law will be reviewed with the goal of highlighting its impact on practical appliance (cf. Hofmann, 2008, p. 343 f; cf. see also Meyding/ Bödeker, 2006, p. 1009; Schlotter, 2007, p. 1).

With the EHUG coming into force, commercial registers must be published electronically. For some time there were even discussions about having the Chambers of Commerce and Industry manage the commercial register due to their allegedly better efficiency. But in the end this shift appeared not to be a real alternative compared to the registers managed by the courts so that the responsibility stayed with the local courts. Documents can only be submitted to the commercial register in an electronic format. As applications to register still require an official certification, notaries must convert the documents that are to be submitted into files with an electronic signature so that it can then be submitted to the court. One can still inspect the Commercial Register free of charge at the office of the register court in charge or via the homepage ([www.handelsregister.de](http://www.handelsregister.de)). Entries are

publicized only in electronic and not in paper form any more (cf. Hofmann, 2008, p. 344 f).

The annual financial statement and consolidated financial statements, management report and other accounting documents that are subject to disclosure are not any more submitted to the Commercial Register but are electronically passed on to the German Federal Gazette. Companies which are required to publically disclose are mainly limited liability companies and commercial partnerships without a natural person as personally liable shareholder (such as, for example, German limited commercial partnership consisting of a general partner and a limited partner (GmbH & Co KG)). The need to publically disclose, though, is also dependent on the size of the company (§§ 326, 327 HGB). Small companies pursuant to § 326 of the German Commercial Code must only submit a condensed balance sheet and the notes and not the profit and loss account. Medium sized companies are obliged to publicize the annual financial statement (balance sheet, profit and loss account, notes), the management report and the independent auditor's certificate. However, there are also size-related simplifications possible for medium sized companies pursuant to § 327 of the German Commercial Code. When the BilMoG came into effect in 2009 the thresholds were significantly increased so that from that point onwards many more companies were able to profit from the simplified rules (cf. Schlauß, 2010, p. 153; Buchheim, 2010, p. 1135).

These simplifications are not extensive enough according to many small and medium-sized companies (SMEs). For example, Andres together with a group of equally minded calls for "an appeal for fact oriented corporate publicity"<sup>103</sup> (translated in context by the author) and is requesting the European parliament to approve a new size regulation for micro-enterprises that would then allow member states to decide whether to relieve these types of companies from the regulations of the fourth European Union guideline and thereby in Germany from the §§ 264-288 of the German Commercial Code. Micro-enterprises are defined as such companies that do not exceed the following criteria on two consecutive balance sheet dates (cf. Andres, 2011, p. 1; Buchheim, 2010, p. 1135):

- An annual turnover of 1 million euros
- A balance sheet total of 500,000 euros
- An average annual number of 10 employees.

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103 „Apell für eine sachorientierte Unternehmenspublizität“



Furthermore, they are requesting the EU Parliament, the parliaments of member states as well as the German federal parliament to review further measures to relieve the burden of regulation for SMEs and to, where applicable, expedite its implementation. They demand that the way in which the duty to publicize is applied, since the introduction of the EHUG in Germany, urgently requires overhauling. This can be seen, amongst other facts, by (cf. Andres, 2011, p. 1):

- the concentration of proceedings on one Federal Authority and one court being responsible throughout Germany has led to mass processing in lieu of doing justice for each individual case,
- the lack of legal hardship provision,
- the legal provision for fines is based on continuous case-law interpreted (wrongly) as a fine with a fixed lower limit,
- the need to publicize twice now that the EHUG has been introduced leads to disproportionate additional costs,
- the free of charge and anonymous access – also for commercial purposes – provides an unjustified benefit for third parties at the expense of companies which are obliged to disclose their financial statements,
- driven by the EHUG publicity, SMEs suffer an unjustifiable competitive disadvantage compared to large companies which are better equipped to handle competitive battles.

In response to Andres' request, Buchheim notes critically that the real effect of workload reduction is not real for the majority of German micro-enterprises which must anyway prepare, next to the normal "standard balance sheet", an annual financial statement for tax purposes and to secure loans with banks and savings banks. Also lots of regulations of the company and insolvency law such as, for example, dividend provisions are affixed to the annual financial statements prepared in according to the German Commercial Code. Even if the fourth EU guideline is amended by the EU parliament, one must wait and see whether the German legislator will codify this exception regulation for micro-enterprises in German law (cf. Buchheim, 2010, p. 1135). Bräuer also takes a critical stance towards the requests raised by Andres. In his opinion the informational needs of current and potential creditors is also great for small companies and is more important than the interests of micro-enterprises to, if possible, not publish their annual financial statement information. Even if microenterprises state that the proportionality based on the high costs is not given, the European Commission assumes that

there is only a net savings potential of 1169 euros for each individual company. Bräuer substantiates his point of view with the amount of people who have access to the electronic Federal Gazette. In 2010 there were 2.6 million monthly accesses to the electronic Federal Gazette of which 2.1 million were to the financial reporting site. Over eighty per cent of these accesses were on small companies. Therefore, the interest with regard to information about small companies appears to be large and, even if not all requests are from potential creditors of the companies being accessed, one can say that the right for freedom of information for all should outweigh the interests of the few who do not want to share information (cf. Bräuer, 2011, p. 54, 56).

Thiele and Nitsche advocate that at least small private companies should be able to avoid altogether the obligation to publish. In their view, there is no large public interest in the annual financial statements of these types of companies so that an abolition of the duty to disclose would be a useful act of deregulation which, however, does require a legal agreement at European level (cf. Theile/Nitsche, 2006, p. 1151).

Especially for companies with a small group of partners, Brete sees considerable disadvantages as competing companies can gain access to company data. And since the annual financial statement is compiled for company management and, in addition, normally only for shareholders and company creditors, electronic publication is not required. The meaning of the annual financial statement is limited to its informational function for the company's creditors with regard to the protection of creditors as well as the fact that there must always be sufficient equity capital available (cf. Brete, 2009, p. 617 f). The protection for creditors which Brete defines as ensuring that repayment and interest is paid to the creditors is already covered by the legislator by multiple creditor protection regulations within and outside of accounting law. As such, German accounting law is characterised by the principles of prudence, realisation and imparity that should, amongst other things, stop the disclosure and distribution of unrealised profits to the shareholders. In addition, there are extensive protective regulations for creditors to safeguard credits such as guarantees, land charges, mortgages and retentions of title. In case of insolvency, they have rights of segregation and separation, the right of preferential claims as well as the legal mechanisms of challenging insolvency proceedings. Company employees are entitled to financial compensation for lost wages as well as, if

necessary, to raise claims on the pension insurance association. The provision for the protection of creditors also include rules on criminal matters that are governed by trade law (§§ 396 ff of the German Stock Corporation Act) as well as criminal law (§§ 283 ff German Code of Penal Procedure). Brete concludes that disclosure does not promote creditor protection as the disclosure itself does not actually protect a creditor from losses of receivables (cf. Brete, 2009, p. 620 f). In his view one must ensure that a company's share capital is turned into a real liability fund. The alternative to disclosure, according to Brete, is the obligation to pay the primary deposit or at least an appropriate part of it on to a separate account which is not accessible to the company and company shareholders. He compares his proposal to the obligation of a lessor to invest the tenancy security deposit to bear interest (cf. Brete, 2009, p. 623).

The way in which the documents are submitted must be in an electronic format such as, for example, via email with attachments in standard data formats. This can be done via the service platform of the electronic Federal Gazette under <https://publikations-plattform.de>. The submitted financial information is then published under [www.ebundesanzeiger.de](http://www.ebundesanzeiger.de) and can be accessed by everyone free-of-charge and is subsequently passed on to the 2007 newly created business register. The required documents must be submitted to the electronic Federal Gazette within twelve months after the end of a fiscal year. Listed companies pursuant to article 4 (1) of the Transparency Directive must publish their annual financial statement within four months after the end of a fiscal year. As such there is a shortened time limit for submission for these companies (cf. Hofmann, 2008, p. 346, Schlauß, 2010, p. 153, Schlotter, 2007, p. 3, Weyand, 2007, p. 936). Schmittmann points out that it is not sufficient to submit the annual financial statement electronically. It is the responsibility of the company to monitor the actual disclosure which is always possible at any time on the platform [www.unternehmensregister.de](http://www.unternehmensregister.de). If, for example, submitted documents were lost within the remit of the operators of the electronic Federal Gazette, the company is obligated to repeat its disclosure (cf. Schmittmann, 2009, p. 544).

Since the implementation of the EHUG it has not led to any changes to the scope of the rules of disclosure. The transparency requirements remain at their current level. Only for micro-enterprises there is relief for the financial filing and disclosure which has been effective since the Act Amending Accounting Law as

Regards Micro-entities (MicroBilG) came into force in December 2012. Micro-entities according to § 267a of the German Commercial Code are defined by them not being allowed to exceed two of the three following characteristics: After deduction of the declared deficit on the asset side, total assets exceeding 350,000 € are not permitted (§ 267a (1) number 1 of the German Commercial Code (HGB)). In the twelve months leading up to the reporting date companies are not allowed to generate more than 700,000 € sales revenue (§ 267a (1) number 2 of the German Commercial Code (HGB)). Companies are not to employ more than ten employees over the average for the year (§ 267a (1) number 3 of the German Commercial Code (HGB)). With regard to disclosures, micro-entities have the option to fulfil their obligations from § 325 of the German Commercial Code (HGB) pursuant to § 326 (2) of the German Commercial Code (HGB) by submitting their accounts in electronic form with the operators of the electronic Federal Gazette for permanent disclosure and to place with them a disclosure contract. According to § 326 (2) sentence 2 of the German Commercial Code (HGB) they are obliged to inform the operator of the electronic Federal Gazette that they do not exceed the size categories. Following this process, third parties can only gain access to the accounts pursuant to § 9 (6) of the German Commercial Code (HGB) by submitting a request to attain a copy. Schmittmann points out that in regard to disclosure, it is harder for interested competitors who wish to engage in a contractual relationship with the micro-entity to get information on the economic status of the company. Requesting a copy takes much more effort as the previous process of simple accessing [www.unternehmensregister.de](http://www.unternehmensregister.de). Taking into consideration the aspect of transparency, Schmittmann also sees here a reason for being sceptical (cf. Schmittmann, 2013, p. 5).

The legal requirements of the EHUG led to a situation whereby companies that wanted to avoid publication of their company results tried harder to find possibilities to restrict the amount of information requiring disclosure. For example, there is the possibility of relief pursuant to § 264 (3) of the German Commercial Code (HGB) to be relieved of the duty to declare if the corporation is a subsidiary of a parent company that is obliged to declare its consolidated financial statement. There is also the possibility for companies to influence the size categories pursuant to § 267 of the German Commercial Code (HGB) by reducing the total assets, sales revenue and the number of employees through skilful means. There is a further opportunity especially for German limited commercial partnerships consisting of a general partner and a limited partner (GmbH & Co. KGs). Here a

natural person can be placed as general partner along with the GmbH. Thereby the Limited Commercial Partnership (KG) as a partnership is not required to apply §§ 264 ff of the German Commercial Code (HGB). Here one must however take into consideration, for example, that pursuant to §§ 159 ff of the German Commercial Code (HGB) especially when a corporation is dissolved, there are liability dangers with regard to the five year continuing liability of the partner or when the personally liable partner leaves (cf. Deilmann, 2006, p. 2349 ff; Schlotter, 2007, p. 3 f; Hofmann, 2008, p. 348 f; Dietrich, 2010, p. 114).

Dealing with breaches: In § 329 (1) of the German Commercial Code, it is stated that the operator of the electronic Federal Gazette checks whether the documents which are to be submitted are submitted in a timely and complete manner. If the operator concludes that this is not the case, then he is obliged pursuant to § 329 (4) of the German Commercial Code (HGB) to inform the Federal Office of Justice that in turn then officially initiates fine proceedings in accordance with § 335 of the German Commercial Code (HGB). The Federal Office of Justice then issues a written warning to the corporation or to the members of those authorized to represent organs that, if the missing documents are not submitted within six weeks, they are liable to pay at least 2,500 euros up to a maximum of 25,000 euros<sup>104</sup>. Thereby it has the free choice of deciding whether to initiate steps against the company or organ separately or to take action against both. If the documents are then submitted within the given time-frame, the company only has to pay 50 euros for the procedural costs. If the documents are not submitted then the amount of the fine is determined and a new warning with a further fine is issued. By this process of cumulating fines, there should be no final way of buying oneself free from the obligation to disclose (cf. Weyand, 2007, p. 936 f; Schmittmann, 2008, p. 692; Henselmann/Kaya, 2009, p. 498; Buchheim, 2010, p. 1134; Lüdenbach, 2010, p. 468; Dietrich, 2010, p. 113).

As such, for example, the Federal Office of Justice initiated 460,000 fine proceedings for the fiscal year 2006. In 2009 for the fiscal year 2007 it was only approximately 120,000 fine proceedings and in 2010 for the fiscal year 2008 it was 144,000 fine proceedings. Approximately fifty per cent of the companies affected in the

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104 Lüdenbach speaks here of a maximum amount of 50.000 euros (cf. Lüdenbach, 2010, p. 468); as he thereby refers to § 335 of the German Commercial Code (HGB) this could be an error.

fiscal year 2006 submitted the required documents within the given six-week time limit; in 2007 it was forty-five per cent. The amount of appeals went down from 105,000 in the fiscal year 2006 to less than 15,000 in the fiscal year 2007. The sharp decline in appeals can be accounted to the fact that the regional court in Bonn – since mid-2008 with several new chambers for Commercial Affairs – made over 15,000 decisions regarding complaints against the fines issued (cf. Buchheim, 2010, p. 1134; cf. hereto also Schlauß, 2010, p. 154 f; Schlauß, 2011, p. 805). So, for example, a financially difficult company situation, referring to the delinquency of the tax consultant, lack of liquidity, waiting for the results of the audit, insufficient staffing or knowledge of the accounting department or the seizure of accounting documentation by the Public Prosecutor are not seen as reasons for raising an objection against the threat of being fined (cf. Schmittmann, 2009, p. 543; Lüdenbach, 2010, p. 469). From a content point of view nearly all normal objections have court rulings which only in rare cases were ruled in favour of the party raising the objection. The concentration of jurisdiction at the regional court in Bonn leads to noticeable uniform judicature (cf. Buchheim, 2010, p. 1134; cf. hereto also Schlauß, 2010, p. 154 f; Schlauß, 2011, p. 805).

From a constitutional point of view, this way of proceeding has also proved its worth. The Federal Constitutional Court took several decisions on constitutional complaints against fine proceedings of the Federal Office of Justice and referring to § 335 of the German Commercial Code (HGB) did not accept the complaints for adjudication. It clarified that there are no constitutional objections to the § 325 of the German Commercial Code (HGB) or to the sanctioning proceedings (cf. Schlauß, 2011, p. 805).

Concerning the culture of disclosure, one can note that in 2007 only 450,000 companies disclosed their accounts for 2006. Here one could still see the wait-and-see attitude of many companies who hoped that the new fine proceedings would not work properly. In the meantime, for the financial year 2006 over 940,000 companies have fulfilled their obligation to declare. For the financial year 2008, the number of declared accounts exceeded the one million mark for the first time so that in the meantime approximately one million annual financial statements have been disclosed. As such, the level of publicity is at over ninety per cent. Every year the high level of publicity is achieved earlier so that the initial reluctance to declare also by smaller companies is increasingly giving way to an automated routine of

annual disclosure (cf. Schlauß, 2010, p. 153 f; Schlauß, 2011, p. 805 f).

The third improvement of the EHUG was the creation of a central electronic Business Register. Here all company data should be bundled in one central place and be made available to everyone through online access. People seeking information do not need to collect key company data from a variety of sources but can call-up the required, bundled information via the website [www.unternehmensregister.de](http://www.unternehmensregister.de). Pursuant to § 8b (2) of the German Commercial Code (HGB) the following data can be accessed:

- Entries in the Commercial Register, the Cooperative Register and the Partner Register
- Documents of the accounts pursuant to § 325 of the German Commercial Code (HGB)
- Pursuant to § 127a of the German Stock Corporation Act the published entries in the shareholder's forum
- Ad-hoc announcements and announcements regarding the changes in shareholdings
- Company law announcements in the electronic Federal Gazette (especially those pursuant to the law governing limited liability companies and those pursuant to the German Stock Corporation Act)
- Announcements, pursuant to capital market law publications, made to the BaFin (worthwhile mentioning are the announcements according to § 15a of the Securities Trading Act – the so-called “directors dealings”).

Every person who is interested can gain access to the business registers as well as the commercial register. Calling-up data is principally free of charge. It is managed by the Federal Ministry of Justice and the scope of accessible data has increased over the last few years. For example, all financial reports that require disclosure pursuant to §§ 37v ff of the Securities Trading Act must be relayed to the business register. It follows that insight can be gained into the accounting documents of both domestic and foreign issuers via the business register (cf. Schlotter, 2007, p. 5; Hofmann, 2008, p. 346; Schlotter, 2008, p. 124).

Conclusion: Before the EHUG was passed many companies did not, or only after being requested to do so by the registry court, fulfill their obligations to declare. Moreover, such a request was only issued on rare occasions. Apparently companies were afraid that sensitive data could fall into the hands of competitors

or other third parties. In order to protect investors but also in the interest of all stakeholders, transparent information that can be accessed worldwide and at any time by companies is vital (cf. Hofmann, 2008, p. 348).

When the EHUG came into force on 1 January 2007, the existing disclosure requirements were significantly improved. With the information being transferred from the commercial register to the business register a one-point-of-call access for company-related data was created via a uniform portal. Those who want to quickly and effectively inform themselves about German companies via public registers need not travel far but with help of the internet can gain access at any time and place to the information required. The law does not only simplify the work for the law enforcement officers and register courts but is also of great interest for the social economy as a whole. Important information in international as well as local business transactions can be called-up in an affordable and reliable manner in regard to the security of the transaction (cf. Meyding/ Bödeker, 2006, p. 1012). Schmittmann and Böing also point out that a person seeking information must not reveal himself by having to request access with the Commercial Register but can complete researches in comfort via the internet. All this leads one to expect that especially competitors, customers, suppliers, employees and other interested parties can gain access to the annual financial statements (cf. Schmittmann/Böing, 2008, p. 5).

As breaches against the disclosure requirements can be sanctioned since the EHUG came into force, the publication quota with the electronic Federal Gazette has improved in the meantime to over ninety per cent. Before the EHUG was passed less than five per cent of companies required to disclose their documents handed these to the commercial register. If one wants to improve the actual adherence to the deadline in Germany, then one should take a look at Great Britain. Here as early as 1992 sanctioning actions were taken against companies with delayed disclosures so that already in 1994 the disclosure percentage was ninety-five per cent. In Great Britain a fine must be paid after the first day of being late whereby the amount of the fine is clearly below 2,500 euros and is related to the length of delay. The fines are between 150 pounds for a one-month delay and 1,500 pounds for a delay of over six months. If the documents are submitted late again in the subsequent year, the fine doubles (cf. Buchheim, 2010, p. 1141). For an English limited company non-adherence to the disclosure requirements can lead



to forced dissolution and related to this an asset transfer to the English Crown (cf. Schlotter, 2007, p. 5). This comparison is the reason for Buchheim to request improved German administrative offense proceedings that should include a staggered system for minimum fines in line with accounting law size classes as well as extent and frequency of the failure to meet deadlines (cf. Buchheim, 2010, p. 1141).

In summary, it can be emphasized that through the EHUG the public releases of companies has increased significantly. Before 2007 it was less than five per cent and in the meantime it is over ninety per cent. With the possibility of being able to access company data and information everywhere and at any time via the internet, there has been an improvement in the transparency in economic life from which the market can only profit. More than ten thousand hits a day on the portal of the business register is clear evidence of this (cf. Schlauß, 2010, p. 156). If one wants to effectively detect and avoid balance sheet manipulations then newly created transparency through the EHUG is indispensable. Deception and manipulations are naturally easier to detect if the company accounts are given maximum public releases. Maximum transparency is important in stopping perpetrators (cf. Hofmann, 2008, p. 349).

### 3.7 ENHANCING THE PROTECTION OF INVESTORS

The condition for an efficient capital market requires the trust of the market participants. This includes not only professional dealers or speculators on the Futures Exchanges but also private investors. The trust of the wider population in a functioning capital market is especially important when taking into account the important role that it plays nowadays with regard to pension plans (cf. Schröder, 2007, p. 47). In order to improve investor protection, the eighth point of the 10-Point-Program was implemented by the German Federal Government in October 2004. The Investor Protection Improvement Act (AnSVG) from 2004 resulted mainly in significant improvements in the arena of the Securities Trading Act. These alterations had a direct relevance especially for companies listed on the stock exchange and its board members as well as for shareholders. The new law requested amongst other things the introduction of an obligation to publish a prospectus for investment products on the so-called “grey capital market”, changed reporting obligations for all director’s dealing and changed requirements for the monitoring of the prohibition of rate and market price manipulation as well as reorganization of the insider trading legislation and the ad-hoc public release legislation (cf. Hofmann, 2008, p. 349 f).

#### 3.7.1 *Insider Trading Legislation Pursuant to the Investor Protection Improvement Act*

Pursuant to § 12 of the Securities Trading Act insider securities are financial instruments that:

- are firstly admitted to listing on a domestic stock exchange or on a regulated market or on the over-the-counter market,
- are secondly admitted to listing on a regulatory market of another Member State of the European Union or on another signatory state to the European Economic Area Treaty or
- thirdly whose price is directly or indirectly dependent on the financial instruments listed above.

The Investor Protection Improvement Act newly defines the term inside information. In line with this, § 13 of the Securities Trading Act states: “Inside information is any specific information about circumstances which are not public knowledge relating to one or more issuers of insider securities, or to the insider

securities themselves, which, if it became publicly known, would likely have a significant effect on the stock exchange or market price of the insider security. Such a likelihood is deemed to exist if a reasonable investor would take the information into account for investment decisions...<sup>105</sup>([http://www.bafin.de/SharedDocs/Aufsichtsrecht/EN/Gesetz/wphg\\_101119\\_en.html](http://www.bafin.de/SharedDocs/Aufsichtsrecht/EN/Gesetz/wphg_101119_en.html), accessed on 20.12.2013).

The term “circumstances” includes forecasts and value judgments such as statements of opinion, personal views and other subjective evaluations. Through this extension of the meaning of the term inside information, issuers of financial instruments pursuant to § 15 (1) sentence 1 of the securities Trading Act are forced to immediately publish inside information that directly affects them. It can be inferred from this that, based on the Investor Protection Improvement Act, it is principally required to publish data as soon as possible. This obligation for ad-hoc reporting is an important measure against the misuse of inside information (cf. Hofmann, 2008, p. 350 f).

Before the Investor Protection Improvement Act came into force, issuers only had to publish information requiring ad-hoc disclosure. With the Investor Protection Improvement Act this duty was extended to third parties. In § 15 (1) sentence 4 of the Securities Trading Act it is stated that: “Any issuer or person acting on behalf or for the account of an issuer, who as part of his function communicates or grants access to inside information to a third party, must at the same time publish the information... unless the third party is legally obliged to observe confidentiality”<sup>106</sup> (<http://www.bafin.de/SharedDocs/Aufsichtsrecht/EN/Gesetz/>

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105 „Eine Insiderinformation ist eine konkrete Information über nicht öffentlich bekannte Umstände, die sich auf einen oder mehrere Emittenten von Insiderpapieren oder auf Insiderpapiere selbst beziehen und die geeignet sind, im Falle ihres öffentlichen Bekanntwerdens den Börsen- oder Marktpreis der Insiderpapiere erheblich zu beeinflussen. Eine solche Eignung ist gegeben, wenn ein verständiger Anleger die Information bei seiner Anlageentscheidung berücksichtigen würde...“

106 „Wer als Emittent oder als eine Person, die in dessen Auftrag oder auf dessen Rechnung handelt, im Rahmen seiner Befugnis einem anderen Insiderinformationen mitteilt oder zugänglich macht, hat diese gleichzeitig... zu veröffentlichen..., es sei denn, der andere ist rechtlich zur Vertraulichkeit verpflichtet“.

wphg\_101119\_en.html, accessed on 20.12.2013). In this context it relates to cases of not passing on information in a confidential manner as well as the passive disclosure of inside information. Lawyers, financial auditors and tax consultants are basically not bound to the publication obligation if they receive inside information within the realms of their professional duty of confidentiality. Only if they pass this confidential information on to other people or give other people access to this information who are not legally bound to the professional duty of confidentiality, are they obliged to immediately publish the inside information. The logic of this regulation is to prevent advance knowledge from occurring (cf. Rodewald/Tüxen, 2004, p. 2249 f).

In accordance, many companies had to enforce comprehensive control measures in order to avoid the uncontrolled flow of information. The access to inside information is limited to people that need to deal with this sensitive data. For this purpose companies created so-called “Chinese Walls”<sup>107</sup>. In addition, one must ensure proper storage of inside information. This applied not only for proper data security in the offices but also outside the offices. Likewise, one had to create access restrictions within the internal data network. It was equally important to undertake measures to ensure that data was also protected outside the offices. Careless handling of inside information in public places, for example, on the train or on the plane could involuntarily lead to a breach of inside information trading regulations (cf. Rodewald/ Tüxen, 2004, p. 2252).

According to § 15b of the Securities Trading Act issuers of financial instruments and any person acting on the issuer’s behalf are obliged to keep a list of insiders. The people that need to be included in this list are, amongst others, members of

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107 Chinese Walls should enable companies, in context with the compliance measures, to establish boundaries to maintain confidentiality. Based on departmentally different needs of information this should enable departments to have operational differentiation. The Chinese Wall should prevent that information is shared in order to avoid conflicts of interest. The term was coined during the global economic crisis when the US government requested banks to split the investment banking from the securities issuing business. The term Chinese Wall was derived from the actual Chinese Wall (cf. [www.boersennews.de/lexikon/begriff/chinese-wall/1205](http://www.boersennews.de/lexikon/begriff/chinese-wall/1205); <http://wirtschaftslexikon.gabler.de/Archiv/5015/chinese-walls-v8.html>; accessed on 20.05.2013)

the management board and supervisory board, employees of the legal department and of the controller's office as well as employees of staff functions. In addition, the scope of parties obligated to maintain such a list must be determined. Hereto belong people that act in the interest of the issuer or act in other areas for the issuer and come into contact with inside information. These can be, for example, lawyers, consultants, tax consultants, investor relations agencies or also external accountants (cf. BaFin's guide for issuers, 2009, p. 115 f).

These registers must list people that are working for issuing corporations and are working on their behalf or for their accounts and according to regulations have access to inside information. The registers must be kept on a current level and must be sent to the BaFin upon request. The issuers have the duty to instruct the people on the list of their legal duties that evolve from their access to inside information as well as to inform them about the legal consequences in case of breaches (cf. BaFin's guide for issuers, 2009, p. 115 f).

The measure regulating the need to maintain insider lists follows two important objectives. On the one hand, the preventive effect on the people listed, as these must specifically be instructed of the general business related confidentiality obligations. The possible consequences of a violation are explained to them explicitly so that they are sensitized to treat inside information with appropriate care. On the other hand, issuers and other people obliged to maintain lists are able to monitor the flow of inside information and can thereby fulfill their confidentiality obligations. Should there be a concrete case of suspicion, the lists help the BaFin in their investigation as the circle of suspects can be limited with the help of the insider lists (cf. BaFin's guide for issuers, 2009, p. 115 f).

Schröder noticed that maintaining lists of insiders has an effect of the evaluation of problems of intent. Due to the listed people being instructed about their legal duties and through the clarification of the legal consequences in case of breaches it is highly unlikely that a perpetrator could successfully appeal to § 17 of the German Criminal Code by maintaining that it was a case of a mistake regarding prohibition<sup>108</sup> (cf. Schröder, 2007, p. 94).

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108 Pursuant to § 17 of the Criminal Code a case for a prohibition error exists when the perpetrator when committing the crime lacked awareness of doing something wrong. So he agitates without guilt, if he could not avoid this error. In such a case, where the mistake could have been avoided the punishment can be

Hienzsch notes that in very few cases the lists of insiders include everybody who has access to concrete inside information, just as one cannot expect that the registers only name people that knew of the information in question. That is why the BaFin needs to make use of their general right of access to the data which was measurably expanded with the introduction of the Investor Protection Improvement Act (cf. Hienzsch, 2006, p. 68).

Listed companies are legally obliged to counter insider trading. In a study on white collar crime in 2009 regarding the security situation of large sized companies in Germany, the auditing firm pwc looked into how companies focused their efforts. For this representative survey on the security situation of German large sized companies, five hundred standardized computer supported telephone interviews were conducted. For this purpose people responsible for crime prevention and education were questioned. The results of the study relating to this topic were that a mere forty per cent, so less than half, had targeted preventive measures for insider offenses. Whistleblowing systems that should help discover an insider offence in context with a functioning informal social control system were only in place in fifty-five per cent of companies polled. As a consequence, less than half of the companies protect themselves against breaches in this sector. A reason for companies underestimating the possible consequences of such an offence is explained by the authors of this study by the so-called "control paradox"<sup>109</sup> (see chapter 2.3.1). Based on the existing inadequacies to discover an insider offense and the corresponding low number of cases discovered, the risks are not recognized and the number of unknown cases is high. Lack of control and preventive measures in companies and shortcomings in the public prosecutor's office as well as partly with the BaFin mislead people into making judgments which do not reflect reality. As such only two per cent of listed companies in Germany see the risk of being directly damaged by breaches against the prohibition of insider trading as high. Only five per cent think the risk is possible, twenty-four per cent think it is unlikely and sixty-nine per cent even rate it as highly unlikely. The authors of the study point out after evaluating the results that an effective prevention of insider trading would not only form an important role in protecting the company against damage but could also, considering the current financial market crisis, lead once

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reduced according to § 49 (1) of the Criminal Code.

109 „Kontrollparadox“

again to an increase in trust in the capital markets (cf. pwc, 2009, p. 39 f).

### 3.7.2 *Ad-hoc Public Releases According to the Investor Protection Improvement Act*

The Investor Protection Improvement Act led to a significant extension of ad-hoc public releases (§ 15 of the Securities Trading Act). It is a core part of the Securities Trading Act. Pursuant to these domestic issuers of financial instruments are obliged to publish inside information that is directly relevant to them immediately. Ad-hoc public releases aim at trying to get a uniform level of information to all people participating in the markets by informing the market quickly and in a widespread manner. They are trying to avoid inappropriate developments of market or share-prices based on faulty or incomplete information reaching the market. Through their transparency ad-hoc public releases ensure that the capital market can function effectively and create more equality in terms of equal chances for all investors. The obligation to ad-hoc public releases also protects against the misuse of inside information. Ascertaining whether there is a need to publish or not is based upon the actual circumstances and must be decided on a case-by-case basis. If uncertain, it should always be decided in favour of what best fulfils the requirements of the law – “Prevention of insider trading and creating maximum equal opportunity and transparency”<sup>110</sup>(translated in context by the author) (cf. BaFin’s guide for issuers, 2009, p. 47).

Pursuant to § 15 (1) of the Securities Trading Act only such kind of inside information requires publishing that affects the issuer directly. The requirement makes it clear that general information does not require publication within the guidelines of ad-hoc public releases. In addition, the information to be published must affect the issuer directly and not only the financial instruments it has issued (cf. BaFin’s guide for issuers, 2009, p. 53). If the inside information affects the issuer only indirectly, then it is not required to be disclosed but triggers the prohibition of insider trading pursuant to § 14 of the Securities Trading Act. The issuers must assess and decide themselves whether there is a case of inside information requiring disclosure (cf. BaFin’s guide for issuers, 2009, p. 55).

§ 15 (1) sentence 4 of the Securities Trading Act requires issuers to publically

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110 „Prävention von Insiderhandel und Herstellung größtmöglicher Chancengleichheit und Transparenz“

disclose inside information at the same time as this information is being passed on or shared with others except if the other party is legally bound to a confidentiality obligation. A person who is acting in his name or for his account is bound by the same legal requirements (cf. BaFin's guide for issuers, 2009, p. 57 f). In BaFin's view also forecasts pursuant to § 15 of the Securities Trading Act can require public disclosure. In order for the prerequisites of a disclosure obligation to be fulfilled, there must be appropriately high chances of the forecast coming true. These do not include generally-worded expectations or longer term planning on behalf of the issuer as these often do not allow sufficiently concrete conclusions to be taken on the true future development of the company (cf. BaFin's guide for issuers, 2009, p. 60).

However, the issuer also has the possibility to postpone the publication of inside information pursuant to § 15 (3) of the Securities Trading Act. In order to do this certain prerequisites must be fulfilled (cf. BaFin's guide for issuers, 2009, p. 65).

"Prior to claiming an exemption, an issuer must carefully assess whether protecting its legitimate interests outweighs the interest of the capital markets in complete and prompt disclosure, there is no risk of misleading the general public, and the issuer is able to guarantee the confidentiality of such information"<sup>111</sup> (English version of BaFin's guide for issuers, 2009, p. 63). A case for a legitimate interest of the issuer can be, for example, newly developed products, patents or inventions that if realised can have a significant impact on price (cf. BaFin's guide for issuers, 2009, p. 66).

The issuer must, however, inform the BaFin on his own account of the reasons for exemption and the date on which the decision regarding postponement was taken. The extent to which the entirety of the decision needs to be shared is done on a case-by-case basis. The BaFin does not accept general justifications. The BaFin must be put in a position to assess interests and understand what grounds exist for assuming that the issuer has a legitimate interest. After the end of the exemption period the publication must be carried out immediately (cf. BaFin's guide for issuers, 2009, p. 65 f).

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111 „Vor Inanspruchnahme einer Befreiung muss der Emittent abwägen, ob der Schutz seiner berechtigten Interessen gegenüber dem Interesse des Kapitalmarktes an einer zeitnahen und vollständigen Veröffentlichung überwiegt, keine Irreführung der Öffentlichkeit zu befürchten ist und er die Vertraulichkeit der Information gewährleisten kann“



A postponement of a publication does bear certain risks for the issuer. If an issuer does not issue an ad-hoc disclosure although the prerequisites for an exemption did not or do not longer exist, then this is a breach of § 15 (1) of the Securities Trading Act with all its legal consequences. In light of the fact that the number of mandatory ad-hoc announcements has experienced a high increase over the past years, the potential person obliged to publish is not faced with an easy task (cf. Schneider/Gilfrich, 2007, p. 53).

The expansion of the scope of § 15 (1) of the Securities Trading Act inevitably caused a flood of new ad-hoc disclosures. Spindler and Speier see this as an increasing danger as an investor can lose the overview with the many additional ad-hoc disclosures and lose sight of the really important news. This was not the intention of the legislature when the disclosure requirement came into force with § 15 (1) of the Securities Trading Act. The aim is to ensure the best possible market transparency so that all market participants are informed as early as possible about all market-relevant information and to thereby put them in a position to take appropriate investment decisions (cf. Spindler/ Speier, 2005, p. 2034). Also Nietsch elaborates on this danger by referring that firstly there must be a very high degree of care taken when formulating the disclosures. It must be clear whether it is a fact or an assessment or forecast. Secondly, when publishing ad-hoc forecasts it is key to point out that despite the probability being high that this will occur there is some uncertainty as it refers to a future event. Thirdly, one must state if the issuer views himself as directly or indirectly impacted. In the case of an indirect concern – in order to ensure the completeness of the disclosure – the basis must be stated on which the assessment is based (cf. Nietsch, 2005, p. 789).

A further complication is that many companies use their obligation of ad-hoc public releases as a marketing tool in order to attract the attention of public opinion. The cases of Infomatec, EM.TV or Comroad show clearly how company's misused ad-hoc public releases for targeted public relations work (cf. Hofmann, 2008, p. 353). The article IV.4.3 of the BaFin's guide for issuers (2009) attempted to stop this kind of misuse. Here it is stated that the use of ad-hoc public releases may not be used for the purpose of public relations. If the elements published are evidently not in line with § 15 of the Securities Trading Act, then the ad-hoc announcement is, according to the BaFin, a misuse of ad-hoc public releases. Public release behaviour of this kind makes it harder for the public to quickly identify and process the

truly important information (cf. BaFin's guide for issuers, 2009, p. 70).

As demonstrated, the Investor Protection Improvement Act extended the duties with regard to ad-hoc announcements. The question that follows is whether the Investor Protection Improvement Act also brought an extension of liability for untruthful and omitted ad-hoc disclosures. Pursuant to §§ 37b and 37c of the Securities Trading Act, issuers are liable for omitted and false inside information that impacts them directly. In this context it is important to mention that also in future only the incorrectness or incompleteness of facts are acts for which one can be held liable. Irregularities of forecasts or of a value judgment are not included. This means that ultimately the Investment Protection Improvement Act did not extend liability (cf. Hofmann, 2008, p. 356).

Issuers have the chance for a discharge in the case of being liable for false inside information if they can prove that they were not aware of the incorrectness of the inside information and that this unawareness is not due to gross negligence. In the case of a failure to publish inside information, they can avoid liability if they can credibly prove that the failure to disclose was not intentional or grossly negligent (cf. Hofmann, 2008, p. 355 f). In order for the issuer to not be made liable for published ad-hoc disclosures which are untrue the issuer must take great care when formulating the disclosures. He must firstly clearly state whether it is a fact or an assessment or forecast. For a forecast or assessment, which is seen as having a high probability of occurring, the starting position which forms the basis for the assessment must be shown. Under no circumstances should the impression be created that this is a real fact. Secondly, a forecast must include a reference stating that despite the high likelihood of occurrence, this is an uncertain future event. Thirdly, the issuer must state whether he thinks he is directly or indirectly affected as well as the reasoning for his assessment (cf. Nietsch, 2005, p. 789). Should the case occur where untrue information is published, then pursuant to § 15 (2) sentence 2 of the Securities Trading Act in connection with § 4 (3) of the Regulation to concretize the disclosure, notification and disclosure duty as well as the duty to issue a list of insiders pursuant of the Securities Trading Act (WpAIV) is to be clarified immediately in a further ad-hoc public release (cf. BaFin's guide for issuers, 2009, p. 72).

The ad-hoc public release requiring disclosure must be published immediately. The issuer is required to publicize regardless of stock exchange trading hours. In addition, the published inside information pursuant to § 15 (1) sentence

1 of the Securities Trading Act must be provided to the business registers immediately after – however, not before – publication. Pursuant to § 15 (5) sentence 2 of the Securities Trading Act at the time of publication a proof of actual publication needs to be passed to the executive boards of domestic stock exchanges to which financial instruments are admitted to trading and to the BaFin. Should there be a wilful or reckless breach of duties when publishing, then this can be punished with a fine of up to 200,000 euros. In contrast should there be a case of wilful or reckless breach of duties with regard to the actual publication, this can be punished with a fine of up to one million euros (cf. BaFin’s guide for issuers, 2009, p. 80 ff). “A breach of duty has been committed where the notification or publication

- has not been made,
- was made incorrectly,
- was made incompletely,
- was not made within the prescribed period, or
- was not made in the prescribed form<sup>112</sup> (English version of the BaFin’s guide for issuers, 2009, p. 79).

### 3.7.3 *Transaction Reporting Requirements for Members of the Management Pursuant to the Investor Protection Improvement Act*

Among other things § 15a of the Securities Trading Act states that persons performing management functions for an issuer of shares, who trades with the issuer’s shares or with related financial instruments must accordingly inform the issuer and the BaFin within 5 working days.

People that hold managerial duties are: “The members of the management (usually the management board), the members of the administrative body, the members of the supervisory body, personally liable partners, and any other persons with managerial responsibilities who are authorised to decide on material corporate matters on behalf of the issuer and who regularly have access to inside information<sup>113</sup> (English version of the BaFin’s guide for issuers, 2009, p. 82). The

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112 „Eine Pflichtverletzung liegt vor, wenn die Mitteilung oder Veröffentlichung - nicht, - nicht richtig,- nicht vollständig,- nicht rechtzeitig oder - nicht in der vorgesehenen Weise erfolgt.“

113 „Mitglieder des Leitungsorgans (in der Regel der Vorstand), Mitglieder

circle of persons under the obligation to notify is extended to include those that are closely connected to members of the management board (cf. BaFin's guide for issuers, 2009, p. 85 f).

Issuers are required to report transactions in shares and in financial instruments in related shares belonging to the issuer, notably derivatives. All transactions as laid down in § 15a (1) sentence 1 of the Securities Trading Act fall under the notification obligation if these exceed in total the amount of 5,000 euros at the end of a calendar year. When calculating the 5,000 euro limit, one must take into account the transactions of the executive management as well as people closely related to the management personnel in total. Transactions which cannot be valued can be calculated in favour of the persons under the obligation to notify with 0 euros when calculating the de minimis limit. Therefore no notification is required as long as these people undergo no further transactions. If these people, however, undergo transactions which lead to the de minimis limit of a calendar year being exceeded then all transactions of these people – independent of their value – are subsequently bound by the obligation to notify (cf. BaFin's guide for issuers, 2009, p. 88 f).

The German share issuer must immediately publish information after receipt of the notification. Normally the publication should follow one working day after receipt of the notification. Pursuant to § 3a (1) of the regulation to concretize the disclosure, notification and publication duty as well as the duty to issue a list of insiders pursuant of the Securities Trading Act (WpAIV) the information requiring publication must be passed on to those media for publication which may be presumed to distribute the information throughout the European Union and in the other countries party to the Agreement on the European Economic Area. Hereby it is not sufficient to provide the information to only one medium but rather different types of media must be used (cf. BaFin's guide for issuers, 2009, p. 93 f). In addition, the notification once published must be transmitted to the business register promptly (cf. BaFin's guide for issuers, 2009, p. 98).

The proposal to extend the obligation to notify not only after the transaction

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des Verwaltungsorgans, Mitglieder des Aufsichtsorgans, persönlich haftende Gesellschafter und sonstige Führungspersonen, die befugt sind, wesentliche unternehmerische Entscheidungen des Emittenten zu treffen und regelmäßig Zugang zu Insiderinformationen haben“

has been made but also before the time of transaction to ensure transparency was not taken into account. This proposal was already rejected during the legislative procedures for the fourth Financial Market Promotion Act (cf. Hienzsch, 2006, p. 99).

#### 3.7.4 *The Prohibition of Rate and Market Price Manipulation Pursuant to the Investor Protection Improvement Act*

The prohibition of rate and market price manipulation pursuant to § 20a of the Securities Trading Act was already reorganized as part of the fourth Financial Market Promotion Act and was further developed with the introduction of the Investor Protection Improvement Act. At the same time as the introduction of the Investor Protection Improvement Act the Market Abuse Directive came into force and thereby the German prohibition on engaging in market manipulation was aligned to the European Directives (cf. BaFin's guide for issuers, 2009, p. 105).

The prohibition of rate and market price manipulation is directed at all of the issuer's company employees. But also external people who have been tasked with the outside representation of the company must take care not to pass on false or misleading information. In the end, everything will depend on who carries the responsibility for the false or misleading information. There is a case of a manipulation having occurred if false or misleading information regarding circumstances that are of crucial importance for the valuation of financial instruments or such information of crucial importance for the valuation of financial instruments in contravention of statutory provisions is withheld and if the information provided or withheld has the potential to have an impact on the stock exchange or market price of the financial instrument (cf. BaFin's guide for issuers, 2009, p. 106 f). As such, for example, fabricated rumors without factual substance, recommendation or warnings made with respect to financial instruments do not represent false information since they lack a factual basis. Nevertheless, they are deemed as other deceptive acts and are prohibited pursuant to § 20a (1) sentence 1, number 3 of the Securities Trading Act (cf. BaFin's guide for issuers, 2009, p. 112). To avert market manipulation a company must pay attention whether and if necessary how it transfers information (cf. BaFin's guide for issuers, 2009, p. 105).

With regard to the "grey capital market" the following should be noted: On 16 February 2011 the German Ministry of Finance published a discussion draft of

the act on the amendment of the financial investment intermediaries and investment law. This discussion draft is supposed to combat untrustworthy issuers on the “grey capital market” by expanding the duties already applied to the regulated market also to the grey market sector. This includes, among others, a consumer orientated advice approach, the disclosure of fees paid and the documentation through the use of protocols of the advisory discussion (cf. Schmittmann, 2011, p. 3). On 27 October 2011 the German federal parliament passed the federal government’s proposed bill for the act on the amendment of the financial investment intermediaries and investment law (BT-Drs. 17/6051) dated 6 April 2011. In its final version dated 6 December 2011 the act was announced on 12 December 2011 (BGBl 2011 Part No. 63) and came into force on 1 June 2012. The information obligations of providers of the so-called “products of the grey capital market” must be designed to allow investors to make an improved assessment of the product risks for shares in closed investments and other non-fungible forms of investments. The law extends the duties that were already in force on the regulated markets for banks and savings banks to include the “grey capital market”. This includes, amongst other things, the obligation based on civil and regulatory law for specific finance and investment advice, the disclosure of provisions and the creation and hand-over of a written consultation protocol. In addition, the existing requirements for publicly-offered investments were increased. Sales prospectuses for investments must fulfil additional content requirements. The potential investor should be able to assess the integrity of the initiators by means of the sales brochures. In addition, the providers of investment products should provide standardised short information leaflets that inform investors in a precise and understandable form about the investment products offered. For the issuers of investment products stricter accounting regulations were introduced. Moreover, the legal prospectus special limitation period was abolished and the final deadline on raising liability claims was extended from six months to two years. This resulted in a toughening of prospectus liability. Intermediaries and consultants in the area of finance investments must provide a certificate of competence and must hold a personal liability insurance to attain commercial permission (cf. [www.der-betrieb.de/content/dft,199,461641](http://www.der-betrieb.de/content/dft,199,461641), accessed on 20.05.2013; [Novellierung\\_Finanzanlagevermittler\\_Vermögensanlagerecht\\_0312.pdf](#), in: [www.cms-ks.com](http://www.cms-ks.com), accessed on 20.05.2013).

The previous deliberations show that when the Investor Protection Improvement Act came into force, new regulations with regard to their preventive

function complemented each other. As such, for example, the obligation for ad-hoc public releases ensures that information with inside information characteristics can no longer be disseminated as all information must be provided to all capital market participants at the same time. Information asymmetry is therefore a thing of the past which according to Hofmann will lead to a strengthening of the capital markets. With the introduction of the many new rules, it will not be as easy in future to commit balance sheet manipulations without undergoing a higher risk of being discovered (cf. Hofmann, 2008, p. 356).

However, Hientsch raises the question whether the Investor Protection Improvement Act has maintained or strengthened the trust of investors in the German capital market and comes to the conclusion that with regard to the prohibition for insider trading this has, to date (2006), hardly had an effect. This can, amongst other issues, be traced back to the enforcement of insider standards. The difficulties could be seen in the inadequacies of uncovering insiders on the part of the Public Prosecutors and the BaFin. In addition, it is difficult to prove non-compliance regarding the prohibition of insider trading. Further, European and national legislature has defined, without apparent reason, the scope of this crime very broadly and has thereby created uncovering of the crime being very hard to prove. Hientsch sees the following as a reason for the results of his study: "If insider punishable offenses are expanded to areas which are practically not enforceable then the investors lose trust in the government's ability to enforce legal propositions and thereby ultimately the trust in the capital market."<sup>114</sup> (Hienzsch, 2006, p. 195).

Schröder stresses that insider legislation is focussed on protecting the assets of those people who invested their capital in organised markets. Individuals are expected, based on the gradual separation of the state from the social provision of subsidies, to make their own provisions for old age. This requires as far as possible capital markets that are fair, trustworthy and transparent as the majority of the money set aside for pensions flows into the capital markets. The state should not just be focussing on the reduction of social welfare legislation. It should, at the

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114 „Wenn Insiderstrafbarkeiten auf Bereiche ausgeweitet werden, in denen die Durchsetzung der Norm faktisch unmöglich ist, verlieren die Anleger ihr Vertrauen in die staatliche Fähigkeit, den Rechtssatz durchzusetzen und damit letztlich das Vertrauen in den Kapitalmarkt.“

same time ensure it creates legal conditions that allow the individual person to make provisions for old age in a trustworthy legalised framework (cf. Schröder, 2007, p. 47 f).

In summary, it can be said that the Investor Protection Investment Act forms at any rate an important step in strengthening anti-fraud management.



### 3.8 POINT NINE AND TEN OF THE GOVERNMENT'S CATALOGUE OF MEASURES

The ninth point which ensures the reliability of company valuations by finance analysts and credit rating agencies requires, among other things, the further development and expansion of the best practice and compliance rules for finance analysts and the review of the possibility of best practice rules for credit rating agencies. The tenth point concerns the toughening of penal provisions for frauds on the capital market and requires a review of the offenses relating to misinformation by members of the board and the independent auditor regarding the state of the company or in the accounts (especially §§ 400, 403 of the Stock Corporation Act and §§ 331, 332 of the German Commercial Code) (the Government's Catalogue of measures to strengthen companies' integrity and to protect investors, 2003, p. 9 f).

With regard to point nine the European Commission committed itself in April 2002 to intensively work on the topic of credit rating agencies. In February 2004 the European Parliament requested the European Commission to investigate the need for legislative measures in this area. After the Italian Parmalat scandal came to light in March 2004, the European Commission, the European Parliament and the Member States jointly launched an investigation into the main regulatory issues of concern with regard to credit rating agencies. In July 2004, the Commission asked the Committee of European Securities Regulators (CESR) to assess the need for introducing European legislation or if other solutions should be taken into account. In March 2005 the CESR presented its proposals to the European Commission. Meanwhile, the International Organization of Securities Commissions (IOSCO) published its Code of Conduct Fundamentals for credit rating agencies which takes account of the results of the CESR investigation. IOSCO resolved that a meaningful improvement would be that credit rating agencies must base their ratings on a diligent analysis of the available information. In addition, they must continuously control the integrity of their information sources. If required the ratings must then be updated. Credit rating agencies should be more open about the way in which they made their assessments. It is important to guarantee the independence and objectivity of the approach that credit rating agencies take. Close contact to issuers should be avoided. Also access to inside information of issuers is viewed as critical. They should be hindered from using this information for other purposes (cf. Mitteilung der Kommission über Rating-Agenturen,

2006, Internet Source). With the measure that issuers need to maintain registers for insiders, German legislation has already successfully reacted to this problem (cf. Chapter 3.7.1). Furthermore, the European Commission is concerned about the high degree of consolidation (Oligopoly) in this sector and the corresponding unfavorable consequences on competition (cf. Mitteilung der Kommission über Rating-Agenturen, 2006, Internet Source). However, the German Federal Government has not passed any comprehensive legislative initiatives with regard to point nine of the Catalogue of Measures.

With regard to point 10 there are no plans for independent legislative initiatives (Hofmann, 2008, p. 263).

## 4 STRUCTURE OF THE RESEARCH DESIGN

After the theoretical part of this study has now been concluded, the next part is to review the empirical study. The companies listed on the market indices DAX, MDAX, SDAX and TecDAX were questioned using a standardized questionnaire. This encompassed 160 companies of which 30 are listed in the largest capital market segment the DAX. The companies next in size are the 50 companies listed in the capital market segment MDAX. This is followed by a further 50 companies listed on the SDAX and 30 companies listed on the technological orientated TecDAX that developed from of the new market capital market segment. In order to become part of any one of these DAX segments companies must fulfill certain criteria. They must be listed in the Prime Standard Segment of the German capital market and demonstrate a free float of at least ten per cent. "The Prime Standard is a sub-segment of the European Regulated official and regulated market segments and is the access portal for companies that want to position themselves towards international investors. In addition to fulfilling the requirements of the General Standard, which constitutes the statutory minimum standard of the Regulated Market, companies admitted to the Prime Standard must meet high international standards of transparency. These standards are:

- carrying-out quarterly reporting in German and English,
- applying international accounting standards (IFRS/IAS or US-GAAP),
- publishing a financial calendar,
- conducting at least one analyst conference per year,
- publishing ad-hoc releases in English, too"<sup>115</sup> (translated in context by the author).

(<http://www.boerse-frankfurt.de/de/wissen/marktsegmente/prime+standard>, accessed on 16.01.2013)

These companies were selected as they must fulfill the statutory regulations that were introduced through the Catalogue of Measures. If one had, for example,

115 „Der Prime Standard ist ein Teilbereich der EU regulierten Marktsegmente Amtlicher und Geregelter Markt und ist das Zulassungsportal für Unternehmen, die sich auch gegenüber internationalen Investoren positionieren wollen. Sie müssen über das Maß des General Standard hinaus, der die gesetzlichen Mindestanforderungen des Regulierten Marktes stellt, hohe internationale

based the study on smaller medium-sized companies, then they would not have been accountable to the German enforcement procedures (point 6) due to their size. 825 companies were subject to the German enforcement procedures in 2012 (cf. BaFin, 2012, p. 200). Including all of these 825 companies would go beyond the scope of this project. As such the 160 largest companies listed in Germany were selected as they can be clearly determined and separated according to the market segment to which they belong.

At this point a possible methodological problem shall be discussed briefly, the so-called “Non Response Bias”. The “Non Response Bias” refers to the distortion of statements that is linked to the response rate. For example, it is possible that companies who do not see any sense in the questionnaire or the statutory regulations do not react and consequently do not return the questionnaire. In order to minimize the distortion within reason, on the one hand, contact people were identified and, on the other hand, regular contact was maintained by checking the status of the return several times. A “Non response Bias” can be defined as follows: “NON-RESPONSE BIAS refers to the mistake one expects to make in estimating a population characteristic based on a sample of survey data in which, due to non-response, certain types of survey respondents are under-represented” (Berg, 2005, Internet resource). For a deeper insight into the field refer to Berg, 2005, Non Response Bias, Internet resource.

The German survey was conducted between May and December 2012.

The goal of the survey was to,

- determine how companies rate the effectiveness of the German government’s 2003 10-Point-Program (Catalogue of Measures) with regard to the disclosure and prevention of balance sheet manipulations;
- determine to what extent companies assume that the legal implementation of the government’s 10-Point-Program is sufficient for their own company in

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Transparenzanforderungen erfüllen. Im Einzelnen sind das:

- quartalsweise Berichterstattung in deutscher und englischer Sprache,
- Anwendung internationaler Rechnungslegungsstandards (IFRS/IAS oder US-GAAP),
- Veröffentlichung eines Unternehmenskalenders,
- Durchführung mindestens einer Analystenkonferenz pro Jahr,
- Ad-hoc-Mitteilungen auch in englischer Sprache.“

- terms of the disclosure and avoidance of balance sheet manipulations;
- gain insight into the companies assessments as to the appropriateness of possible measures with regard to the disclosure and avoidance of balance sheet manipulations;
  - determine how companies assess the cost-benefit ratio for the implementation of the legislative measures that were initiated by the Catalogue of Measures for the disclosure and prevention of balance sheet manipulations for their own company.

The questionnaire was targeted at board members, area directors, department chiefs or specialists working for companies listed on the German capital markets of all four DAX segments. Of the 160 companies contacted, 50 answered. The return rate is therefore 31.25 per cent. As such the representativeness of this survey and the applicability of most testing and estimating procedures of statistical analysis was fulfilled. The minimum requirement of 30 answered and evaluable questionnaires was achieved (cf. Raab-Steiner/Benesch, 2010, p. 20).

The study is subdivided as follows: first the methodology applied to the empirical study is described. Then there is a depiction of the evaluation of the regulations by the companies polled. After the evaluation of possible concrete measures by the polled companies has been reviewed there follows the assessment of the cost-benefit ratio by the companies polled. And in conclusion, the final results are evaluated.

#### 4.1 METHODOLOGY APPLIED TO THE EMPIRICAL STUDY

The following study results are based on the analysis of the questionnaires that were sent to 160 companies of the four DAX segments between the end of April 2012 and the beginning of December 2012. Companies who did not respond to the initial survey request were sent a reminder a couple of weeks later. Companies who still did not respond after being contacted twice were asked a third time to participate in the survey.<sup>116</sup>

116 Companies are placed in the segments/indices which they belonged to at the time the survey commenced. Following companies were listed in the individual DAX segments: Listed in the DAX 30 were Adidas, Allianz, BASF, Bayer, Beiersdorf, BMW, Commerzbank, Daimler, Deutsche Bank, Deutsche Börse, Deutsche Lufthansa, Deutsche Post, Deutsche Telekom, E.ON, Fresenius Medical Care, Fresenius, Heidelberg Cement, Henkel, Infineon Technologies, K+S, Linde, MAN, Merck, Metro, Munich Re, RWE, SAP, Siemens, Thyssen Krupp and Volkswagen.

The MDAX included the companies Aareal Bank, Aurubis, Axel Springer, BayWa, Bilfinger Berger, Brenntag, Celesio, Continental, Deutsche Euroshop, Deutsche Wohnen, Deutz, Douglas Holding, Dürr, EADS, Elring Klinger, Fielmann, Fraport, Fuchs Petroclub, GAGFAH, GEA Group, Gerresheimer, Gerry Weber International, Gildemeister, GSW Immobilien, Hamburger Hafen und Logistik, Hannover Rückversicherung, Hochtief, Hugo Boss, Kabel Deutschland, Klöckner & Co SE, Kronos, KUKA, Lanxess, Leoni, MTU Aero Engines Holding, ProSieben Sat.1 Media, Puma, Rational, Rheinmetall, Rhön-Klinikum, Salzgitter, SGL Carbon SE, Sky Deutschland, STADA Arzneimittel, Symrise, Südzucker, TUI, Vossloh, Wacker Chemie and Wincor Nixdorf.

The SDAX was comprised of the following companies: Air Berlin plc, Alstria office REIT, Amadeus Fire, Balda, BAUER, Bertrandt, Biotest, C.A.T. Oil, CENTROTEC Sustainable, CeWe Color Holding, Comdirect bank, Constantin Medien, CTS Eventim, Delticom, Deutsche Beteiligung, DIC Asset, Gesco, GfK SE, Grammer, GRENKELEASING, H & R, HAMBORNER REIT, Hawesko Holding, Heidelberger Druckmaschinen, Highlight Communications, Hornbach Holding, Indus Holding, IVG Immobilien, Jungheinrich, Koenig & Bauer, KWS SAAT, MLP, MVV Energie, NORMA Group, PATRIZIA Immobilien, Praktiker, Prime Office Reit, SAF-HOLLAND SA, Schaltbau Holding, Schuler, Sixt, SKW Stahl Metallurgie Holding,

Of the 160 companies contacted, 50 companies responded. Two companies listed on the DAX 30 replied to the questionnaire with an individual statement but did not answer the questionnaire itself. These versions could not be used for the analysis of the questionnaires so that in the end 48 completed questionnaires were evaluated. The return rate was therefore 31.25 per cent and the rate of evaluable questionnaires was exactly 30 per cent. The return rate of answered and completed questionnaires was highest from the DAX 30 with 36.67 per cent. This was followed by the MDAX with a return rate of 32 per cent. Then came the TecDAX with a return rate of still 30 per cent and the lowest return rate was from the SDAX with still some 24 per cent.

The following tables 1 to 4 represent the individual segments (DAX, MDAX, SDAX and TecDAX) of the companies polled using important key figures. To ensure the accountability of the analysis, a syntax file is included in the appendix (CD ROM).

For the 30 DAX companies the comparison of the characteristic companies who answered and did not answer shows that no clear statement can be made as to whether there is an interdependence between the willingness to participate and the size of the company. The eleven companies who responded had an average turnover of 49 488 million euros in 2011 whereas the corresponding key number of the 19 companies that did not respond was 40 693 million euros<sup>117</sup>. However, the picture is completely different with regard to the number of employees. Whilst in 2011 the average number of employees of the companies who did not respond was 132 832, the average number was merely 122 835 employees with the companies

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Ströer Out-of-Home Media, TAG Immobilien, TAKKT, Tipp 24 SE, Tom Tailor Holding, VTG, Wacker Neuson and Zooplus.

The TecDAX included the companies ADVA Optical Networking, Aixtron, Bechtle, CANCOM, Carl Zeiss Meditec, Centrotherm photovoltaics, Drägerwerk, Drillisch Telekom, Euromicron, EVOTEC, Freenet, Gigaset, Jenoptik, Kontron, MorphoSys, Nordex, Pfeiffer Vacuum Technology, PSI, Qiagen, QSC, Sartorius, Singulus Technologies, SMA Solar Technology, Software, Solar World, STRATEC Biomedical, Süss Micro Tec, United Internet, Wirecard and XING.

117 When calculating the arithmetic mean and the standard deviation for turnover the banks were not included due to their special way of accounting. For the DAX 30 companies this affected the Deutsche Bank and the Commerzbank.

who did respond. In terms of market capitalization the situation in December 2012 was such that the companies who answered had an average market capitalization of 35 238 million euros and the companies who did not respond only an average market capitalization of 22 582 million euros.

Comparison of companies that answered and those that did not answer (split into groups of companies)

DAX Descriptive Statistics	Answering Companies			Non Answering Companies		
	N	Arithmetic Mean	Standard-Deviation	N	Arithmetic Mean	Standard-Deviation
Market Capitalization in € millions	11	35 238	28 192	19	22 582	16 657
Turnover in € millions	10	49 488	49 877	18	40 693	35 306
Number of Employees	11	122 835	133 950	19	132 832	128 660

#### *Spreadsheet 1: DAX*

The data on turnover and number of employees is based on the financial year 2011. The data for the market capitalization is based on December 2012. The source of the data is finanzen.net GmbH situated in Karlsruhe (see enclosures) ([www.finanzen.net](http://www.finanzen.net)).

For companies listed on the MDAX, the comparison of the characteristic companies who answered and did not answer shows that there is a negative interdependence between the willingness to participate and the size of a company. The 16 companies who answered in 2011 had an average turnover of 4 679 million euros whereas the 34 companies who did not answer had an average turnover in 2011 of 6 714 million euros<sup>118</sup>. The average number of employees of the companies who responded was 11 819 compared to 24 936 with the companies who did not respond. Also the average market capitalization of the companies participating in the survey was far lower with 2 799 million euros compared to that of the companies who did not participate where it was 3 358 million euros.

Comparison of companies that answered and those that did not answer (split

<sup>118</sup> When calculating the arithmetic mean and the standard deviation for turnover the banks were not included due to their special way of accounting methods. For the MDAX listed companies the Aareal Bank was affected.



into groups of companies)

MDAX Descriptive Statistics	Answering Companies			Non Answering Companies		
	N	Arithmetic Mean	Standard- Deviation	N	Arithmetic Mean	Standard- Deviation
Market Capitalization in € millions	16	2 799	1 933	34	3 358	4 340
Turnover in € millions	16	4 679	4 918	33	6 714	10 513
Number of Employees	16	11 819	17 517	34	24 936	36 610

### *Spreadsheet 2: MDAX*

The data on turnover and number of employees is based on the financial year 2011. The data for the market capitalization is based on December 2012. The source of the data is finanzen.net GmbH situated in Karlsruhe ([www.finanzen.net](http://www.finanzen.net)).

The comparison of companies listed on the TecDAX of the characteristic companies who answered and did not answer shows a different result. A positive interdependence exists between the willingness to participate and the size of the company. The nine companies who answered achieved an average turnover of 1 208 million euros in 2011 whereas the corresponding key number for the 21 companies who did not respond was only 608 million euros. The average number of employees at the companies that responded was 3 962 compared to 2 112 with the companies who did not respond. Also the average market capitalization of the companies who participated was much higher with 1 172 million euros than that of those who did not participate which accounted to 696 million euros.

Comparison of companies that answered and those that did not answer (split into groups of companies)

TecDAX Descriptive Statistics	Answering Companies			Non Answering Companies		
	N	Arithmetic Mean	Standard- Deviation	N	Arithmetic Mean	Standard- Deviation
Market Capitalization in € millions	9	1 172	1 218	21	696	847
Turnover in € millions	9	1 208	1 075	21	608	511
Number of Employees	9	3 962	3 528	21	2 112	1 747

### *Spreadsheet 3: TecDAX*

The data on turnover and number of employees is based on the financial year 2011. The data for the market capitalization is based on December 2012 respectively January 2013. The source of the data is finanzen.net GmbH situated in Karlsruhe ([www.finanzen.net](http://www.finanzen.net)).

For SDAX companies, the comparison of the characteristic companies who answered and did not answer shows a similar result to that of the TecDAX companies. The interdependence between the willingness to participate and the size of a company is positive. The twelve companies who answered had an average turnover of 1151 million euros in 2011 whereas the key number with regard to the thirty-eight companies who did not respond was only 788 million euros<sup>119</sup>. The average number of employees of the companies who responded was 4416 compared to 3435 with the companies who did not respond. Also the average market capitalization of the companies participating was much higher with 527 million euros compared to the companies who did not participate where it was 447 million euros.

Comparison of companies that answered and those that did not answer (split into groups of companies)

<sup>119</sup> When calculating the arithmetic mean and the standard deviation for turnover the banks were not included due to their special way of accounting methods. For the SDAX listed companies the comdirect Bank was affected.

SDAX Descriptive Statistics	Answering Companies			Non Answering Companies		
	N	Arithmetic Mean	Standard- Deviation	N	Arithmetic Mean	Standard- Deviation
Market Capitalization in € millions	12	527	418	38	447	345
Turnover in € millions	11	1 151	1 140	38	788	924
Number of Employees	12	4 416	4 343	38	3 435	4 536

*Spreadsheet 4: SDAX*

The data on turnover and number of employees is based on the financial year 2011. The data for the market capitalization is based on December 2012. The source of the data is finanzen.net GmbH situated in Karlsruhe ([www.finanzen.net](http://www.finanzen.net)).

Spreadsheet 5 shows the positions the people who responded held in their respective companies. Two people did not provide the data as to their position within the company. Other papers were marked by several people in different positions and they were, therefore, subsequently questioned by telephone, who of them had responded to the main part. Of the remaining forty-six people, nearly all hold a managerial position within the company.

		frequency	per cent	valid per cent	accumulated percentage
Valid	Area Director	15	9.4	32.6	32.6
	Department Chief	17	10.6	37.0	69.6
	Subject Specilization	11	6.9	23.9	93.5
	Other Position	3	1.9	6.5	100.0
	Overall	46	28.7	100.0	
Missing	Not at all	2	1.3		
	System	112	70.0		
	Overall	114	71.3		
Overall		160	100.0		

*Spreadsheet 5: Position of the responding company representative*

Spreadsheet 6 shows the functional areas of the people who responded. Some companies did not provide concrete information or marked several functional areas and were, therefore, subsequently questioned by telephone. In the end there was only one company left which did not provide the relevant information pertaining to this question. The main emphasis of the company representation is in the areas of accounting, legal department and others. Of the sixteen company representatives that fall into the category of other areas, eleven people were from the investor relations department. The representatives from this area, therefore, form the third key area. Other areas mentioned in the category of other departments were corporate communication, compliance, finance and treasury.

		frequency	per cent	valid per cent	accumulated percentage
Valid	Internal Auditing Department	1	0.6	2.1	2.1
	Accounting Department	17	10.6	36.2	38.3
	Controlling	2	1.3	4.3	42.6
	Legal Department	11	6.9	23.4	66.0
	Other Area	16	10.0	34.0	100.0
	Overall	47	29.4	100.0	
Missing	Not at all	1	0.6		
	System	112	70.0		
	Overall	113	70.6		
Overall		160	100.0		

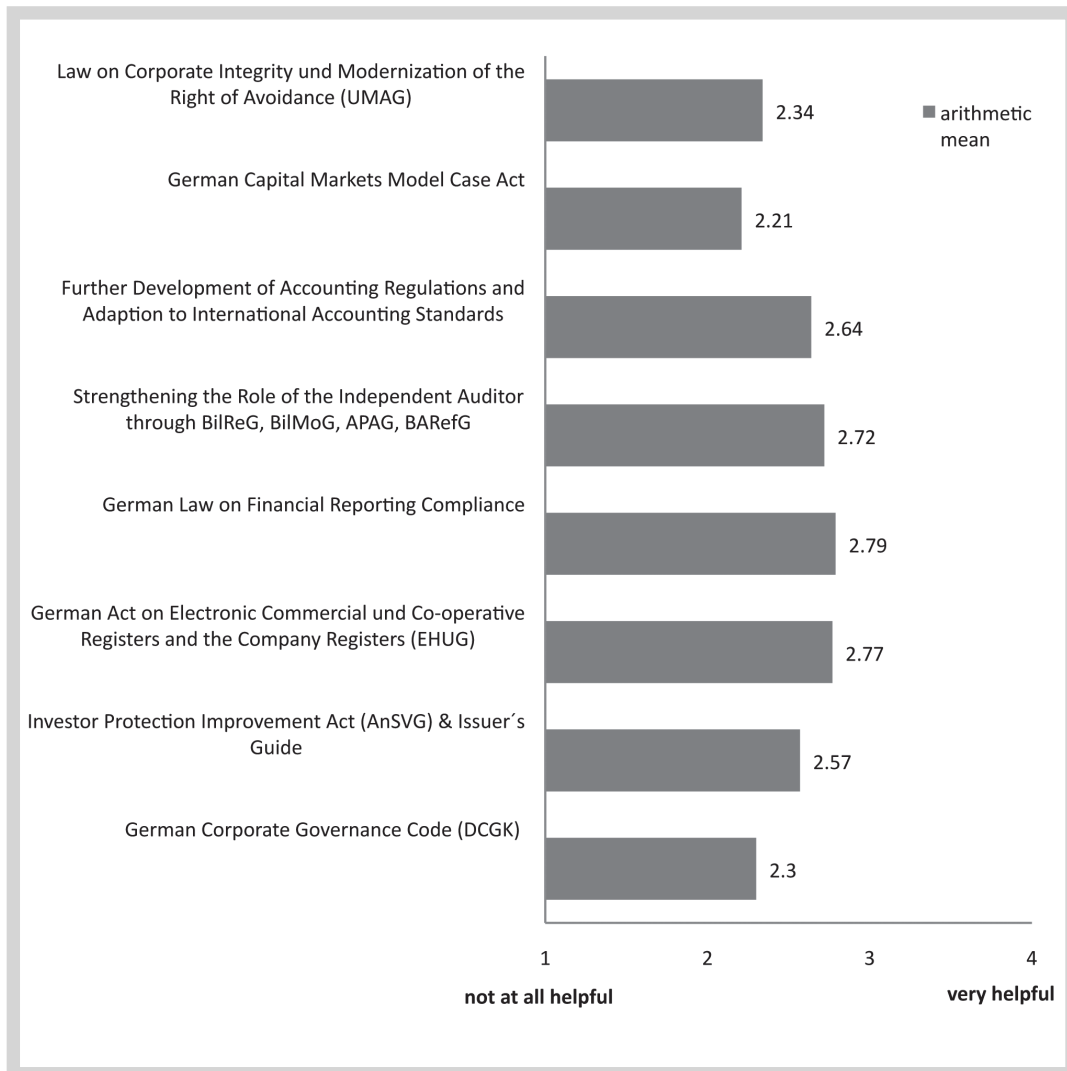
*Spreadsheet 6: Functional area of the responding company representative*

In some cases the position respectively the functional area of the responding company representative could be derived from a written reply via email.

#### **4.2 ASSESSMENT OF THE REGULATIONS BY THE COMPANIES POLLED**

The companies participating were asked in the questionnaire under point 1 to provide a view on the effectiveness of the government's 10-Point-Program (Catalogue of Measures) with regard to the disclosure and prevention of balance sheet manipulations. Point nine "Ensuring the reliability of company ratings made by finance analysts and rating agencies" and point 10 "Tightening of penal provisions for offenses within the capital market sector" of the 10-Point-Program were omitted from the questionnaire as at the time of the survey the German government had made no comprehensive legislative measures with regard to point nine and there were no independent legislative measures planned with regard to point ten.

To answer the questions, four categories were applied from "not at all helpful" (=1) over "somewhat helpful" (=2) and "helpful" (=3) to "very helpful" (=4). The value of 2.5 can be interpreted as a "value of indifference". The answers were then aggregated to average levels of endorsement.



*Spreadsheet 7: Effectiveness of the new legal regulations*

The results were summarized in the above chart. The chart shows that the company representatives view the legislative measures with regard to the disclosure and prevention of balance sheet manipulations in total as rather helpful. Only three values are below the value of indifference of 2.5. The majority of values, namely five, are above the value of indifference of 2.5. The least helpful measure to disclose and prevent balance sheet manipulations is seen in the German Capital

Markets Model Case Act with an average score<sup>120</sup> of merely 2.21 per cent. This act is about the introduction of a legal test case whereby the requirement for the high court to take a decision on the exemplary hearing keeps the trial courts occupied. The standard deviation<sup>121</sup> is with only 0.570 the smallest of all eight questions. The net result means that the answers rather lie closely around the average value so that there are rather only a few outliers in the one or other direction. This question was answered by thirty-nine of the total forty-eight companies who responded.

Another measure which is seen by companies as being only somewhat helpful for disclosing and preventing balance sheet manipulations is the German Corporate Governance Codex (DCGK) with an average value of 2.30. In particular, this involved the transparency of share-based and incentive-based compensation of board members. The standard deviation is with 0.866 the second largest of all eight questions. This means that the arithmetical mean is not typical for the distribution as there are rather high or numerous divergences from the average value. This question was answered by forty-six of the forty-eight companies who responded to the survey.

With an average value of 2.34 the Law on Corporate Integrity and Modernization of the Right of Avoidance (UMAG) is also seen as not very helpful

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120 “The arithmetic mean is the average distribution. This would be the value of each statistical unit if all distribution values were the same meaning that the total value of the statistical units was distributed evenly across all statistical units”(translated in context by the author) (Zwerenz, 2001, p. 131). “The arithmetic mean is the best-known measure of central tendencies and is often used as a synonym for the average value. In everyday language one often speaks of the average value. Calculating the arithmetic mean: Addition of all measured values. Dividing the resulting measured value by the number of measured values (=n)” (translated in context by the author) (Raab-Steiner/Benesch, 2010, p. 96).

121 “The variance (or the standard deviation) is the average division of a distribution. It expresses how different or how similar the values are among themselves. It describes the average distance of the individual values to the arithmetic mean” (translated in context by the author) (Zwerenz, 2001, p. 131). “The standard deviation is a measure for the dispersion of the measurement values, it is the square root of the variance. It has the initial unit of the variable” (translated in context by the author) (Raab-Steiner/Benesch, 2010, p. 101).



for the disclosure and prevention of balance sheet manipulations. This law is amongst other things about the introduction of a general derivative action (§§ 147-149 of the German Stock Corporation Act). Integrated into this is the obligation to file damage claims against founding members and administrative officials (§147 of the German Stock Corporation Act) as well as the admissibility of legal action (§148 of the German Stock Corporation Act). Furthermore, it is about lowering thresholds for special audits (§ 142 (2) of the German Stock Corporation Act), the introduction of a shareholders' forum for communication purposes (§ 127 (a) of the German Stock Corporation Act) and the introduction of the "Business Judgement Rule" (§ 93 (1) of the German Stock Corporation Act). The standard deviation is the second smallest with 0.617 - so fairly low. This means that the arithmetic mean is rather typical for the distribution as the individual values are fairly similar and do not deviate strongly from the average value. These questions were answered by forty-one of the forty-eight companies who responded to the survey.

The highest level of approval with regard to the effectiveness of the legal regulations for the disclosure and prevention of balance sheet manipulations was given with an average value of 2.79 to the German Law on Financial Reporting Compliance and closely followed by the German Act on Electronic Commercial and Co-operative Registers and the Company Registers with an average value of 2.77.

The German Law on Financial Reporting Compliance stands for monitoring the legality of specific annual financial statements by an independent party (Enforcement). The goal of this act is to prevent irregularities in the accounts and to rebuild and strengthen the trust of investors in the capital market. Pursuant to § 342 (2) of the German Commercial Code (HGB), the role of the German Enforcement is to audit the annual financial statements and the management report or the consolidated financial statements and the consolidated management report. The standard deviation for the question relating to the German law on Financial Reporting Compliance is 0.771. This can be seen with regard to the standard deviation of all eight questions as a medium-sized standard deviation. This question was answered by all forty-eight companies who responded to the survey.

The German Act on Electronic Commercial and Co-operative Registers and the Company Registers (EHUG) led to three significant changes:

1. The changeover to an electronically operating system of the companies,

cooperatives and partnerships registers.

2. Accounting information is now not published in the Commercial Register but in the electronic federal gazette.
3. The creation of business registers.

With the introduction of the EHUG, the public releases of companies have significantly increased. Before 2007 the rate was less than five per cent whereas in 2010 it increased to over ninety per cent. With the possibility to access company data and information at any time and from everywhere via the internet, there has been an immense improvement in the transparency of economic activity. This is viewed similarly by the 48 companies who responded to the survey. This point received the second highest level of consent with 2.77 with regard to the effectiveness of legal regulations for the disclosure and prevention of balance sheet manipulations. An increase in the transparency of the economy leads at the same time to a higher rate of disclosure and prevention of accounting crimes and thereby strengthens investor trust. It must be stated though in this context that there was also the highest standard deviation with 0.973. This is the highest value of all eight questions and means that there are numerous and/or large variations from the arithmetic mean. These variations go in both directions from “very helpful” to “not at all helpful”.

A similarly high level of consent with 2.72 was given to the effectiveness of the legal regulations in view of the disclosure and prevention of balance sheet manipulations for the strengthening of the role of the independent auditor. This was implemented with the German Accounting Reform Act, the Final Auditor Supervision Act, the Professional Supervision Reform Act and the German Act to Modernize Accounting Law. The questionnaire touched mainly on the extension of the auditing activities of the group’s independent auditor (§ 317 (3) sentence 2 HGB, BilMoG), the extension of the grounds for exclusion of an independent auditor (§ 319 (3) HGB and § 319a HGB, BilReG/BilMoG), the binding of the proposal regarding the appointment of the independent auditor to be put before the Annual General Meeting to the recommendation of the Auditing Committee (§ 124 (2) sentence 2 of the German Stock Corporation Act, BilMoG), the extension of auditing requirements of the independent auditor through the new regulation of reporting duties (§ 171 (1) of the German Stock Corporation Act, BilMoG), the disclosure of the fees for auditing the annual financial statements (§ 285 sentence 1 number 17 HGB,

BilReG/ BilMoG), placing the German Chamber of Public Accountants (WPK) under the supervision of the independent Auditors' Supervision Commission (APAK) and the introduction of special random and scheduled inspections (Professional Supervision Reform Act). The standard deviation is rather small with 0.655 which means that the individual assessments are rather close to the average value.

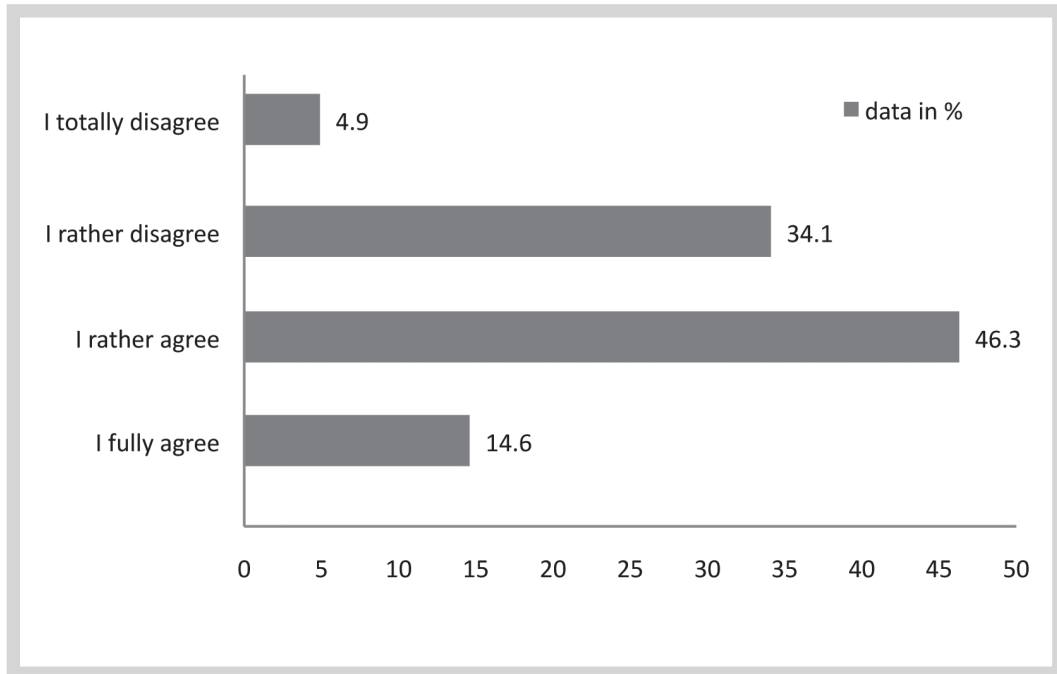
With regards to the effectiveness of the legal regulations for the disclosure and prevention of balance sheet manipulations, the slightly worse level of agreement with 2.64 was achieved regarding the further development of accounting standards and the adoption to international accounting standards. This was put into effect with the introduction of the German Accounting Reform Act and the German Act to Modernize Accounting Law. One of the main areas of focus of the German Accounting Reform Act was the adaptation of the German Accounting Law to the IAS Regulation of 2002. This was primarily about the option given to Member States with regard to the application of international accounting standards such as the IAS/IFRS for the consolidated financial statements and separate financial statements. The regulation to adopt the German Commercial Code (HGB) in line with the IAS regulation constitutes the centerpiece of the law. The primary goal of the German Act to Modernize Accounting Law was to further develop German accounting law to become a long-term and fully fledged alternative to international accounting standards (IFRS). It was to be a simpler and more cost effective alternative that was to offer especially small and medium-sized companies the possibility to apply modern accounting law without having to make use of the IFRS. Also here the standard deviation is rather small with 0.673, which in turn means that the individual measurements (answers) lie rather close to the average value. This question was answered by forty-seven companies.

A more average agreement level of 2.57 was given for the Investor Protection Improvement Act and the Issuer Guide of the German Federal Financial Supervisory Authority. This touched on the topics of, for example, realignment of insider trading (§ 13 WpHG), the requirement to maintain insider registers (§ 15b WpHG), changes to the reporting requirements disclosing transactions of senior executives (§ 15a WpHG) or the changes to the requirements for the supervision of the ban on market price manipulations (§ 20a WpHG) and the extension of ad hoc public releases (§ 15 WpHG). The introduction of the Investor Protection Improvement Act brought about all substantial changes in the area of the Securities Trading

Act. These innovations were especially of direct relevance for listed corporations and their board members but also for their shareholders. Also this question was answered by forty-six companies. The standard deviation was relatively high with 0.834 which means that the average value was not necessarily typical as there can exist numerous or also large deviations from the average value.

In conclusion, it can be noted that, according to the results of the questionnaire, company representatives rate the legal regulations with regard to the implementation of the German government's 10-Point-Program with regard to the disclosure and prevention of balance sheet manipulations as somewhat helpful.

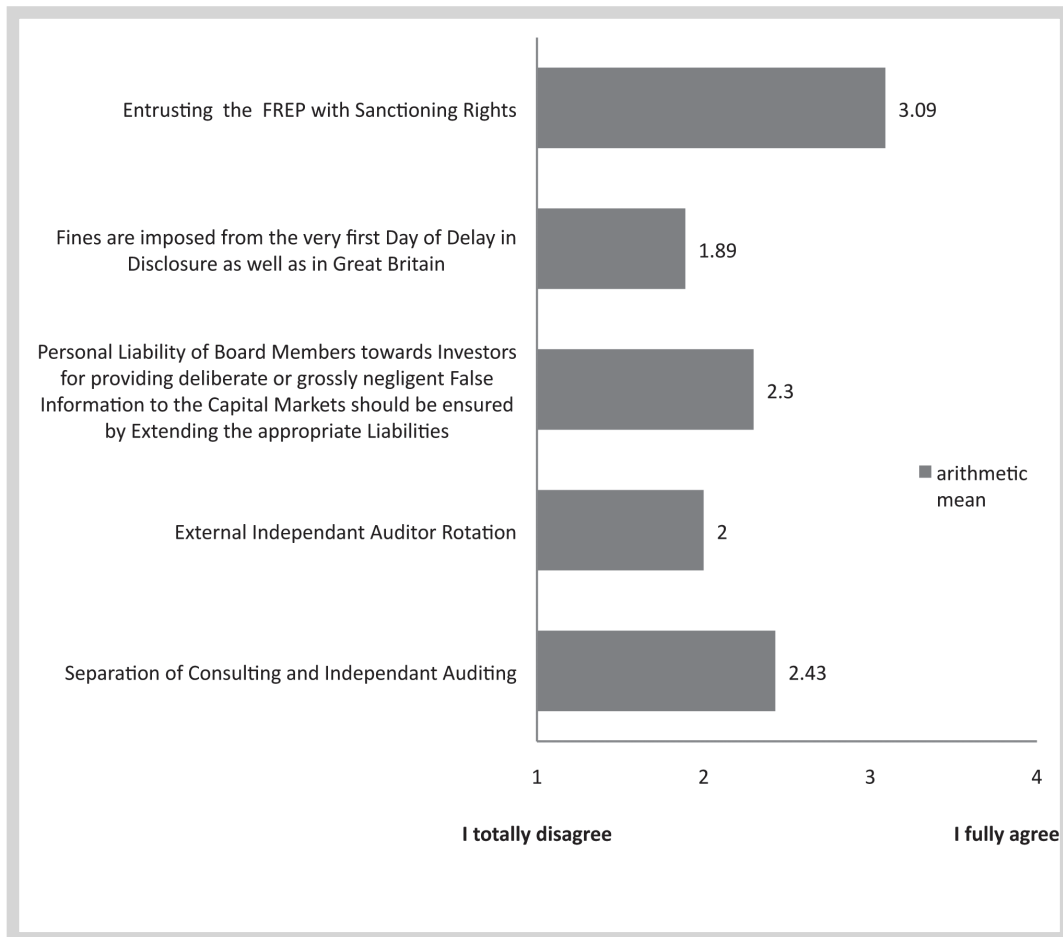
With regard to point II of the survey, participants were asked as part of the questionnaire to provide their level of acceptance to following statements: "The legal implementation of the government's 10-Point-Program is sufficient for our company in terms of the disclosure and avoidance of balance sheet manipulations". This statement could be rated using a four-point scale from "I totally disagree" to "I fully agree". Subsequently the answers were coded ("I totally disagree" = 1; "I rather disagree" = 2; "I rather agree" = 3; "I fully agree" = 4) and summarized as average levels of agreement. An agreement level of 2.5 can be rated as indifference by the participants with regard to the question concerned. This question attained an average agreement level of 2.71. This means that the companies who responded just assume that for themselves the legal implementation of the government's 10-Point-Program with regard to the disclosure and prevention of balance sheet manipulations is sufficient. The standard deviation is 0.782 and therefore in the middle range of the standard deviations so far. 41 out of 48 companies responded to this question. The following chart provides a view of the level of agreement in percent.



*Spreadsheet 8: Assessment of the 10-Point-Program regarding your own company*

#### **4.3 EVALUATION OF THE USEFULNESS OF POSSIBLE CONCRETE MEASURES BY THE COMPANIES POLLED**

The discussed thesis in this chapter looks at the usefulness of possible concrete measures with regard to the disclosure and prevention of balance sheet manipulations. These theses are more or less being publicly discussed in context with a tightening of the government's Catalogue of Measures. The thesis could be ranked using a four-stage index from "I totally disagree" to "I fully agree". Subsequently the answers were encoded ("I totally disagree" = 1; "I rather disagree" = 2; "I rather agree" = 3; "I fully agree" = 4) and summarized as average levels of agreement. An agreement level of 2.5 can be rated as indifference by the participants with regard to the question concerned. The answers were then aggregated to average levels of agreement. The results are summarized in the following chart.



*Spreadsheet 9: Views on the desirability of possible measures*

The first thesis states that entrusting the German Financial Reporting Enforcement Panel with sanctioning rights is deemed appropriate for the disclosure and prevention of balance sheet manipulations. This was rated with an arithmetic mean of 3.09 and was by far the most positively rated result. In addition, this was also the only of the five theses that got more agreement than disagreement in the first place. All other four theses were more or less refused. The standard deviation is 0.830 and is in the lower range of the five calculated standard deviations with regard to the five theses. All in all, forty-four of the forty-eight companies who responded to the survey provided a rating to this statement.

The second thesis stated that it would also be appropriate in Germany, as already in practice in Great Britain, to impose fines from the very first day of delay in disclosure. The arithmetic mean at a mere 1.89 shows a strong resistance to this thesis. The standard deviation is 0.840 and is, therefore, in the lower area of the five calculated standard deviations with regard to the five theses. Altogether forty-seven companies provided an opinion on this thesis.

The third thesis said that personal liability of board and supervisory board members towards investors for providing deliberate or grossly negligent false information to the capital market should be ensured by extending the appropriate liabilities. With an arithmetic mean of 2.3 this thesis showed a low level of rejection as a mere 0.2 percentage points are missing to meet the value of indifference. The standard deviation was relatively high with 0.916 and additionally highlights the rather high spectrum of answers provided by the respondents. Forty-six companies responded to this thesis.

The fourth thesis was that the introduction of an external independent auditor rotation should be put on a legal footing. The majority of the survey participants rejected this with an arithmetic mean of 2.00. This question scored the highest standard deviation with 0.933 in relation to all five theses. This means that the arithmetic average is rather not very typical for the distribution because there is a rather large or numerous divergence from the average value. Forty-seven companies provided a statement to this thesis.

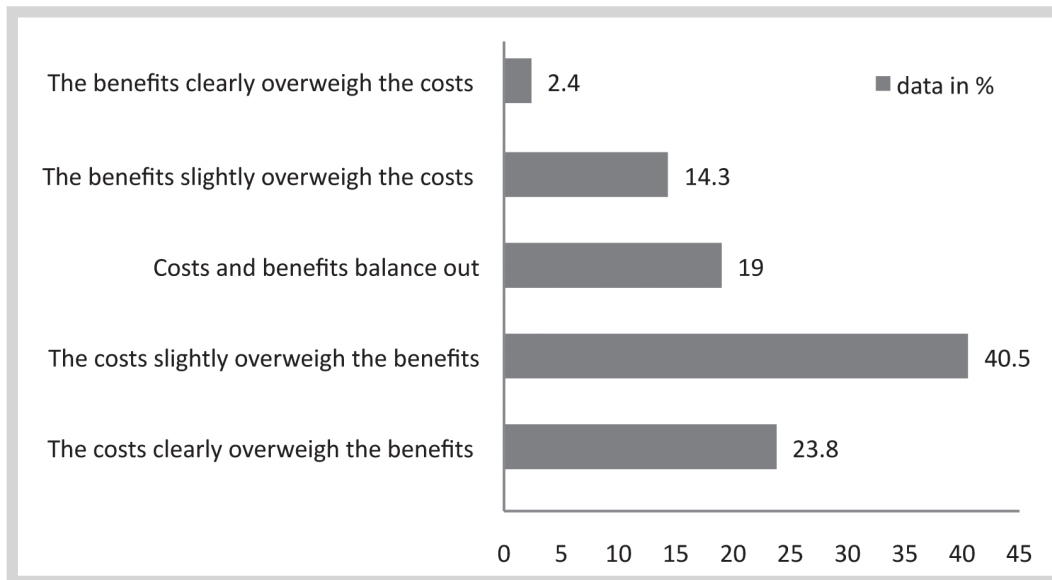
The fifth thesis read that the introduction of the separation of consulting and independent auditing services should be put on a legal footing. The arithmetic mean of 2.43 shows a more or less indifferent position of the survey participants towards this thesis. The standard deviation is also the smallest calculated standard deviation with regard to the five theses with 0.827. The above finding would suggest that the answers are rather towards the average value and that there are rather no large spikes either up- or downwards. To this last of the five theses forty-seven of the forty-eight companies who participated responded.



#### 4.4 THE POLLED COMPANIES' EVALUATION OF THE COST-BENEFIT RATIO

With the so-called 10-Point-Program to strengthen companies' integrity and to protect investors, the German Federal Government wanted to counteract the numerous cases of balance sheet fraud in Germany. Their goal was, on the one hand, to achieve an improvement in the general framework to strengthen self-regulation of the capital market and, on the other hand, to prevent behavior that damages the capital market through direct intervention. The implementation of these measures occurred in different, separate legislative procedures. The additional requirements that were regulated through the new legislation had to be implemented by affected companies. This in consequence led to additional costs for the respective companies. That is why in the questionnaire undertaken the companies contacted were asked to provide an assessment of the cost-benefit ratio with regard to the legislative regulations that were initiated in response to the Catalogue of Measures to disclose and prevent balance sheet manipulations.

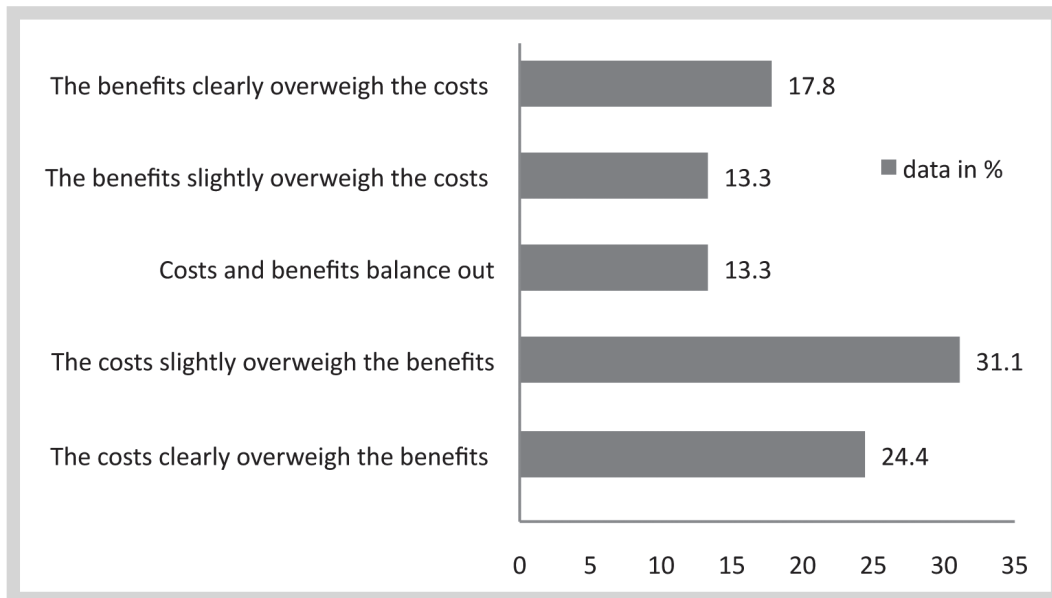
In order to evaluate the cost-benefit ratio, the companies were asked to respond making use of a five-point scale from "the benefits clearly outweigh the costs" = 1; "the benefits slightly outweigh the costs" = 2; "costs and benefits balance out" = 3; "the costs slightly outweigh the benefits" = 4; "the costs clearly outweigh the benefits" = 5. The result is shown in the following illustration.



*Spreadsheet 10: Assessment of the cost-benefit ratio in respect to varied aspects regarding all measures*

The result is fairly conclusive in its statement. Nearly 65 per cent of the companies who responded thought that the costs outweighed the benefits; nearly 24 per cent thought even that the costs clearly outweighed. 19 per cent of the questioned companies saw the cost-benefit ratio as balanced. And only 2.4 per cent are of the opinion that the benefit clearly outweighs the costs.

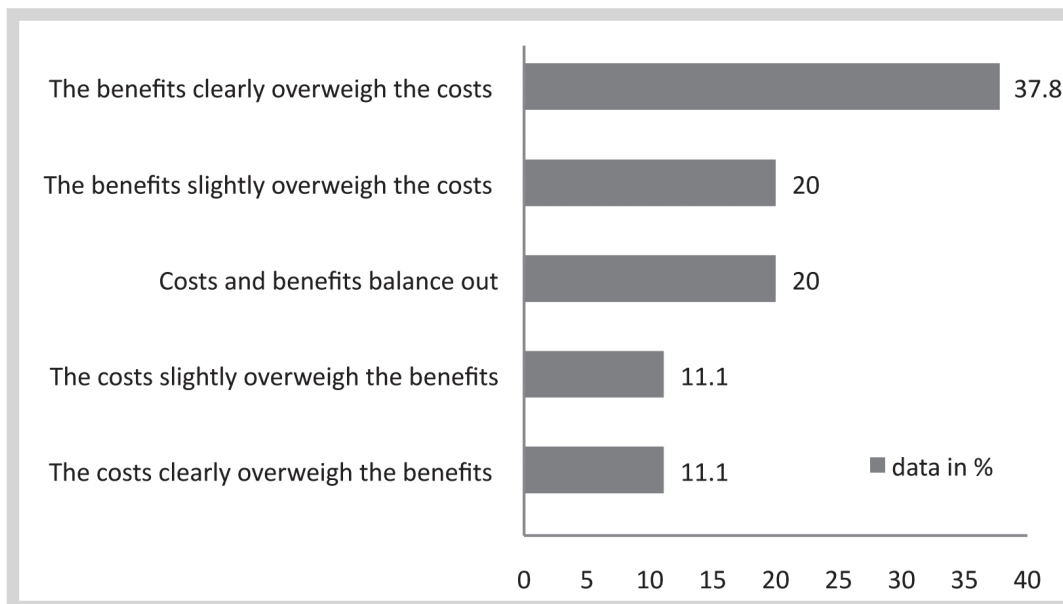
The answer to the first question was targeted at the general cost-benefit ratio for all measures. The answers to the three following questions were aimed at ascertaining the cost-benefit ratio specifically in relation to concrete legislative regulations. The first of the following questions was aimed at the cost-benefit ratio with regard to the monitoring of the legality of actual financial statements by an independent institution (DPR/BaFin). The result is shown in the following illustration.



***Spreadsheet 11: Assessment of the cost-benefit ratio in respect to varied aspects regarding the monitoring of the legality of actual financial statements by FREP/BaFin***

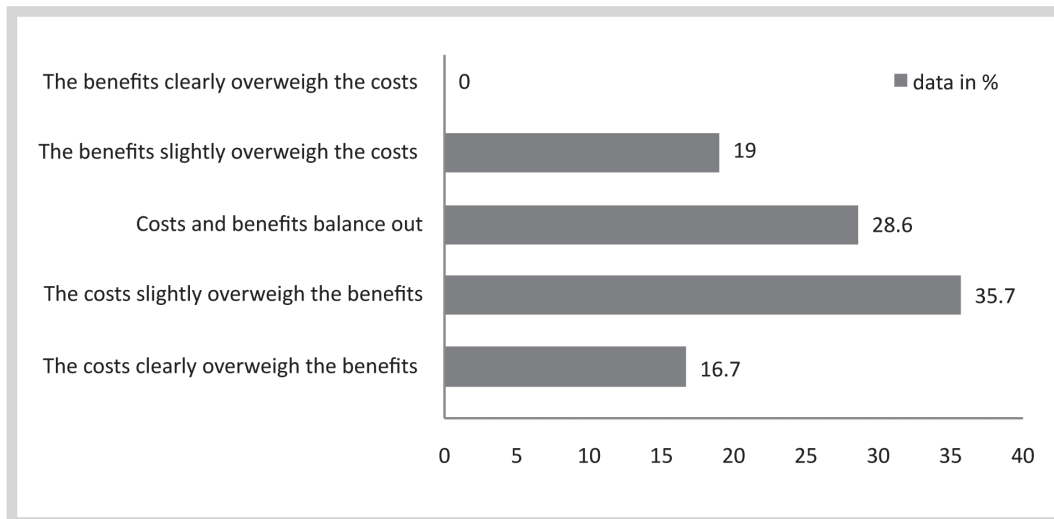
The result for this question is not as clear as the one with regard to all measures. Only a good 55 per cent of the respondents saw a domination of costs compared to the benefit. On the other hand, also over 31 per cent of the companies questioned saw the benefit outweigh the costs; nearly 18 per cent of the company representatives viewed the benefit as clearly outweighing the costs.

The second question was targeted at the cost-benefit ratio with regard to the electronic publication of company accounts. Here the answer shows a completely different picture to that of the first general cost-benefit ratio question. Nearly 58 per cent of the companies which responded assume that the benefit of the legislation regarding the need to electronically publicize outweighs the costs. 20 per cent of the participants believe that the benefits and the costs balance out and only 22 per cent of the survey participants see the costs outweigh the benefits. The corresponding results are depicted in the following chart.



*Spreadsheet 12: Assessment of the cost-benefit ratio in respect to varied aspects regarding the electronic publication of company accounts*

The third question was aimed at the cost-benefit ratio regarding the extended company obligations made by the Investor Protection Improvement Act. The result is depicted in the following chart.



*Spreadsheet 13: Assessment of the cost-benefit ratio in respect to varied aspects regarding the extended company obligations made by the Investor Protection Improvement Act*

It has become apparent that just over 52 percent of the polled companies see a domination of the costs over the benefits. Almost 29 percent of the attendants believe that costs and benefits balance out. 19 per cent of the participants see the benefits slightly outweigh the costs and what is noticeable is that nobody views the benefits as clearly outweighing the costs.

## 4.5

## ASSESSING THE OUTCOMES

With regard to assessing the effectiveness of the new legislative regulations regarding the disclosure and prevention of balance sheet manipulations the companies polled view the German Law on Financial Reporting Compliance from 2005 to be most suitable closely followed by the German Act on Electronic Commercial and Co-operative Registers and the Company Registers from 2007. All forty-eight responding companies provided an assessment on these two legislations. This fact alone can lead to the conclusion that this question with regard to the context of the prevention and disclosure of balance sheet manipulations can be viewed as well classified. The high level of agreement by companies towards the German Law on Financial Reporting Compliance is in line with Hofmann's assessment who said that the German enforcement (DPR and BaFin) was a step in the right direction (cf. Hofmann, 2008, p. 343). The formulated criticism raised through external publications towards the German Law on Financial Reporting Compliance and which questions its effectiveness (cf. Baetge/Thiele/Matena, 2004, p. 231 f) is a view which is not shared or seen in this way by the companies polled. As a result of the German enforcement policy having uncovered, however, already at least two cases of balance sheet manipulations in which the annual financial statement of 2006 included an incomplete portrayal of speculation with US credit instruments (Sachsen LB) (see chapter 3.5.1) or where the own company share packages were sold with a million two-digit profit before the sudden fall in price (Conergy) (see chapter 3.5.1) one can – despite all criticism raised – be of the opinion that this is a step in the right direction. The positive acceptance of the legislation relating to the Electronic Commercial and Co-operative Registers and the Company Registers from 2007 by the companies surveyed is also in line with the views raised in external publications in which above all the need and importance of transparency as well as facilitating the work of law enforcement officers and register courts is highlighted (cf. Meyding/Bödeker, 2006, p. 1012).

The German Corporate Governance Code which is reworked on an annual basis as needed is, however, according to the opinion of the companies surveyed not a suitable contribution towards disclosing and preventing accounting fraud. This seems somewhat surprising given that the commission is formed by eminent representatives of the economy and politics. A possible explanation for the assessment made by the companies is that the German Corporate Governance Code,

apart from statutory provisions, includes mainly recommendations and suggestions. One can deviate from recommendations if one provides a rationale and suggestions can be deviated from without providing a rationale. For this reason one can call this a weapon without ammunition in the fight against accounting fraud. External publications support this view, for example, through Zünd (cf. Zünd, 2005, p. 8) and Hofmann (cf. Hofmann, 2008, p. 369). The question of the effectiveness of the German Corporate Governance Code with regard to the disclosure and prevention of balance sheet manipulations was answered by forty-six of the forty-eight companies who responded. One can therefore assume also in this case that the respondents were well able to place this question into the context of disclosure and prevention of balance sheet manipulations.

Also the Law on Corporate Integrity and Modernization of the Right of Avoidance from 2005 and German Capital Markets Model Case Act from 2005<sup>122</sup> are not very helpful in disclosing and preventing accounting fraud according to the survey participants. Here it is particularly noticeable that, only thirty-nine or forty-one of the forty-eight companies answered both of these questions. Possible reasons for the fact that nine respectively seven participants did not answer this question could be that the survey participants do not know this legislation in detail or that they do not make the connection between this legislation and accounting fraud. This presumption is based on the fact that from all questionnaires returned, eleven were answered by members of the legal department whereas thirty-seven questionnaires were answered by members of other departments such as, for example, accounting or investor relations.

Question II "To what extent do you agree or disagree with the following statement: The legal implementation of the government's 10-Point-Program is sufficient for our company in terms of disclosure and avoidance of balance sheet manipulations" was clearly answered in favor of the legal framework. Over sixty per cent of the survey participants assume that the existing legislative measures are sufficient for their company to successfully disclose and avoid balance sheet manipulations. This view is strengthened by a survey conducted in the summer of 2012 by the auditing firm KPMG that was targeted at German medium-sized companies. This study clearly showed that concerning companies affected by white-collar-crime

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122 This legislation had a time limit and was re-evaluated in 2011 and then re-adopted in 2012 with some changes made with a new time limit of 2020.

the number of falsifications of financial information and annual financial statements declined from thirteen per cent in 2010 (cf. KPMG, 2010, p. 8 f) to three per cent (cf. KPMG, 2012, p. 11).

The answers received to question III asking for the views on the desirability of possible measures relating to the disclosure and prevention of balance sheet manipulations showed that the majority of the survey respondents are of the opinion that it is appropriate to entrust the German Financial Reporting Enforcement Panel (DPR) with sanctioning rights. Heretofore the DPR had absolutely no sanctioning rights. Only the German Financial Supervisory Authority (BaFin) which stands above the DPR has such rights but also only in a restricted form. If the DPR had similar rights as the BaFin, then it would also have more opportunities to influence fraudulent companies. In this case the legislator could at least investigate whether giving the DPR sanctioning rights would lead to improved power and efficiency and would then also be taken more seriously by companies as an official inspection agency. External publications demand that enforcement bodies should in principle be given sanctioning rights. The limited rights of BaFin whose possibility to exert influence ends when they inform the general public would have to be appropriately extended (cf. Baetge/Thiele/Matena, 2004, p. 208; Hofmann, 2008, p. 342).

With regard to the thesis that fines should be imposed from the very first day of a delay in disclosure, the result of the analysis showed disapproval by the companies polled. The negative stance towards being sanctioned from the very first day of a delay can possibly be seen in the fact that companies, in general, adhere to the required period of notice of disclosure and therefore view a fine being imposed from the very first day of a delay as being too severe. With the German Act on Electronic Commercial and Co-operative Registers and the Company Registers (EHUG) coming into force the rate of publication by companies has increased significantly. In the financial years leading up to 2007 it was less than five per cent but for the financial year 2008 it rose to over ninety per cent (cf. Schlauß, 2010, p. 153 f; Schlauß, 2011, p. 805 f). Against this background, it also does not seem appropriate to put much effort into the daily documentation of missing disclosures.

Extending the personal liability of board and supervisory board members for providing deliberate or grossly negligent false information to the capital markets was rejected by the narrow majority of the company's questioned. This is in line with external publications in which, on the one hand, an extension of personal



liability is desired but in which there is also the thesis that the statutory regulations are sufficient for the question of personal liability. For instance, Jürgen Kurz from the German Protection Association for the Ownership of Securities hoped that a corresponding extension of the cases for liability, for which he sees currently a large gap in investor protection, would be closed (cf. Drost, 2004a, p. 27). Also Wolfgang Gerke evaluates the situation as such that the existing civil liability foundation of claims has not proved itself as unsuitable with regard to helping aggrieved investors effectively make their claims for compensation (cf. Gerke, 2004, p. I). Jan Wulfetange, a specialist in capital market law of the Federation of German Industries, holds a completely different view. He expects that a related expansion of the prerequisites for liability will lead to an increasingly legal nature of entrepreneurial decisions (cf. Drost, 2004a, p. 27). Also according to Klaus Bräuning, member of the executive board of the Federation of German Industries, there is no need to strengthen the rules governing liability (cf. Drost, 2004b, p. 29). And also Duve and Basak are of the opinion that the jurisprudence in the cases of Infomatec, EM.TV and Comroad have clearly demonstrated that the general standards of tort law are sufficient (cf. Duve/Basak, 2005, p. 2650).

A legal anchoring of the introduction of external independent auditor rotation was largely refused by the companies questioned. The legislator also refused the request for an externally enforced rotation, the reason provided being that there is a danger of loss in the quality of the audits after a change of auditing firms. The reaction of external publications to the reason provided is to state that the legislator has failed to provide proof that its point of view is correct (cf. Ruhnke, 2000, p. 91 f; Niehus, 2003, p. 1638). Also the question of having internal and external independent auditor rotations received mixed views as found in external publications. For instance, Baetge and Matena are in favor of an external independent auditor rotation every five to six years (cf. Baetge/Matena in Wollmert et al, 2003, p. 195 f). And also Peemöller and Hofmann are of the opinion that an external rotation can be an appropriate instrument for strengthening the trust in the integrity of the statutory audit and for combating fraudulent accounting. But Schruoff maintains that the introduction of external rotation would give criminal preparers of balance sheets a constant head start of at least two years (cf. Peemöller/Hofmann, 2005, p. 199). Weißenberger raises the concern that if there was a forced external rotation then too little money and know-how would be invested into new mandates (cf. Weißenberger, 1997, p. 2319). The results of the survey would indicate that the

companies who responded also mainly follow the reasoning of the people opposing enforced external rotation.

The controversy surrounding the thesis that the introduction of the separation of consulting and independent auditing services should be put on a legal footing on behalf of the companies polled is also reflected in external publications, where this topic is also the subject of controversial debate. From the standpoint of a supporter of the separation of consulting and independent auditing, one can refer to Baetge and Matena. In their opinion the danger exists that, by providing auditing services as well as audit related consultation to the same company, the auditor loses his independency and becomes a servant of two masters. On the one hand, he has to pursue the role of independent auditor in representing the interests of the shareholders and creditors and, on the other hand, due to his consultation services he has to fulfill the wishes of the company's management. As the consultation services promises higher profit margins, it can lead to a situation where the auditor is not orientated towards the expectations of the investors and shareholders but rather towards the demands and provisions of the company's management (cf. Baetge/Matena in Wollmert et al, 2003, p. 185 f). A further advocate of a distinct separation between independent auditors and simultaneous consulting within the same company is Riecke. In his view the criminal acts of some auditors point to a cultural decline (cf. Riecke, 2002, p. 9 f). A strict opponent of the request to separate the services of auditing and consultation is Ring. He views the general problem as being such that the auditors per se – meaning regardless of whether they provide other services – are facing growing competition. This has resulted in the situation that independent audits are sometimes offered at a fee that can barely cover costs if the audit is performed according to the regulations that apply (cf. Ring, 2002, p. 1348 f).

Considering the result of the survey it can be noted that, beyond the context of assertion of each assessment, four of the five suggestions that had been refused by the participants possibly received a negative rating because they might limit the power of the board of the company and also the power and personal influence of individual managers.

The last set of questions in part IV are about assessing the cost-benefit ratio for the implementation of the legislative measures for your company that were initiated by the Catalogue of Measures for the disclosure and prevention of balance

sheet manipulations. The overall assessments of the measures of the 10-Point-Program that have been implemented to date show a clear result. According to the company representatives, the costs clearly outweigh the expected benefit. The assessment questions the desired effectiveness of the 10-Point-Program as one can assume that companies only follow the legislative changes that resulted from the Catalogue of Measures where they must.

As part of the questions on individual points of the Catalogue of Measures with regard to the cost-benefit ratio, it could be established that, with a view to the monitoring of the legality of actual financial statements by an independent institution (DPR/BaFin) and with a view to the extended company obligations made by the Investor Protection Improvement Act, the costs were still seen as outweighing the benefits but to a lesser extent than the overall assessment. With respect to the electronic publication of company accounts, on the other hand, one can state that companies clearly see that the benefits outweigh the costs. This result corresponds with the assessment of the effectiveness of the new statutory regulations with regard to the disclosure and prevention of balance sheet manipulations addressing the issue of whether they are helpful or not. The highest level of agreement was given to monitoring the legality of actual financial statements by an independent institution closely followed by the electronic publication of company accounts. The result of the first measure is valued at 2.79 and the result of the second measure is valued at 2.77. Although these values are nearly identical one can, however, notice that with regard to the question of the cost-benefit ratio they differ. Here the electronic publication of company accounts clearly achieves the higher level of consent meaning that the benefit is seen as outweighing the costs. So it is reasonable to assume that the electronic publication of company accounts can provide great benefit to companies from a competitive point of view. As part of this study, 160 of the largest companies in Germany were questioned. These companies have the most capital and highly experienced employees and therefore hold the market power. Through the electronic publication of competitor' and smaller companies company' accounts they can access information that can be useful to them for intended acquisitions or dismantling of other companies.



**CONCLUSION**

A study conducted by KPMG in 2010 concluded that concerning companies affected by white-collar-crime between 2006 and 2010 falsifications of annual financial statements and financial information increased from six to thirteen per cent. Furthermore, in the same time-frame there was a strong shift in the white-collar crime sector towards the areas of finance and accounting as well as the lending business according to this study. Based on these findings KPMG concludes that white-collar crimes are being committed by people in increasingly higher hierarchical positions (cf. KPMG, 2010, p. 8 f). This study was a joint survey conducted by the auditing firm KPMG and the social science institute TNS Emnid who have been conducting such studies at irregular intervals since 1999. The study conducted in 2012 was already the fifth. The three-hundred and thirty-two medium-sized companies chosen, based on being representative by sector and size, were questioned as to their experiences with white-collar crime.

In their study from 2012, KPMG found out that concerning companies affected by white-collar-crime between spring 2010 and the summer of 2012 the number of falsified annual financial statements and financial information decreased from thirteen to three per cent. Whilst the study conducted in 2010 focused only on medium-sized companies, the study conducted in 2012 also included the top hundred companies in Germany by size of which thirty-two participated in the study. Even if the result of this study shows that the manipulation of information relevant to the annual financial statements occurs relatively rarely compared to other types of crime, KPMG stresses that with regard to the damage caused and the reputational loss of the companies affected it is considerable (cf. KPMG, 2012, p. 11, 24). The details of this study were reviewed in detail as part of this study (see chapter 2.4.1). The decline in manipulations of information relevant for annual financial statements within this short time-frame of ten per cent seems to be significant.

A study conducted in regular intervals in Germany by the TNS Emnid on behalf of pwc and the University of Halle-Wittenberg also reinforces this trend. The result of this study showed that the number of incorrect balance sheets declined from three per cent in 2011 to two per cent in 2013. In this study 603 companies with over 500 employees were questioned (cf. pwc, 2013, p. 12, 13 and 17).

The statutory as well as company-internal provisions for the prevention of

accounting fraud appear to be working. The company survey conducted especially for this study also goes in the same direction. The majority of the companies polled agreed with the statement that the implementation of the government's 10-Point-Program is sufficient for the disclosure and prevention of balance sheet manipulations within their company.

However, it must be borne in mind that accounting fraud still exists and must continue to be addressed. The study conducted by KPMG in 2012 came to the result with regard to white-collar criminals that in medium-sized companies every third case involved management or top management. In regard to the top 100 companies, the study concluded that the percentage affected was even higher (cf. KPMG, 2012, p. 7). Furthermore, the study draws attention to the fact that the higher the number of employees, the higher the risk for the company of white-collar crimes occurring (cf. KPMG, 2012, p. 24). Nearly every fourth medium-sized company in Germany was victim of white-collar crime over the two years from 2010 to 2012. With regard to the top 100 companies, even more than half were affected (KPMG, 2012, p. 6).

If one asks medium-sized companies about the risk of becoming a victim of the white-collar crime of manipulation of information relevant to the annual financial statement, the following picture emerges. Only four per cent of the companies see a very high risk. Thirty-three per cent see a high risk. Fifty-four per cent see a low risk and nine per cent see only a very low risk (cf. KPMG, 2012, p. 16). With regard to the top 100 companies here only twenty-five per cent assume that there is a high or very high risk of them becoming a victim of white-collar crimes in the area of manipulation of information relevant to the annual financial statement (cf. KPMG, 2012, p. 27). It therefore appears that the medium-sized companies as well as the top 100 companies questioned have an adequate awareness of the risk as the perception of risk specific to an offence corresponds with the actual risks in the area of manipulations of annual financial statements. Here the risk of becoming a victim of such an act is seen as low and the overall damage is actually the lowest of all types of offences (cf. KPMG, 2012, p. 17 and 28).

White-collar crime can be prevented in many ways. Based on the survey conducted, the most important sources of detecting an offense are indications from within the company or incidental discoveries. But also indications from outside of the company or also anonymous tips are important. The last two of these types

of sources of indications have increased in priority since the last time the study was conducted (cf. KPMG, 2012, p. 18). The fact that the types of indications have increased may be related to the changed disclosure requirements in Germany. On January 1 2007 the German Act of Electronic Commercial and Co-operative Registers and the Company Registers (EHUG) came into force. The act allowed for electronic access to all relevant company information. Consequently, also company external or otherwise interested persons attain information regarding specific companies and thereby also contribute to the detection of accounting crime. The higher the transparency of the business practices of individual companies, the harder it is for fraudulent managers to cover their wheelings and dealings. Also the company survey conducted solely for this study concluded that, with regard to the electronic publication of company accounts, the benefits outweigh the costs.

Concerning companies affected by white-collar-crime the indications of economy fraud having occurred in the annual audit declined from eleven to five per cent in 2011 compared to the previous study (cf. KPMG, 2012, p. 18). These indications were provided by auditing firms as part of their yearly annual audit. Here one has to raise the question as to what is the reason for this positive trend. As one can assume that the auditing firms have not changed their approach, one must assume that there are fewer cases of balance sheet manipulations in companies. An explanation for this can be the legal implementation of the points raised in the government's Catalogue of Measures. Point 5 (Strengthening the Role of the Independent Auditor) of the Catalogue of Measures could have contributed to this improvement. Through the implementation of the planned measures of point 5 there were, for example, a multitude of statutory changes such as the implementation of international auditing standards (§ 317 (5) of the German Commercial Code), an increase in the responsibility of the group auditor (§ 317 (3) sentence 2 of the German Commercial Code), changes in the reports of the independent auditor (§ 171 (1) sentences 2 and 3 of the German Stock Corporation Act), a disclosure of auditors' fees (§ 285 sentence 1 number 17 of the German Commercial Code) and changes to professional supervision (Final Auditor Supervision Act). However, it should be noted that the demands raised in the Catalogue of Measures have been interpreted too loosely and/or have not been implemented such as, for example, the separation of simultaneous auditing and consultancy functions or the extension of an auditor's liability. The results of the present study whereby 160 companies from different DAX segments were questioned shows that the companies

which responded are satisfied with the scope of the legal implementation of the points raised in the government's Catalogue of Measures. As such, for example, the separation of simultaneous auditing and consulting services by the same auditing firm was rejected by the companies. The assessments with regard to this question were widely scattered. In summary, a small majority of companies voted against the separation of simultaneous auditing and consulting services.

Concerning companies affected by white-collar-crime also the indications through law enforcement agencies or supervisory authorities declined from thirty-five to thirteen per cent compared to the previous study from 2010 (cf. KPMG, 2012, p. 18). Here it is also likely that the work of law enforcement agencies has not significantly changed. In this respect, it should also be considered that in general the prosecutors working the cases of economic crime are also responsible for small-scale crime (cf. Hienzsch, 2004, p. 126 f). Hienzsch points out that even if a case were to be handled by specialized public prosecutors, one could still not always guarantee proper handling as also specialized public prosecutor offices have difficulties keeping up with the level of education that a very highly equipped lawyer has compared to that of their public prosecutors. Especially the BaFin took a critical stance towards the often low level of professional qualifications held by public prosecutors. The low number of public prosecutor personnel, too, is a cause for concern. The result of the labor shortage is an extremely high workload for the individual public prosecutor who demonstrates a great willingness to take the path of least effort when handling white-collar crimes. With all goodwill in the world, the shortage of labor is often the root cause for the failure to follow criminal procedural processes properly as it results in a time-lag. A time-lag in turn makes it harder to clarify and assess the actual facts. In summary, Germany's public prosecutors are also financially ill equipped to prosecute white-collar criminals (cf. Hienzsch, 2004, p. 126-129).

An explanation for the decline from thirty-five to thirteen per cent with regard to the indications through law enforcement agencies and supervisory authorities can also be found in the legally implemented points of the government's 10-Point-Program. Point 6 (Monitoring the legality of actual financial statements by an independent institution) of the government's Catalogue of Measures could have contributed to this improvement.

The German Law on Financial Reporting Compliance introduced a two-stage



enforcement procedure in which in the first stage the German Financial Reporting Enforcement Panel (DPR or FREP) organized under private law according to §§ 342b – 342e of the German Commercial Code takes action. In the second stage the Federal Financial Supervisory Authority (BaFin) becomes active pursuant to §§ 37a – 37u of the WpHG and which holds sovereign rights. The DPR audits are not only based on concrete evidence for a breach against accounting standards or upon request by the Federal Financial Supervisory Authority (BaFin) but also on a random basis without any due reason. Based on the results of the survey conducted solely for this study, the companies surveyed are in favor of the DPR (FREP) having sanctioning rights as this is seen as important for the prevention of balance sheet manipulations. The DPR to date has, however, not got the possibility to impose sanctions. Here, the legislator has failed to date to tackle this issue.

To prevent and disclose balance sheet manipulations and, therefore, for the protection of society, the safeguarding of functioning capital markets and to protect investors there is, however, a need to fight fire with fire. Effective legislation as well as speedy, functioning criminal prosecution is required. It also requires, apart from financial resources, the need for support from specialists in the public prosecutor offices for the sector of company annual financial statement analysis. Also the kind of punishment could lead to a reduction in balance sheet fraud. Here one can refer to Henzler to the procedures applied in the US against balance sheet offenders. Members of company management, who can expect a sentence of up to twenty years for making false statements in the annual financial statements, must add a declaration to the financial statements in which they personally declare that it does not include any untruths and that they convey an accurate image in line with the actual condition of the assets, financial position and earnings. Henzler stresses that this does not only make a valuable contribution to the prevention of accounting fraud but also strengthens the trust in the correctness of company financial statements and therefore also in the capital market (cf. Henzler, 2006, 134).

Point ten of the Catalogue of Measures addresses this issue. Here it is not only suggested that the version of the elements of criminal offenses are checked for gaps and unclarities but that one also considers increasing the range of sentences for the basic facts of offence as well as for the cases where there was an intent to realize a profit. However, there are no legislative measures planned for point ten of the Catalogue of Measures by the Federal Government.

The thesis that the personal liability of board and supervisory board members towards investors for providing deliberate or grossly negligent false information to the capital market should be ensured by extending the appropriate liabilities was, despite broad divergences in the assessments received, rejected by a slight majority of the companies questioned as part of this study. It can thus be concluded that a slight majority of 160 DAX companies also see no need for further action with regard to the legal implementation of point ten of the Catalogue of Measures.

The question as to how medium-sized companies sanction fraudulent behavior was investigated by KPMG. They found that, in ninety-six per cent of the cases companies took appropriate action when discovering a crime. In seventy-five per cent of the cases, there are adjustments made to the corporate structure, in seventy-one per cent there are changes made to the preventative measures and in sixty-nine per cent there are steps taken against the person who committed the fraud. With regard to the people who committed the fraud, the measures taken are mostly of a labour-law nature, in nearly every second case of a penal nature and in every third case of a civil law nature. All in all the legal measures taken have declined compared to preceding years (cf. KPMG, 2012, p. 20 f). The top 100 companies take labour-law related action and penal action much more frequently against fraudulent action which has caused them damage. As such, medium-sized companies take labour-law action in sixty-four per cent of the cases and in forty-nine per cent there are penal consequences, whereas with the top 100 companies it is eighty-three and sixty-seven per cent (cf. KPMG, 2012, p. 20 und 30). The numbers highlight that action against fraudulent behaviour under both civil and penal law is taken relatively seldom by medium-sized companies. If one does not have to fear being taken to civil or criminal court, then one cannot expect an effective preventative effect.

Ruter points out that world-wide a mere forty per cent of white-collar crimes discovered have led to disciplinary action, less than a quarter of the cases claims for damages have been raised and only six per cent of the cases have ended up in court. As white-collar crimes are mostly not communicated and often not even employees are informed, one can assume that inconspicuous economic perpetrators use this lack of communication as well as insufficient sanctioning for their own benefit. This is relevant with regard to plans to take preventative measures as seventy-seven per cent of the cases never reach the public (cf. Ruter, 2012, Internet

Source). There is no deterrent effect on the potential offender as he sees neither a danger for himself to be pilloried nor a danger of losing his financial and social status.

In conclusion, it is safe to say that the gradual legal implementation of the government's 10-Point-Program is a step in the right direction for prevention and disclosure of accounting fraud. This is also borne out of the figures that show the regressive nature of manipulations of information relevant to the annual financial statements as shown in the study conducted by KPMG and NMS-Emnid in 2012. The effectiveness of the legal implementation depends not least on companies' behavior. If companies fully exhaust their means to prevent and disclose balance sheet manipulations, then white-collar crime could be even more effectively combated.



**TABLE OF ENCLOSURES**

## Enclosures Notational

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## Enclosures Digital

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- Enclosure 6: SPSS Syntax File
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## Fragebogen

I Die folgenden Fragen beziehen sich auf die Umsetzung des 10-Punkte-Programms (Maßnahmenkatalog) der Bundesregierung von 2003. Dabei geht es zunächst um die Frage, wie Sie die Wirksamkeit der neuen gesetzlichen Regelungen im Hinblick auf die **Aufdeckung** und **Verhinderung** von Bilanzmanipulationen einschätzen.

- 1 Gesetz zur Unternehmensintegrität und Modernisierung des Anfechtungsrechts (UMAG) von 2005.

Zum Beispiel: Einführung einer allgemeinen Aktionärsklage (§§ 147-149 Aktiengesetz), darin die Verpflichtung zur Geltendmachung von Ersatzansprüchen gegen Gründungs- und Verwaltungsmitglieder (§ 147 Aktiengesetz) als auch das Klagezulassungsverfahren (§ 148 Aktiengesetz); Senkung der Schwellenwerte für eine aktienrechtliche Sonderprüfung (§ 142 Abs. 2 Aktiengesetz); Einführung eines Aktionärsforums zu Kommunikationszwecken (§ 127 a Aktiengesetz); Einführung einer „Business Judgement Rule“ (§ 93 Abs. 1 Aktiengesetz).

- gar nicht hilfreich
- wenig hilfreich
- hilfreich
- sehr hilfreich

- 2 Kapitalanleger-Musterverfahrensgesetz von 2005.  
Einführung einer Musterklage, die gemäß § 16 Kapitalanlegermusterverfahrensgesetz, die Prozessgerichte bindet. Deren Entscheidung hängt von der im Musterverfahren getroffenen Feststellung oder der im Musterverfahren zu klärenden Rechtsfrage ab.
- gar nicht hilfreich
- wenig hilfreich
- hilfreich
- sehr hilfreich
- 3 Bilanzrechtsreformgesetz von 2004 und Bilanzrechtsmodernisierungsgesetz von 2009.  
Fortentwicklung der Bilanzregeln und Anpassung an internationale Rechnungslegungsgrundsätze.
- gar nicht hilfreich
- wenig hilfreich
- hilfreich
- sehr hilfreich
- 4 Bilanzrechtsreformgesetz von 2004, Abschlussprüferaufsichtsgesetz von 2004, Berufsaufsichtsreformgesetz von 2007 und Bilanzrechtsmodernisierungsgesetz von 2009.  
Zum Beispiel: Ausweitung der Prüfungshandlungen des Konzernabschlussprüfers (§ 317 Abs. 3 Satz 2 HGB, BilMoG), Erweiterung der Ausschlussgründe des Abschlussprüfers (§ 319 Abs. 3 HGB und § 319a HGB, BilReG/ BilMoG), Bindung des Vorschlags der Hauptversammlung zur Wahl des Abschlussprüfers an die Empfehlung des Prüfungsausschusses (§ 124 Abs. 2 Satz 2 Aktiengesetz, BilMoG), Erweiterung der Prüfungspflichten des Abschlussprüfers durch die

Neuregelung der Berichtspflicht (§ 171 Abs. 1 Aktiengesetz, BilMoG), Offenlegung der Abschlussprüferhonorare (§ 285 Satz 1 Nr. 17 HGB, BilReG/ BilMoG), Unterstellung der Wirtschaftsprüferkammer unter die Aufsicht der neuen berufsstandsunabhängigen Abschlussprüferaufsichtskommission (APAG), Einführung der anlassabhängigen und anlassunabhängigen Sonderuntersuchungen (Berufsaufsichtsreformgesetz).

gar nicht hilfreich

wenig hilfreich

hilfreich

sehr hilfreich

- 5 Bilanzkontrollgesetz von 2005.  
Überwachung der Rechtmäßigkeit konkreter Unternehmensabschlüsse durch eine unabhängige Stelle.

gar nicht hilfreich

wenig hilfreich

hilfreich

sehr hilfreich

- 6 Gesetz über elektronische Handelsregister und  
Genossenschaftsregister sowie das Unternehmensregister von 2007.  
Elektronische Offenlegung der Unternehmensrechnungslegung.

gar nicht hilfreich

wenig hilfreich

hilfreich

sehr hilfreich



- 7 Anlegerschutzverbesserungsgesetz von 2004 und Emittentenleitfaden der BaFin von 2009.  
Zum Beispiel: Neuordnung des Insiderrechts (§ 13 WpHG), Führen von Insiderverzeichnissen (§ 15b WpHG), Ausweitung der Ad-hoc-Publizität (§ 15 WpHG).
- gar nicht hilfreich
- wenig hilfreich
- hilfreich
- sehr hilfreich
- 8 Überarbeitete Fassung des DCGK von 2010.  
Weiterentwicklung des Deutschen Corporate Governance Kodex, insbesondere zur Transparenz von aktienbasierten oder anreizorientierten Vergütungen der Vorstände.
- gar nicht hilfreich
- wenig hilfreich
- hilfreich
- sehr hilfreich

II Inwieweit stimmen Sie folgender Aussage zu: Die gesetzliche Umsetzung des 10-Punkte-Programms der Bundesregierung reicht für unser Unternehmen zur Aufdeckung und Verhinderung von Bilanzmanipulationen aus.

Ich stimme überhaupt nicht zu

Ich stimme eher nicht zu

Ich stimme eher zu

Ich stimme voll zu

III Stellungnahmen zur Zweckmäßigkeit möglicher Maßnahmen im Hinblick auf die Aufdeckung und Verhinderung von Bilanzmanipulationen:

1 Die Betrauung der Deutschen Prüfstelle für Rechnungslegung mit Sanktionsrechten ist im Hinblick auf die Aufdeckung und Verhinderung von Bilanzmanipulationen zweckmäßig.

Ich stimme überhaupt nicht zu

Ich stimme eher nicht zu

Ich stimme eher zu

Ich stimme voll zu

2 In Großbritannien wird bereits ein Bußgeld am ersten Tag der Verspätung der Offenlegung fällig. Die Einführung dieser Maßnahme ist auch in Deutschland zweckmäßig.

Ich stimme überhaupt nicht zu

Ich stimme eher nicht zu

Ich stimme eher zu

Ich stimme voll zu

- 3 Die persönliche Haftung von Vorstands- und Aufsichtsratsmitgliedern gegenüber Anlegern für vorsätzliche oder grob fahrlässige Falschinformationen des Kapitalmarkts müsste durch eine entsprechende Erweiterung der Haftungstatbestände gesichert werden.
- Ich stimme überhaupt nicht zu
  - Ich stimme eher nicht zu
  - Ich stimme eher zu
  - Ich stimme voll zu
- 4 Die Einführung der externen Prüferrotation sollte gesetzlich verankert werden.
- Ich stimme überhaupt nicht zu
  - Ich stimme eher nicht zu
  - Ich stimme eher zu
  - Ich stimme voll zu
- 5 Die Einführung der Trennung von Beratung und Abschlussprüfung sollte gesetzlich verankert werden.
- Ich stimme überhaupt nicht zu
  - Ich stimme eher nicht zu
  - Ich stimme eher zu
  - Ich stimme voll zu

IV Wie beurteilen Sie für Ihr Unternehmen das Verhältnis von Kosten und Nutzen der Umsetzung der gesetzlichen Regelungen, die durch den Maßnahmenkatalog zur Verhinderung und Aufdeckung von Bilanzmanipulationen initiiert wurden?

- Der Nutzen überwiegt eindeutig
- Es herrscht ein leichtes Übergewicht des Nutzens
- Kosten und Nutzen gleichen sich aus
- Es herrscht ein leichtes Übergewicht der Kosten
- Die Kosten überwiegen eindeutig

a Im Hinblick auf die Überwachung der Rechtmäßigkeit konkreter Unternehmensabschlüsse durch eine unabhängige Einrichtung (DPR/BaFin)?

- Der Nutzen überwiegt eindeutig
- Es herrscht ein leichtes Übergewicht des Nutzens
- Kosten und Nutzen gleichen sich aus
- Es herrscht ein leichtes Übergewicht der Kosten
- Die Kosten überwiegen eindeutig

b Im Hinblick auf die elektronische Offenlegung der Unternehmensrechnungslegung?

- Der Nutzen überwiegt eindeutig
- Es herrscht ein leichtes Übergewicht des Nutzens
- Kosten und Nutzen gleichen sich aus
- Es herrscht ein leichtes Übergewicht der Kosten
- Die Kosten überwiegen eindeutig

- c Im Hinblick auf die erweiterten Unternehmenspflichten durch das Anlegerschutzverbesserungsgesetz?
- Der Nutzen überwiegt eindeutig
  - Es herrscht ein leichtes Übergewicht des Nutzens
  - Kosten und Nutzen gleichen sich aus
  - Es herrscht ein leichtes Übergewicht der Kosten
  - Die Kosten überwiegen eindeutig

- V Zur Position und Funktion des antwortenden Unternehmensvertreters:

Position:

- Vorstandsmitglied
- Bereichsleiter
- Abteilungsleiter
- Fachreferat
- Sonstige Position: \_\_\_\_\_

Funktionsbereich:

- Interne Revision
- Rechnungswesen
- Controlling
- Rechtsabteilung
- Sonstiger Bereich: \_\_\_\_\_

Ich bedanke mich herzlich für Ihre Mitwirkung, mit der Sie meine Promotion sehr unterstützen!



## Questionnaire

I The following questions relate to the implementation of the German government's 10-Point-Program (catalogue of measures) from 2003. The first concern is with identifying the effectiveness of the new legal regulations in relation to the **disclosure** and **prevention** of balance sheet manipulations.

- 1 Law on Corporate Integrity and Modernization of the Right of Avoidance (UMAG) from 2005.

For example: Introduction of the general derivative action (§§ 147-149 German Stock Corporation Act), included in the obligation to assert damage claims against founding members and administrative officials (§ 147 German Stock Corporation Act) as well as the admissibility of legal action (§ 148 German Stock Corporation Act); lowering the thresholds for special audits in accordance with the Stock Corporation Law (§ 142 (2) German Stock Corporation Act); introduction of a shareholders' forum for communication purposes (§ 127 a German Stock Corporation Act); introduction of the "Business Judgement Rule" (§ 93 (1) German Stock Corporation Act).

- Not at all helpful
- Somewhat helpful
- Helpful
- Very helpful

- 2 German Capital Markets Model Case Act from 2005.  
Introduction of an exemplary hearing that pursuant to § 16 of the German Capital Markets Model Case Act is binding for the trial courts. Their ruling is dependent on the statements made in the exemplary hearing or the legal questions clarified in the exemplary hearing.
- Not at all helpful
- Somewhat helpful
- Helpful
- Very helpful
- 3 German Accounting Reform Act from 2004 and German Act to Modernize Accounting Law from 2009.  
Further development of accounting regulations and adaptation to international accounting standards.
- Not at all helpful
- Somewhat helpful
- Helpful
- Very helpful
- 4 German Accounting Reform Act from 2004, Final Auditor Supervision Act from 2004, Professional Supervision Reform Act from 2007 and German Act to Modernize Accounting Law (BilMoG) from 2009.  
For example: Extension of the auditing activities of the group's independent auditor (§ 317 (3) sentence 2 HGB, BilMoG), extension of the grounds for exclusion of an independent auditor (§ 319 (3) HGB and § 319a HGB, BilReG/ BilMoG), binding the proposal regarding the appointment of the independent auditor to be put before the Annual General Meeting to the recommendation of the Auditing Committee (§ 124 (2) sentence 2 German Stock Corporation Act, BilMoG), extending the auditing requirements of the independent auditor

through the new regulation of reporting duties (§ 171 (1) German Stock Corporation Act, BilMoG), disclosure of the fees for auditing the annual financial statements (§ 285 sentence 1 number 17 HGB, BilReG/ BilMoG), placing the German Chamber of Public Accountants (WPK) under the supervision of the independent Auditors' Supervision Commission (APAK), introduction of special random and scheduled inspections (Professional Supervision Reform Act).

- Not at all helpful
- Somewhat helpful
- Helpful
- Very helpful

- 5 German Law on Financial Reporting Compliance from 2005.  
Monitoring the legality of specific annual financial statements by an independent party.

- Not at all helpful
- Somewhat helpful
- Helpful
- Very helpful

- 6 German Act on Electronic Commercial and Co-operative Registers and the Company Registers from 2007.  
Electronic publication of a company's annual financial statement.

- Not at all helpful
- Somewhat helpful
- Helpful
- Very helpful



- 7 Investor Protection Improvement Act from 2004 and the issuer's guide published by BaFin in 2009.

For example: Realignment of insider trading legislation (§ 13 WpHG), requirement to maintain insider registers (§ 15b WpHG), extension of ad hoc publicity (§ 15 WpHG).

Not at all helpful

Somewhat helpful

Helpful

Very helpful

- 8 Revised version of the DCGK from 2010.

Further development of the German Corporate Governance Codex, especially in regard to the transparency of share based or incentive-based compensation of board members.

Not at all helpful

Somewhat helpful

Helpful

Very helpful

II To what extent do you agree or disagree with the following statement:  
The legal implementation of the government's 10-Point-Program is sufficient  
for our company in terms of the disclosure and avoidance of balance sheet  
manipulations.

I totally disagree

I rather disagree

I rather agree

I fully agree

III Views on the desirability of possible measures relating to the disclosure  
and prevention of balance sheet manipulations:

1 Entrusting the German Financial Reporting Enforcement Panel with  
sanctioning rights is appropriate for the disclosure and prevention of  
balance sheet manipulations.

I totally disagree

I rather disagree

I rather agree

I fully agree

2 In Great Britain fines are imposed from the very first day of a delay in  
disclosure. The introduction of such a measure would also be  
appropriate in Germany.

I totally disagree

I rather disagree

I rather agree

I fully agree

- 3 Personal liability of board and supervisory board members towards investors for providing deliberate or grossly negligent false information to the capital market should be ensured by extending the appropriate liabilities.

- I totally disagree
- I rather disagree
- I rather agree
- I fully agree

- 4 The introduction of external independent auditor rotation should be put on a legal footing.

- I totally disagree
- I rather disagree
- I rather agree
- I fully agree

- 5 The introduction of the separation of consulting and independent auditing services should be put on a legal footing.

- I totally disagree
- I rather disagree
- I rather agree
- I fully agree

IV How do you assess the cost-benefit ratio for the implementation of the legislative measures for your company that were initiated by the catalogue of measures for the disclosure and prevention of balance sheet manipulation?

- The benefits clearly outweigh the costs
- The benefits slightly outweigh the costs
- Costs and benefits balance out
- The costs slightly outweigh the benefits
- The costs clearly outweigh the benefits

a Regarding the monitoring of the legality of actual financial statements by an independent institution (FREP/BaFin)?

- The benefits clearly outweigh the costs
- The benefits slightly outweigh the costs
- Costs and benefits balance out
- The costs slightly outweigh the benefits
- The costs clearly outweigh the benefits

b Regarding the electronic publication of company accounts?

- The benefits clearly outweigh the costs
- The benefits slightly outweigh the costs
- Costs and benefits balance out
- The costs slightly outweigh the benefits
- The costs clearly outweigh the benefits

c Regarding the extended company obligations made by the Investor Protection Improvement Act?

- The benefits clearly outweigh the costs

- The benefits slightly outweigh the costs
- Costs and benefits balance out
- The costs slightly outweigh the benefits
- The costs clearly outweigh the benefits

V Regarding the position and function of the responding company representative:

Position:

- Board member
- Area Director
- Department Chief
- Subject Specilization
- Other position: \_\_\_\_\_

Functional Area:

- Internal Auditing Department
- Accounting Department
- Controlling
- Legal Department
- Other area: \_\_\_\_\_

I would like to thank you for your participation since it greatly supports my doctorate!



## Codebook

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### Part S: General Information concerning Companies

s001: Company name:

1	Adidas	28	Siemens
2	Alianz	29	Thyssen Krupp
3	BASF	30	Volkswagen
4	Bayer	31	Aareal Bank
5	Beiersdorf	32	Aurubis
6	BMW	33	Axel Springer
7	Commerzbank	34	BayWa
8	Daimler	35	Bilfinger Berger
9	Deutsche Bank	36	Brenntag
10	Deutsche Börse	37	Celesio
11	Deutsche Lufthansa	38	Continental
12	Deutsche Post	39	Deutsche Euroshop
13	Deutsche Telekom	40	Deutsche Wohnen
14	E.ON	41	Deutz
15	Fresenius	42	Douglas Holing
16	Fresenius Med Care	43	Dürr
17	Heidelberg Cement	44	EADS
18	Henkel	45	Elring Klinger
19	Infineon Technolo	46	Fielmann
20	K+S	47	FraPort
21	Linde	48	Fuchs Petroclub
22	MAN	49	GAGFAH
23	Merck	50	GEA Group
24	Metro	51	Gerresheimer
25	Münch Rückversicherung	52	Gerry Weber international
26	RWE	53	Gildemeister
27	SAP	54	GSW Immobilien

55	Hamburger Hafen & Logistic	94	Kontron
56	Hannover Rückersicherung	95	Morphosys
57	Hoch Tief	96	Nordex
58	Hugo Boss	97	Pfeiffer Vacuum Tech
59	Kabel Deutschland	98	PSI
60	Klöckner & Co	99	Qiagen
61	Krones	100	QSC
62	KUKA	101	Sartorius
63	Lanxess	102	Singulus Technologies
64	Leoni	103	SMA Solar Tech
65	MTU Aero Engines Holding	104	Software
66	ProSieben Sat1 Media	105	Solarworld
67	Puma	106	STRATEC Biomedical
68	Rational	107	Suess Microtec
69	Rheinmetall	108	United Internet
70	Rhön-Klinikum	109	Wirecard
71	Salzgitter	110	XING
72	SGL Cabon	111	Air Berlin
73	Sky Deutschland	112	alstria office REIT
74	STADA Arzneimittel	113	Amadeus Fire
75	Symrise	114	Balda
76	Südzucker	115	Bauer
77	TUI	116	Bertrandt
78	Vossloh	117	Biotest
79	Wacker Chemie	118	C.A.T. Oil
80	Wincor Nixdorf	119	Centrotec Sustain
81	Adva Optical Networ	120	CEWE Color Hold
82	Aixtron N	121	Comdirect bank
83	Bechtle	122	Constantin Medien
84	CANCOM	123	CTS EVENTIM
85	Carl Zeiss Meditec	124	Delticom
86	Centrotherm photovoltaics	125	Deutsche Beteiligung
87	Drägerwerk	126	DIC ASSET
88	Drillisch	127	GESCO
89	euromicron	128	Gfk
90	Evotec	129	Grammer
91	freenet	130	GrenkeLeasing
92	Gigaset	131	H&R
93	Jenoptik	132	Hamborner REIT

133	HAWESKO Holding	147	Prime Office REIT
134	Heidelberger Druckm	148	SAF Holland
135	Highlight Communica	149	Schaltbau Holding
136	Hornbach Holing	150	Schuler
137	INDUS Holding	151	Sixt
138	IVG Immobilien	152	SKW Stahl-Met
139	Jungheinrich	153	Stroeer out-of-h
140	König & Bauer	154	TAG Immobilien
141	KWS SAAT	155	TAKKT
142	MLP	156	Tipp 24
143	MVV Energie	157	Tom Tailer
144	NORMA Group	158	VTG
145	Patrizia Immo	159	Wacker Neuson
146	Praktiker	160	zooplus

s002: company group

- 1 DAX (Update: 18.04.2012)
- 2 MDAX (Update: 26.08.2012)
- 3 TecDAX (Update: 14.09.2012)
- 4 SDAX (Update: 16.09.2012)

s003: market capitalization of the company in Mio. €

Source: finanzen net GmbH (Update: December 2012)

s004: turnover of the company in Mio. €

Source: finanzen net GmbH (Update: Accounting Year 2011)

s005: number of employees

Source: finanzen net GmbH (Update: Accounting Year 2011)



s006: Fill out the form

- 1 yes
- 2 no

**Part A: The following questions relate to the implementation of the German government's 10-Point-Program (catalogue of measures) from 2003. The first concern is with identifying the effectiveness of the new legal regulations in relation to the disclosure and prevention of balance sheet manipulations.**

a001: Law on Corporate Integrity and Modernization of the Right of Avoidance (UMAG) from 2005.

For example: Introduction of the general derivative action (§§147-149 German Stock Corporation Act), included in the obligation to assert damage claims against founding members and administrative officials (§ 147 German Stock Corporation Act) as well as the admissibility of legal action (§148 German Stock Corporation Act); lowering the thresholds for special audits in accordance with the Stock Corporation Law (§142 (2) German Stock Corporation Act); introduction of a shareholders' forum for communication purposes (§ 127 a German Stock Corporation Act); introduction of the "Business Judgement Rule" (§ 93 (1) German Stock Corporation Act).

- 1 Not at all helpful
- 2 Somewhat helpful
- 3 Helpful
- 4 Very helpful
- 9 Not at all

a002: German Capital Markets Model Case Act from 2005.

Introduction of an exemplary hearing that pursuant to § 16 of the German Capital Markets Model Case Act is binding for the trial courts. Their ruling is dependent on the statements made in the exemplary hearing or the legal questions clarified in the exemplary hearing.

- 1 Not at all helpful
- 2 Somewhat helpful
- 3 Helpful
- 4 Very helpful
- 9 Not at all

a003: German Accounting Reform Act from 2004 and German Act to Modernize Accounting Law from 2009.

Further development of accounting regulations and adaptation to international accounting standards.

- 1 Not at all helpful
- 2 Somewhat helpful
- 3 Helpful
- 4 Very helpful
- 9 Not at all

a004: German Accounting Reform Act from 2004, Final Auditor Supervision Act from 2004, Professional Supervision Reform Act from 2007 and German Act to Modernize Accounting Law (BilMoG) from 2009.

For example: Extension of the auditing activities of the group's independent auditor (§ 317 (3) sentence 2 HGB, BilMoG), extension of the grounds for exclusion of an independent auditor (§ 319 (3) HGB and § 319a HGB, BilReG/ BilMoG), binding the proposal regarding the appointment of the independent auditor to be put before the Annual General Meeting to the recommendation of the Auditing Committee (§ 124 (2) sentence 2 German Stock Corporation Act, BilMoG), extending the auditing requirements of the independent auditor through the new regulation of reporting duties (§ 171 (1) German Stock Corporation Act, BilMoG), disclosure of the fees for auditing the annual financial statements (§ 285 sentence 1 number 17 HGB, BilReG/ BilMoG), placing the German Chamber of Public Accountants (WPK) under the supervision of the independent Auditors' Supervision Commission (APAK), introduction of special random and scheduled inspections (Professional Supervision Reform Act).

- 1 Not at all helpful
- 2 Somewhat helpful
- 3 Helpful
- 4 Very helpful
- 9 Not at all

a005: German Law on Financial Reporting Compliance from 2005.

Monitoring the legality of specific annual financial statements by an independent party.

- 1 Not at all helpful
- 2 Somewhat helpful
- 3 Helpful
- 4 Very helpful
- 9 Not at all

a006: German Act on Electronic Commercial and Co-operative Registers and the Company Registers from 2007.

Electronic publication of a company's annual financial statement.

- 1 Not at all helpful
- 2 Somewhat helpful
- 3 Helpful
- 4 Very helpful
- 9 Not at all

a007: Investor Protection Improvement Act from 2004 and the issuer's guide published by BaFin in 2009.

For example: Realignment of insider trading legislation (§ 13 WpHG), requirement to maintain insider registers (§ 15b WpHG), extension of ad hoc publicity (§ 15 WpHG).

- 1 Not at all helpful
- 2 Somewhat helpful
- 3 Helpful
- 4 Very helpful
- 9 Not at all

a008: Revised version of the DCGK from 2010.

Further development of the German Corporate Governance Codex, especially in regard to the transparency of share based or incentive- based compensation of board members.

- 1 Not at all helpful
- 2 Somewhat helpful
- 3 Helpful
- 4 Very helpful
- 9 Not at all

**Part B: To what extent do you agree or disagree with the following statement:**

b001: The legal implementation of the government's 10-Point-Program is sufficient for our company in terms of the disclosure and avoidance of balance sheet manipulations.

- 1 I totally disagree
- 2 I rather disagree
- 3 I rather agree
- 4 I fully agree
- 9 Not at all

**Part C: Views on the desirability of possible measures relating to the disclosure and prevention of balance sheet manipulations:**

c001: Entrusting the German Financial Reporting Enforcement Panel with sanctioning rights is appropriate for the disclosure and prevention of balance sheet manipulations.

- 1 I totally disagree
- 2 I rather disagree
- 3 I rather agree
- 4 I fully agree
- 9 Not at all

c002: In Great Britain fines are imposed from the very first day of a delay in disclosure. The introduction of such a measure would also be appropriate in Germany.

- 1 I totally disagree
- 2 I rather disagree
- 3 I rather agree
- 4 I fully agree
- 9 Not at all

c003: Personal liability of board and supervisory board members towards investors for providing deliberate or grossly negligent false information to the capital market should be ensured by extending the appropriate liabilities.

- 1 I totally disagree
- 2 I rather disagree
- 3 I rather agree
- 4 I fully agree
- 9 Not at all

c004: The introduction of external independent auditor rotation should be put on a legal footing.

- 1 I totally disagree
- 2 I rather disagree
- 3 I rather agree
- 4 I fully agree
- 9 Not at all

c005: The introduction of the separation of consulting and independent auditing services should be put on a legal footing.

- 1 I totally disagree
- 2 I rather disagree
- 3 I rather agree
- 4 I fully agree
- 9 Not at all

**Part D: How do you assess the cost-benefit ratio for the implementation of the legislative measures for your company that were initiated by...**

d001: the catalogue of measures for the disclosure and prevention of balance sheet manipulation?

- 1 The benefits clearly outweigh the costs
- 2 The benefits slightly outweigh the costs
- 3 Costs and benefits balance out
- 4 The costs slightly outweigh the benefits
- 5 The costs clearly outweigh the benefits
- 9 Not at all

d002: Regarding the monitoring of the legality of actual financial statements by an independent institution (DPR/BaFin)?

- 1 The benefits clearly outweigh the costs
- 2 The benefits slightly outweigh the costs
- 3 Costs and benefits balance out
- 4 The costs slightly outweigh the benefits
- 5 The costs clearly outweigh the benefits
- 9 Not at all

d003: Regarding the electronic publication of company accounts?

- 1 The benefits clearly outweigh the costs
- 2 The benefits slightly outweigh the costs
- 3 Costs and benefits balance out
- 4 The costs slightly outweigh the benefits
- 5 The costs clearly outweigh the benefits
- 9 Not at all

d004: Regarding the extended company obligations made by the Investor Protection Improvement Act?

- 1 The benefits clearly outweigh the costs
- 2 The benefits slightly outweigh the costs
- 3 Costs and benefits balance out
- 4 The costs slightly outweigh the benefits
- 5 The costs clearly outweigh the benefits
- 9 Not at all

**Part E: Regarding the position and function of the responding company representative:**

e001: Position of the responding company representative:

- 1 Board member
- 2 Area Director
- 3 Department Chief
- 4 Subject Specilization
- 5 Other position: \_\_\_\_\_
- 9 Not at all

e002: Functional area of the responding company representative:

- 1 Internal Auditing Department
- 2 Accounting Department
- 3 Controlling
- 4 Legal Department
- 5 Other area: \_\_\_\_\_
- 9 Not at all

I would like to thank you for your participation since it greatly supports my doctorate!





Company (DAX)	Turnover in Mio €	Numbers of employees	Market capitali- zation in Mio €
Adidas	13,344	46,824	14,059.33
Allianz	103,560	141,938	45,731.79
BASF	73,497	111,141	63,329.11
Bayer	36,528	111,800	58,134.43
Beiersdorf	5,633	17,666	15,263.64
BMW	68,821	100,306	43,256.20
Commerzbank	-----	55,917	8,079.71
Daimler	106,540	271,370	40,712.64
Deutsche Bank	-----	100,996	32,081.68
Deutsche Börse	2,233	3,278	8,464.98
Deutsche Post	52,829	423,348	19,162.90
Deutsche Telekom	58,653	240,369	37,029.38
E.ON	115,046	78,889	27,733.86
Fresenius Medical Care	9,192 (12,795 Mio USD)	79,159	16,264.14
Fresenius SE	16,522	149,351	15,625.22
Heidelberg Cement	12,902	52,526	7,920.00
Henkel	15,605	47,753	24,717.32
Infineon Technologies	3,997	25,750	6,163.15
K+S	5,151	14,496	6,571.72
Linde	13,787	50,417	24,364.57
Lufthansa	28,734	119,084	6,108.10
MAN	16,472	52,542	11,732.66
Merck	9,906	40,676	6,617.20
Metro	66,702	280,856	6,913.80
Munich Re	49,570	47,206	23,655.11
RWE	51,686	72,068	19,682.10
SAP	14,233	55,765	75,112.97
Siemens	73,515	402,000	70,180.46
Thyssen Krupp	43,356	179,534	8,020.88
Volkswagen	159,337	501,956	73,979.83

The data on turnover and number of employees is based on the financial year 2011. The data for the market capitalization is based on December 2012. The source of the data is finanzen.net GmbH situated in Karlsruhe ([www.finanzen.net](http://www.finanzen.net)).

Company (MDAX)	Turnover in Mio €	Numbers of employees	Market capi- talization in Mio €
Aareal Bank	-----	2,353	996.62
Aurubis	13,335.8	6,279	2,210.30
Axel Springer	3,184.9	12,885	3,307.56
BayWa	9,585.7	16,834	1,143.29
Bilfinger Berger	8,208.5	59,210	3,465.62
Brenntag	8,679.3	12,950	5,096.44
Celesio	23,026.5	46,977	2,268.28
Continental	30,504.9	163,788	17,014.51
Deutsche Euroshop	190	5	1,691.19
Deutsche Wohnen	387.1	1,201	2,176.91
Deutz	1,529	4,060	381.92
Douglas Holding	3,378.8	24,323	1,497.30
Dürr	1,922	6,823	1,117.96
EADS	49,128	133,115	21,980.26
Elring Klinger	1,032.8	5,779	1,558.66
Fielmann	1,053.4	14,214	3,163.44
Fraport	2,371.2	20,595	3,879.55
Fuchs Petroclub	1,668.1	3,722	3,663.63
GAGFAH	399.7	1,383	1,734.20
GEA Group	5,416.5	23,834	4,587.84
Gerresheimer	1,094.7	10,212	1,222.72
Gerry Weber International	702.7	3,011	1,698.29
Gildemeister	1,687.7	6,032	892.90
GSW Immobilien	141.1	581	1,647.92
Hamburger Hafen und Logistik	1,217.3	4,797	1,219.55
Hannover Rückversicherung	12,100	2,217	6,753.44
Hochtief	23,282.2	75,449	3,213.98
Hugo Boss	2,058.8	11,004	5,629.89
Kabel Deutschland	1,598.9	2,714	4,921.88
Klöckner & Co SE	7,095.4	11,381	816.15

Krones	2,480.3	11,389	1,383.30
KUKA	1,435.6	6,589	885.02
Lanxess	8,775	16,390	5,498.86
Leoni	3,701.5	60,745	865.73
MTU Aero Engines Holding	2,932.1	8,202	3,547.96
ProSieben Sat,1 Media	2,756.2	4,112	2,500.85
Puma	3,009	10,043	3,374.70
Rational	391.7	1,184	2,319.48
Rheinmetall	4,454	21,516	1,409.72
Rhön-Klinikum	2,629.1	39,325	2,107.35
Salzgitter	9,839.5	25,478	2,134.65
SGL Carbon SE	1,540.2	6,447	2,110.59
Sky Deutschland	1,138.7	1,716	3,015.16
STADA Arzneimittel	1,715.4	7,826	1,344.44
Symrise	1,583.6	5,557	3,139.27
Südzucker	6,160.8	17,656	6,165.25
TUI	17,480.3	73,707	1,964.79
Vossloh	1,197.2	5,000	986.07
Wacker Chemie	4,909.7	17,168	2,185.19
Wincor Nixdorf	2,328	9,171	1,053.10

The data on turnover and number of employees is based on the financial year 2011. The data for the market capitalization is based on December 2012. The source of the data is finanzen.net GmbH situated in Karlsruhe ([www.finanzen.net](http://www.finanzen.net)).

Company (TecDAX)	Turnover in Mio €	Numbers of employees	Market capitali- zation in Mio €
ADVA Optical Networking	310.9	1,304	198.12
Aixtron	611	978	964.84
Bechtle	1,994.9	5,479	592.52
CANCOM	544.4	2,097	156.53
Carl Zeiss Meditec	758.8	2,366	1,808.33
Centrotherm photovoltaics	698.5	1,928	18.20
Drägerwerk	2,255.8	11,924	1,063.49
Drillisch Telekom	349.1	329	585.08
Euromicron	305.3	1,455	119.25
EVOTEC	80.1	590	323.83
Freenet	3,217.9	4,057	1,845.36
Gigaset	520.6	1,875	46.96
Jenoptik	543.3	2,894	446.46
Kontron	589.6	3,057	202.02
MorphoSys	100.8	446	629.44
Nordex	927	2,643	220.66
Pfeiffer Vacuum Technology	519.5	2,276	864.60
PSI	169.5	1,491	234.28
Qiagen	1,169.7	3,938	3,333.32
QSC	478.1	1,305	282.89
Sartorius	733.1	4,887	1,321.07
Singulus Technologies	160	455	79.17
SMA Solar Technology	1,676.3	6,366	548.26
Software	1,098.3	5,535	2,837.10
Solar World	1,046.9	2,701	107.92
STRATEC Biomedical	116.6	458	403.72
Süss Micro Tec	175.4	624	164.91
United Internet	2,094	5,593	3,418.50
Wirecard	324.8	498	2,105.29
XING	65.1	456	238.30

The data on turnover and number of employees is based on the financial year 2011. The data for the market capitalization is based on December 2012 respectively January 2013. The source of the data is finanzen.net GmbH situated in Karlsruhe ([www.finanzen.net](http://www.finanzen.net)).

Company (SDAX)	Turnover in Mio €	Numbers of employees	Market capitalization in Mio €
Air Berlin plc	4,227.3	9,113	115.06
Alstria office REIT	90.8	50	753.81
Amadeus Fire	130.1	2,368	196.23
Balda	66.3	1,178	182.80
BAUER	1,219.6	9,646	316.58
Bertrandt	576.2	8,603	732.44
Biotest	422	1,774	550.98
C,A,T, Oil	280.7	2,360	309.22
CENTROTEC Sustainable	537.8	2,906	231.62
CeWe Color Holding	469	2,823	231.95
Comdirect bank	-----	1,148	1,091.64
Constantin Medien	465.7	1,468	133.23
CTS Eventim	502.8	1,441	1,219.20
Delticom	480	116	370.75
Deutsche Beteiligungs	-4.5	53	259.10
DIC Asset	106.8	127	331.92
Gesco	335.2	1,775	217.79
GfK SE	1,374	11,220	1,350.83
Grammer	1,093.5	8,429	183.33
GRENKELEASING	202.9	585	721.15
H & R	1,209.5	1,431	360.58
HAMBORNER REIT	32.2	25	335.65
Hawesko Holding	411.4	739	363.83
Heidelberger Druckmaschinen	2,628.9	15,828	230.50
Highlight Communications	383.5	733	179.55
Hornbach Holding	3,017	12,894	426.80
Indus Holding	1,104.7	6,733	450.00
IVG Immobilien	517.6	613	377.10

Jungheinrich	2,116.3	10,711	479.68
Koenig & Bauer	1,167.2	6,401	214.32
KWS SAAT	855.4	3,560	1,540.44
MLP	526.7	1,584	612.31
MVV Energie	3,804.5	5,923	1,476.31
NORMA Group	581.4	4,400	621.79
PATRIZIA Immobilien	180.5	498	365.33
Praktiker	3,183	20,000	64.73
Prime Office Reit	75.3	6	166.21
SAF-HOLLAND SA	831.3	3,107	221.82
Schaltbau Holding	318.4	1,534	181.55
Schuler	958.5	5,168	580.46
Sixt	1,563.7	3,052	679.46
SKW Stahl Metallurgie Holding	428.9	979	88.98
Ströer Out-of- Home Media	577.1	1,730	284.16
TAG Immobilien	178.3	281	1,023.20
TAKKT	852.2	1,869	701.37
Tipp 24 SE	139.3	128	296.73
Tom Tailor Holding	411.7	1,541	383.71
VTG	750	1,170	249.50
Wacker Neuson	991.6	3,514	664.93
Zooplus	244.8	191	191.86

The data on turnover and number of employees is based on the financial year 2011. The data for the market capitalization is based on December 2012. The source of the data is finanzen.net GmbH situated in Karlsruhe ([www.finanzen.net](http://www.finanzen.net)).

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