2.2 Corporate Governance and Financial Reporting at Daimler-Benz (DaimlerChrysler) AG: From a “Stakeholder” toward a “Shareholder Value” Model

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1. Introduction

During the last decade of the twentieth century, Daimler-Benz AG radically transformed its approach to corporate governance and financial reporting. The company’s governance traditionally had conformed closely to the German “stakeholder” model, with representation on its Supervisory Board by labor, by closely affiliated banks, and directly and indirectly by government. Its financial reporting reflected German-style balance sheet conservatism, with low book values of assets, overstated liabilities, and “hidden reserves” of equity. Balance sheet conservatism allows the companies to “smooth” earnings and allows managers to hide both the amount of assets under their control and any losses they are making from public accountability. This in turn allows the company to make stable dividend, bonus, and tax payments, and to avoid or defer the pain to labor and other parties resulting from actions necessary to stem losses, such as plant closings. Daimler’s financial reporting certainly did not reflect U.S.-style income statement conservatism with more timely recognition of economic losses and hence high volatility and skewness of reported earnings.

This all changed with astonishing rapidity. By mid-decade, the company’s management was openly espousing a variant of the U.S.
“shareholder value” governance model, had implemented a stock option scheme for executives, had reduced its dependence on a single bank for capital, was reporting under U.S. Generally Accepted Accounting Principles (GAAP) and, by listing its stock on the New York Stock Exchange (NYSE), had bonded itself henceforth to publicly report its economic losses in a timely fashion. Not by coincidence, it had drastically reduced its workforce and closed several plants. By the end of the decade, it had ruthlessly discarded several loss-making businesses, had focused its efforts more closely on its core businesses, and had executed a stunning acquisition (billed as a merger) of the U.S.-based Chrysler Corporation.

The case illustrates many important principles. For example, the changes Daimler made to its corporate governance and financial reporting appear to have been driven primarily by market forces, and certainly were not due to changes in regulation. Daimler faced substantial problems in its core businesses, automobiles and aerospace. Resolving those problems required plant closings, headcount reduction in part through involuntary redundancy, and closure or divestiture of perennial loss-making businesses. The enthusiasm of labor, banks, and the German government for such actions most likely would have been lower than that of shareholders in competing auto and aerospace companies operating under a shareholder value model. In this respect, the case illustrates an important general proposition: that an inefficient corporate governance and financial reporting model is a competitive disadvantage. Competition in global product markets creates pressure on firms to adopt globally efficient corporate governance and financial reporting practices, regardless of the regulatory framework and accepted practice in their home countries. Even if individual firms find it too costly to adapt, global competition creates a competitive survival mechanism for governance and reporting systems. Thus, to the extent that international homogenization of corporate governance and financial reporting practice is efficient, some convergence will evolve as a consequence of international product market competition. Conversely, to the extent that heterogeneity is efficient, market pressures will tend to generate multiple models. The strength and speed of market forces operating on corporate governance and financial reporting is unclear, but in Daimler’s case the pressure is clear: it was losing ground quickly in its core automobile business.

Lest the case be misconstrued as supporting the naïve idea of a universally efficient system of corporate governance or financial reporting, three clarifying observations are in order. First, Daimler did not fully embrace the shareholder value model: it remained a German
corporation, complying with German governance rules, and grafted elements of the shareholder value model onto its governance and reporting system. Second, complementarity among institutional variables makes fundamental organizational change a costly process, with no guarantee that the net outcome is positive. Third, adopting elements of the shareholder value model might be efficient during a transitional period requiring workforce reductions, plant closings, and disposing noncore businesses, but the efficient solution for a German company in the long term could well be closer to the traditional stakeholder model.

The shareholder value model has obvious attractions for a company that needs to drastically reduce its workforce, close several plants, and dispose of or liquidate several businesses. Nevertheless, changing from one system to the other is fraught with difficulties. How the shareholder value philosophy would catch on in a German context was unclear, particularly in view of the legal requirement that half of the supervisory board be elected by labor. The merger imposed additional complications due to the substantial cultural differences between German and U.S. managers. For example, German Chief Executive Officers (CEOs) historically have acted to develop and implement a consensus among members of their managerial boards, whereas U.S. CEOs are accustomed to acting more as decision-makers. After the merger, the compensation of U.S. executives was found to exceed that of their German counterparts by a considerable margin. Some indication of cross-cultural difficulties is apparent in the composition of DaimlerChrysler’s management board, which immediately after the merger had approximately half German and U.S. managers, but which soon lost most of its U.S. members. In general, the complementary nature of institutional variables makes fundamental organizational change a complex, difficult, and risky—and thus, in economic terms, costly—process. There was no guarantee that the net outcome would be positive, that the benefits of change would exceed the substantial costs.

Even if Daimler management was correct in assessing the shareholder value model to be more efficient for the company at the time, and even if the benefits of changing to it exceeded the costs, it would not follow that this would be the most efficient model for the long term. Assigning to shareholders the primary rights to appoint managers is particularly appealing in times of strategic transition and rapid change, as was the case in Daimler’s core businesses at the time it made the governance and reporting changes. However, if the company’s businesses were to return to a more stable, steady-state condition, then it might be efficient to return more closely to the stakeholder model. That model certainly
served the company well during more stable times. If the relative efficiencies of the various governance models do turn out to be state-dependent, then the current worldwide interest in the shareholder value model, with increased transparency in reporting and disclosure, could be merely transitory. It seems difficult to avoid one of two conclusions: that one system is globally optimal; or that the most efficient outcome is to eschew worldwide homogeneity and allow companies a choice of governance and financial reporting systems. Either way, imposing worldwide homogenization of standards by fiat would have the undesirable effect of removing valuable options for companies to adapt their governance and reporting systems in response to changes in state variables. For Daimler, grafting elements of the shareholder value model onto its governance and reporting might only be efficient during a transitional period requiring workforce reductions, plant closings, and focusing on core businesses.

Moving its country of domicile allows a company to transform its governance system. More intriguingly, the ability to cross-list its securities gives a company valuable options to graft elements of one governance system onto another. By listing its shares in New York, Daimler bonded itself to publicly report its economic losses in a timely fashion, an important ingredient in monitoring and disciplining the actions of its managers (Ball 2000; Ball, Kothari, and Robin 2000; Ball, Robin, and Wu 2001). During 1973, Daimler had padded its earnings to disguise its loss that year, by “booking” two separate gains totalling DM 4.3 billions (US$ 2.6 billions), without informing the German public. NYSE listing required the company to disclose its loss-making for the first time. More importantly, it bonded the company to not repeat such an act, by exposing the company—and its managers and auditors—to stockholder litigation as well as Securities Exchange Commission (SEC) action. Stockholder litigation rights are largely suppressed in most code-law environments, Germany included, so there is less incentive to publicize one’s failures. Any changes in governance or accounting standards that are not accompanied by listing in an environment with significant stockholder litigation rights have low credibility (Ball 2000; Ball, Robin, and Wu 2000, 2001). By cross-listing its securities in New York, Daimler grafted substantial elements of the shareholder value governance model onto its stakeholder system, thereby creating an intriguing and instructive hybrid.

The case also illustrates the proposition that financial reporting is an integral property of corporate governance. The comparative transparency of external reporting under U.S. GAAP was seen as an essential ingredient of a shareholder value perspective, presumably by enhancing
the capital market’s monitoring of managers (Daimler-Benz 1997: 44; Gentz 1999: 6–8). Furthermore, as Daimler-Benz management made clear at the time, it adopted U.S. GAAP for internal reporting purposes as well, apparently to enhance corporate managers’ monitoring of individual business-unit managers (Daimler-Benz 1997: 45). The implication is that the discretion that German accounting traditionally has given managers over recorded earnings was being used by business-unit managers to disguise their performance from their superiors, which would have to change if faster and more decisive attention to loss-making businesses was required. The complexity of all the changes made by Daimler (which included internal accounting, public reporting, stock listing, and espousal of the shareholder value model) illustrates the complementary nature of institutional variables.

Initially, Daimler’s radical moves were not well received in the German corporate world, but over time they were understood, and emulated. They were a precursor to widespread change in Western European corporate governance and financial reporting practices, though the extent and permanence of the changes is not yet clear.

2. Background to the events of the case

To understand why Daimler-Benz management saw a need for such fundamental and thorough change in the corporation’s governance, and to form a view on whether the shareholder governance model was thought to be superior in a period of rapid change or whether it was deemed more universally efficient, it is necessary to review the corporation and the position in which it found itself during late 1993.

2.1. The company

Daimler-Benz Aktiengesellschaft (AG) was one of the pioneers of the automobile industry and one of the great corporations of the twentieth century. Daimler-Motoren-Gesellschaft was incorporated in Stuttgart in 1890. Benz & Co. Rheinische Gasmotoren-Fabrik, Mannheim was founded as a partnership by Karl Benz in 1883. In 1910, Daimler shares commenced trading on the Stuttgart exchange and Benz was the world’s largest automobile manufacturer, with sales of 603 automobiles. Daimler
and Benz merged in 1924, and during the following seven decades the company grew almost continually.

In 1993, almost 40 percent of Daimler-Benz’s revenues were derived from aircraft, space, defense, rail systems, microelectronics, and financial services. Nevertheless, passenger cars and commercial vehicles continued to provide the bulk of its revenues and were the primary source of the company’s fame. Mercedes Benz had become one of the best-known brand names in the world, and the company’s products had a long-standing and well-earned reputation for quality engineering, reliability, refinement, and luxury.

On May 7, 1998, Daimler-Benz and the Detroit-based Chrysler Corporation agreed to merge. Chrysler, the number three U.S. auto company, dated from Walter Chrysler’s first model in 1924. By the mid-1990s, it was selling 2.5 million cars and trucks annually. The merger transaction, which was completed on November 12 that year, created DaimlerChrysler AG. At the time, it was the largest cross-border merger in history.

DaimlerChrysler AG currently is the largest manufacturing corporation in Germany. Its revenues for the year 2001 totalled €152,873 million ($136,072 million), making it the seventh largest corporation in the world, in terms of sales. At the end of 2001, it reported total assets of €207,410 million ($184,616 million) and stockholders’ equity of €39,004 million ($34,717 million). On December 31, 2001, the market capitalization of DaimlerChrysler on the Frankfurt Stock Exchange was €48.5 billion ($43.2 billion), 6.8 percent of the widely cited Deutsche Aktienindex (DAX). Its principal trading markets were Frankfurt and New York, but it also traded in Germany on Berlin, Bremen, Düsseldorf, Hamburg, Hanover, Munich, and Stuttgart, in the United States on the Chicago Stock Exchange, the Pacific Stock Exchange, and the Philadelphia Stock Exchange, and elsewhere on Paris, Tokyo, Toronto, and Zurich.

2.2. Problems in Stuttgart

In contrast with its remarkable history, by late 1993 Daimler-Benz faced significant challenges. While its automobile products continued to live up to their vaunted reputation, a variety of economic and political changes threatened the company’s viability as an independent auto manufacturer. Compounding matters, recent diversification moves had turned sour. Daimler-Benz management was struggling to address these problems, but was shackled by a system of corporate governance that
was better suited for steering corporate growth and for dividing its spoils among stakeholders, than for confronting strategic decisions with painful consequences for some stakeholders.

The problems facing Daimler-Benz management in late 1993 included:

1. Automobiles:
   - Increasing competition in the luxury passenger-car market (including Toyota’s stunning entry with its Lexus brand and BMW’s resurgence in top-end models) threatened the company’s market niche.
   - Weakening sales of passenger cars throughout Europe had caused Daimler-Benz to revise its 1993 sales plans and production schedules downward.
   - Increasing fixed costs of developing models, platforms, and engines were causing increasing scale economies and therefore problems for lower-volume manufacturers.
   - Platform development costs increasingly were being shared by its competitors across a range of models, creating substantial cost disadvantages for companies that operated with a limited product range. Daimler-Benz production was concentrated in high-end luxury cars, and companies that were trapped in that segment of the market alone were disappearing one by one through merger and acquisition. Sharing platform costs across models was what had allowed Toyota to sell the superbly engineered and produced Lexus at such a low price—a price that Daimler was unable to match with a comparable Mercedes. On the other hand, management was concerned that extending its product range down-market to achieve cross-model economies would dilute the Mercedes brand’s cachet.
   - The market had recently moved toward sports utility vehicles (SUVs) and light trucks, generating an urgent need to revamp and extend the company’s product line.
   - High German labor costs (hourly rates approximately double those in the United States) made it crucial that production be moved to other countries.
   - Daimler had a substantially unhedged income statement, with a strategic imbalance between costs (incurred largely in Deutsche Marks) and revenues (received in a variety of currencies, including the U.S. dollars). This exposed the company to considerable foreign exchange risk over the long term. Recent strength in the Deutche Marks had eroded profit margins, convincing management of the
need to source more costs offshore. This required closing several German plants and reducing German employment.

- The European auto industry had a glut of capacity. Several Daimler-Benz plant closures were needed, but were politically difficult to implement.

2. Aerospace:
- A downturn in defense expenditure by European and worldwide governments, arising from the so-called “peace dividend,” together with a fall in and space expenditures, had severely impacted the company’s Deutsche Aerospace business. Aerospace accounted for 18 percent of Daimler’s 1993 revenues.
- Losses were running unstemmed in the Fokker aircraft corporation acquired during 1993. The acquisition had become an immediate drain on both cash flow and earnings. It was like a voluntary tax on Daimler’s core automobile business.

Many of these problems were large and urgent. Their resolution quite possibly could adversely affect employees in several plants as well as companies with which Daimler had close ties. A key question was whether the company’s system of corporate governance allowed it to confront such a daunting list of problems within the necessary time frame.

3. Code-law and common-law models of corporate governance, financial reporting, and disclosure

The extent and nature of political influence on corporate governance, financial reporting, and disclosure vary substantially across countries. A simple but helpful proxy for political influence is a dichotomous classification of countries as predominantly code law (high political influence on governance, reporting, and disclosure practices) or common law (governance, reporting, and disclosure practices are determined primarily in the private sector). Furthermore, this simple dichotomy captures important differences in how information asymmetry between managers and parties contracting with the firm is ameliorated (Ball, Kothari, and Robin 2000).

As always, the code- and common-law classes overlap in practice, so caution must be exercised when interpreting such broad categorization. For example, no country follows a purely market or planning
system. The U.K. Companies Acts imposed codification on a predominantly common-law system, as did the U.S. Securities and Exchange Acts that created the SEC. Nevertheless, the distinction between code- and common-law countries does reflect the extent of political relative to market influences on corporate governance, financial reporting, and disclosure, and captures important differences in how information asymmetry is ameliorated, so it is employed here as a useful organizing vehicle.

3.1. The code-law model

Most Continental European countries—Germany included—operate ‘code law’ systems of corporate governance, financial reporting, and disclosure. The origin of law codification normally is attributed to the Roman system of *jus civile* developed under the Emperor Justinian in the sixth century AD. Government codification was “exported” to most of Continental Europe during Roman occupation.

Code law is established and enforced by governments and their agencies—that is in the public sector not in the private sector. A government agency, such as the French *Conseil national de la comptabilité*, typically is responsible for recommending rules to a legislature for formal approval, or it might even be delegated direct rule-making authority. Either way, code-law systems of corporate governance, financial reporting, and disclosure are written as formal rules (the “code”). Code-law rule enforcement, which requires detection, investigation, and prosecution, also is a public sector activity. By definition, violating code law is a criminal act, subject to the penalties provided by legislation, which typically include fines, incarceration, and exclusion from practice, as well as adverse publicity.

In comparison with common-law countries, code-law countries typically exhibit powerful economic intermediaries. These organizations represent large classes of economic actors (notably labor, capital, and management). There are both economic and political reasons for this.

On grounds of economic efficiency alone, one would expect a greater amount of intermediation in code-law countries. All the economic actors who actually are—or potentially could be—affected by provisions of the code (e.g. millions of shareholders throughout the country) cannot be involved individually in writing and enforcing the code. This would be extremely inefficient and essentially impossible. Hence, codification
increases the economic demand for intermediation, such as a single, national body representing all labor unions and hence all unionized employees. The intermediaries act as economic agents for their members, representing them in code writing and enforcement decisions. The usual economics of agency relations presumably apply.

Furthermore, there are political reasons for greater intermediation in code-law countries. Because code writing and enforcement is undertaken by governments or their agencies, it is a politicized process. Even if they have no direct economic interest in an issue, all organized political groups can influence the political process. This in turn increases the rewards to powerful intermediaries, which act as political agents for their members, representing them in code writing and enforcement decisions. The politics of class representation thus are more likely to emerge in code-law countries.

The code-writing authority itself typically is composed of class representatives. In the case of the financial reporting code, these will include top industrialists, bank representatives, labour representatives, and government treasury officials. Representatives of professions, religions, and other interest groups might be involved, depending on the country’s politics. Assistance usually is given by nonrepresentative expert members (e.g. academics).

Major politically organized groups frequently are described as stakeholders, a term whose usage in the context of corporate governance appears to have originated, ironically, in the United States, at the Stanford Research Institute during 1963 (Gregg 2001: 21). The origin of their “stake” can be purely political, not economic, in nature. Thus, a group can gain from exercising its political influence, even in an area of economic activity in which it has no direct interest or expertise.

Typically there is a widely accepted hierarchical system of intermediating institutions in code-law countries. The members of each class are represented by those institutions. Thus, we typically observe:

- Strong, cohesive nationwide labor organizations;
- Strong national-level banks, central banks, and pension and insurance regulatory bodies; and
- Strong nationwide business/employer organizations.

Because the national code requires constant enforcement and adaptation to changes in events, these organizations must be able to both: (a) speak for their membership; and (b) work effectively with other national-level organizations.
In code-law countries, the stakeholder model also predominates at
the level of the individual corporation. The stakeholders with political
power in a given country are in a position to demand representation in
corporate governance. This contrasts with the common-law model in
which shareholders alone typically are represented.

The political influence of particular groups varies internationally, and
consequently there are many variants of the stakeholder model. In Asia,
the Japanese *keiretsu* and South Korean *chaebol* systems of investing
and trading largely within internally informed corporate groups, and
the Chinese system of family-controlled businesses and *guanxi* (con-
nections) networks, are prime examples. Labor unions have little say
in code-law writing or enforcement decisions in most Asian countries,
because labor is not a strong political force in those countries. Similarly,
there is no formal labor representation in corporate governance.

Japanese culture traditionally has emphasized group consciousness.
Japan’s emergence from a feudal structure therefore did not evolve along
the Anglo-Saxon model of arm’s length transacting (described below).
Japan’s emergence from a feudalism naturally evolved into the *keiretsu*
system of related-party transacting, reinforced by cross-shareholdings.
For securities trading and accounting rules, Japan most naturally pro-
vided a strong role for government codification. The most suitable role
models were found in Continental Europe, so the German Commercial
Code was adopted toward the end of the nineteenth century, during
the *Meiji* Restoration. At the corporate level, the “President’s Council”
(similar to the German Supervisory Board) typically meets frequently
(e.g. monthly) and is consensus-oriented. The inclusion of related cor-
porations (major customers, suppliers, banks), as a consequence of
cross-holding, is an extension and refinement of the German system,
described below.

3.2. The common-law model

Common law emerged in post-Conquest England, approximately a mil-
leennium ago. It too was “exported,” primarily to former English colonies,
and thus it is the basis for much law in Australia, Canada, India, Ireland,
and New Zealand, as well as U.S. federal (and much state) law. Common
law originates in private practice, not in the public sector. In common
law, principles arise largely from accepted practice. After a practice has
become widely accepted as being reasonable, it achieves the legal status
of being assumed by any reasonable person to have been followed in subsequent instances.

An accounting example is the widespread application of the conservatism principle. If accountants consistently prepare conservative balance sheets over an extended period of time, then that practice would be found to be generally accepted, and any reasonable user of any subsequently prepared balance sheet is entitled to assume it has been followed. Failure to prepare a company’s balance sheet on a conservative basis then violates a (lower-case) generally accepted accounting principle.

A more-detailed accounting example concerns noncancellable long-term lease agreements. If managers and accounting and financial practitioners almost universally come to view such leases as a nonequity method of financing assets, then a reasonable user of balance sheets would be entitled to assume they were counted as long-term debt. Failure to record them as such would expose the company’s managers and accountants to the charge that they failed to record all the long-term debts that any reasonable person would assume had been recorded.

In a pure common-law (private sector) system, the consequence of a failure to comply with the rules—whether they are formally agreed to or implicit in an agreement because a “reasonable person” would expect them to be—is the risk that one is sued by the offended party or parties. If one loses, the penalty is a monetary award of damages to the plaintiff(s).

Judicial and quasi-judicial (e.g. arbitration) processes are central to the creation and implementation of common law. The standard to which parties’ conduct is held in common law is that of a reasonable person. A reasonable person would assume that the other party to a contract (including a company disclosing information) is following normal or generally followed practice. When there is disagreement as to what that is, resolution is via arbitration, court proceedings, or some other independent review. In common-law countries, independent accountants and an independent accounting profession play an important and quasi-judicial role in the economy. Adjudicators must take into account a truthful version of all facts and must make judgments that are fair as among parties affected by their decisions—hence the term “true and fair view.”

Some decisions have widespread application and thus are implemented as principles or rules. In a private sector system, these are most efficiently decided on a centralized basis by the independent accounting profession as a whole, for two reasons: (a) efficiency due to scale effects, as in a franchise system; and (b) rules allow individual accounting
firms to be more independent when negotiating with managers. Examples of profession-wide accounting decisions are counting long-term noncancellable leases as debt, or requiring amortization of purchased goodwill. Economically, mandating centralized accounting rules is akin to McDonald’s Corporation requiring all franchisees to meet strict standards on food preparation and service as a condition of using its corporate trademarks.

Some decisions have only company-specific application. These are left to the individual independent accountant to make. Examples are the number of transactions to be sampled during the audit, or the application of the revenue recognition rule in a complex sales transaction that is unique to the client. Again, this is similar to McDonald’s Corporation decentralizing decisions that are most efficiently made on the basis of local knowledge by franchisees.

Precedent plays an important role in a common-law system. It is an efficient way of conveying information. If prior cases have decided as a matter of fact that a practice is generally acceptable, then there is no need to regather and reevaluate all that evidence. In subsequent cases, it is sufficient to impose the principle that was established in the precedent case. Hence the U.S. audit report certifies the accounts are “in accordance with generally-accepted accounting principles” (GAAP, in upper case).

The common-law function of the Financial Accounting Standards Board (FASB) in the United States is not widely appreciated. There most likely would be a standard-setting process in the absence of political interference—that is, without Congress, the Securities Acts, and the SEC. Professions voluntarily establish standards to which their members must comply. While the FASB is a lightning rod for political influence, its common-law market function is to discern the accounting principles that are generally accepted as appropriate in U.S. commercial affairs. In economic terms, its market role is to increase the efficiency of contracting with the firm.

There are many variants of the basic common-law system, and the political realities are that in most common-law countries there is parallel legislative code-law operating. For example, relative to the United Kingdom the United States has tended to formally record its precedents in the form of written statements of the FASB. This does not in itself mean that the United States is a code-law country, because GAAP nevertheless originates in the private sector. However, the political process and the SEC have been moving U.S. accounting toward a public sector code-law system since 1933–4. U.S. accountants still need to exercise considerable
judicial-style discretion at a decentralized level, because no set of central rules can anticipate all contingencies. Hence, there remains an element of certification of “truthfulness and fairness” in the U.S. audit report. Formal written statements of accounting principles in the United Kingdom are fewer in number and shorter in length, thus leaving more guidance to the individual accountant. Consequently, there is an element of certification of “compliance with GAAP” in the U.K. audit report. While the U.K. notion of “true and fair” initially appears to apply to a purely judicial approach, common law gives a special role to precedent (including precedent that has been formalized in written rules). Formal statements of the Accounting Standards Board (ASB) in the United Kingdom inevitably play a special role as strongly persuasive precedent.

The shareholder value model of corporate governance tends to dominate in common-law countries. Unlike the stakeholder model, the explanation is economic rather than political. Alchian and Demsetz (1972) argue that, from an economic efficiency viewpoint, stockholders have the greatest incentive to monitor managers, because they are the residual claimants to the value of the company (all other parties are paid-off first), and hence they have the most to gain or lose from actions by managers that affect value. If governance is not politicized, then economic efficiency should prevail, and stockholders or their elected representatives are the most efficient monitoring party. So it is not surprising that the shareholder model is dominant in common-law corporate governance, with shareholders alone having voting rights in appointing the governing board and in establishing the rules governing its conduct.

3.3. Financial reporting and disclosure under code law versus common law

The hierarchical nature of code-law institutional structure has one particularly important implication for corporate governance, financial reporting, and disclosure. Code-law systems typically assume that firms transact with stakeholder representatives, who by dint of their representation in governance are privately informed about relevant events. They are not presumed to rely on information that has been publicly disclosed; the presumption is that they have “insider” access to information. Code-law systems therefore tend to require a lower
standard of financial reporting and public disclosure, and thus generate less public information.

Even in large, listed 'public' companies, representatives of all major groups are privately informed. The typical supervisory board thus will have representation from management, employees, banks (and other major suppliers of capital, such as pension or insurance trusts), major suppliers of materials or components, and major customers. Information asymmetry is more likely to be reduced by direct or insider communication between managers and the Supervisory Board representatives of intermediaries (banks and employee organizations). Investment and lending decisions, as well as decisions in relation to the election, reappointment, and compensation of managers, are more likely to be made as a consequence of information that is directly acquired through representation on the Supervisory Board.

In sharp contrast, common-law systems typically assume that transactions are conducted “at arm’s length”—that is by parties who do not know each other. This is not surprising in light of common-law’s market—versus political—origins. Common law therefore presumes that economic actors have a right to information and rely upon the information disclosed to them. Conversely, it is not assumed that they have access to private information. The demand for intermediaries (banks, insurance companies, and other institutional shareholders) is lower than under code law, and disclosure to individual shareholders and lenders is a cornerstone of the financial markets.

High standards of public disclosure apply particularly to public corporations. These companies deal with a wide range of the public. For example, when shares are listed on a stock exchange (particularly national or international), then the number of potential shareholders is very large and the identities of all potential shareholders are essentially unknowable. Similar observations can be made about potential lenders, creditors, employees, suppliers, and customers. The practice thus has emerged of reporting to the “public at large.” Common-law systems therefore tend to require a higher standard of public financial reporting and disclosure by corporations, and thus generate more public information.

Common-law systems support large public markets. For example, a corporation can raise debt capital directly from the public by selling debt securities in comparatively small amounts (e.g. US$ 1000 bonds) to the general public. None of the individual investors need have access to private information about the corporation’s risks; they presume these have been publicly disclosed.
Enhanced public disclosure allows individual investors and analysts to make informed investing and lending decisions. But public disclosure also plays an important role in monitoring managers, including both executives and the nonexecutive members of the Board of Directors. Shareholders vote on the appointment and reappointment of Directors, and approve the schemes that determine management compensation. Public disclosures also influence share prices (Ball and Brown 1968), and therefore affect the stock-based component of executive compensation. Informed stockholders, security analysts, and lenders thus play an important role in common-law corporate governance.

4. Some properties of the German institutional structure

Daimler’s actions during the period of this case are best understood against the background of German institutional structure. Those selected are: corporate governance; accounting standards under the German commercial code; incentives to reduce volatility and hide losses in German financial reporting; influence of taxation on German financial reporting; and differences in views on the ownership of corporate earnings.

4.1. Corporate governance

The governance structure of the German stock corporation (Aktiengesellschaft, or AG) is prescribed by law, the principal provisions of which are surveyed by Roe (1994). The Supervisory Board (Aufsichtsrat) comprises entirely nonexecutive members. It appoints and monitors the Management Board (Vorstand), which comprises entirely executives, and thus has ultimate responsibility for the company’s strategy. As part of its monitoring function, the Supervisory Board receives and approves the company’s financial statements. Reflecting the German stakeholder view of corporate governance, half the Supervisory Board membership of a large corporation is elected by employees and half is elected by shareholders. While shareholders also elect a Chair, and thus can maintain a controlling edge, labor representation in corporate governance is substantial. Despite some occasional experiments with
labor or consumer representation, the United States has never seriously embraced the stakeholder view of the corporation. In most public U.S. corporations, shareholders alone appoint the Board of Directors.

The Vorstand traditionally is a consensus-oriented structure. Its head has a radically different role than the U.S.-style CEO. The German head does not sit on the Supervisory Board, and functions more as the distiller of the Management Board’s consensus, and frequently is referred to as its “speaker.” The U.S. equivalent to this board typically is an Executive Committee that is handpicked by the CEO. It comprises the key executives who advise the CEO and implement his or her decisions. The greater emphasis on consensus in the Vorstand is not surprising, given that it ultimately is accountable to the pluralistic Aufsichtsrat and that it functions in the context of a stakeholder governance system and a “social contract” environment generally.

German banks are the dominant suppliers of equity capital and have a monopoly over the stock broking industry. In addition, they tend to hold individual shareholders’ shares in trust and to vote them in a block. Consequently, a few large German banks dominate the representation of shareholders on the Supervisory Boards of German stock corporations. In 1993, Deutsche Bank had representatives on the Supervisory Board of approximately 25 percent of German public corporations (AGs), including Daimler-Benz. In addition, banks are a dominant supplier of credit to German corporations. In the United States, the suppliers of debt and equity capital to a particular firm are considerably more disperse, individuals own relatively more shares and financial intermediaries (banks, insurance companies, and institutional shareholders) typically do not dominate corporate boards.

More than in common-law countries such as the United States, code-law governments and politics influence corporate decision-making. Because taxes generally are paid on essentially the same amount of earnings that is reported in the public financial statements (further described below), government is one of the direct stakeholders in the corporation. A less direct but powerful influence is the close working relation between governments and large corporations that is a characteristic of code-law countries. Some notion of a social contract tends to exert a strong influence on corporate decision-making.

Daimler-Benz’ twenty-person Supervisory Board at the end of 1993 included ten elected labor representatives, as required by law. The remainder were bank, corporate, or government representatives. It was chaired by Hilmar Kopper of Deutsche Bank, which has owned almost 30 percent of Daimler-Benz stock.
4.2. Accounting standards under the German commercial code

The Handelsgesetzbuch (HGB, or “commercial code”) codifies most German rules governing both financial reporting and disclosure. The HGB is legislative in origin; while the situation has changed somewhat in recent years, the German accounting profession historically played little role in standard-setting. Despite popular conception, it is written in relatively abstract terms and is not nearly as detailed as the formal accounting standards governing financial reporting in the United States (GAAP). GAAP are established by the FASB, a private sector body comprising full-time members, who must sever previous connections with accounting firms and corporations, and an extensive staff. It is financed by a wide range of private sector organizations. FASB standards are numerous and detailed. They are recognized by the SEC as authoritative, giving them a quasi-code status.

Perhaps the greatest axiomatic difference between U.S. and German accounting standards lies in accrual accounting. The FASB’s Statement of Financial Accounting Concepts No. 6 makes it clear that (para. 145, emphasis added) “the goal of accrual accounting is to account in the periods in which they occur for the effects on an entity of transactions and other events and circumstances.” In contrast, German rules allow firms to accrue future expenses, and in some cases require them to do so. For example, firms are required to accrue estimated repairs and maintenance expenses for the first three months of the following year, as a charge against current-period earnings, and are allowed to accrue as much as the estimated expenses for the entire following year (Nobes and Parker 1995: 277). Other charges, including additional depreciation, can be taken against income but transferred to a tax-deferred stockholders’ equity account (Nobes and Parker 1995: 277).

The greater flexibility allowed by German accounting standards is no accident. It provides ample opportunity for German managers to bend financial reporting in order to meet a variety of corporate and personal objectives, such as minimizing corporate taxes, smoothing earnings, underreporting the assets at their disposal, and hiding losses.

In explaining its decision to change to reporting under U.S. accounting standards, the Daimler-Benz management described the difference in these terms:

German and U.S. accounting principles are based on fundamentally different perspectives. While accounting under the German HGB emphasizes the principle
of caution and creditor protection, the availability of relevant information for shareholder decision-making is the chief objective of U.S. accounting. The comparability of financial statements—both from year to year and from company to company—and the determination of performance on an accrual basis therefore rank higher under U.S. GAAP than under the HGB. (Daimler-Benz 1997: 44)

Earlier, they had noted wryly: “U.S. accounting principles by far do not allow provisions and reserves to the extent as the German Commercial Code.” (Daimler-Benz 1995: 96).

The company’s decision to change to U.S. GAAP is tantamount to bonding itself to forego the flexibility in financial reporting that is permitted and encouraged under HGB rules.

4.3. Incentives to reduce volatility (hide losses) in German HGB reporting

There are universal incentives for managers to smooth reported income, that is to reduce earnings volatility. Managers generally have poorly diversified human capital portfolios, and much of their wealth and prestige is tied to the performance of the firm, so volatility avoidance is natural. Typical compensation schemes place a ceiling on earnings-based bonuses, thus causing a managerial preference to defer recognition of very large profits (Healey 1985). Managers also prefer to hide very large losses, to retain their positions (think Enron). Managers therefore generally have incentives to avoid both large profits and large losses, and to reduce earnings volatility. Employees are in a similar position, accentuated by company-wide bonus schemes based on profits. Earnings volatility impacts debt agreements, which explicitly or implicitly monitor income-based or balance-sheet-based ratios). Thus there are widespread incentives to reduce earnings volatility.

Several German institutional variables combine to accentuate the universal desire to reduce earnings volatility. They include:

1. The Vorsicht (literally foresight) principle pervades German accounting and leads to conservative reserves of equity as a prudent buffer for the protection of creditors. This implies reducing earnings in good years to the level needed to pay “prudent” dividends and bonuses, creating reserves that can be drawn on to pad earnings in bad years.

2. In code-law countries, Germany included, the incentives to reduce earnings volatility—and, in particular, to hide very large losses—are
unusually strong. They arise from a diverse but consistent set of institutional factors, many of which are outlined below.

3. Stock options and other stock-related compensation schemes are not common in code-law countries, Germany included. Under the stakeholder governance model, rewarding managers on the basis of outcomes to one stakeholder alone—shareholders—would not be as well received by other parties as it is under the shareholder value model. Consequently, code-law managers are evaluated and incentivized to a lesser degree on the basis of shareholder value, and more on the basis of reported profits. Risk aversion among managers implies a greater preference to reduce earnings volatility.

4. Employee bonuses and stockholder dividends also are closely linked to reported earnings, creating incentives to reduce earnings volatility. Reporting a loss could eliminate both dividends and bonuses. Earnings therefore are underreported in “good” years and overreported in “bad” (especially loss-making) years.

5. The incentive to reduce earnings volatility is compounded by agency issues that are superimposed. For example, employee representatives on code-law corporate governing bodies usually are annually reelected agents for employees, which gives them additional incentives to avoid reporting losses (and hence omitting bonuses) or even to avoid decreases in earnings (and bonuses).

6. Bank, pension fund, and insurance company shareholders are regulated on the basis of capital adequacy, and hence are harmed by volatility in their own earnings. If they own 20 percent or more of the company’s stock they must “equity account” their investment, and hence earnings volatility in their client companies flows directly into volatility of their own earnings and capital adequacy (leverage) ratios. If they do not own enough stock to equity account they show dividends in their own earnings (and retained earnings), so they have an incentive to reduce dividends volatility. Given the typically close dividends–earnings linkage in code-law countries, this translates to reducing the volatility of the earnings of companies in which they hold equity investments.

7. Additional taxes on undistributed earnings create strong incentives to reduce earnings in typical years (other things equal, to not report earnings in excess of those needed to pay the desired dividends and bonuses). This creates reserves to draw on in bad years.

8. Under code law, income calculations for tax and financial reporting are almost identical (the German case is described below). Tax
considerations therefore distort reported earnings. Nonlinearities in the tax rate penalize earnings volatility.

9. Governments also prefer low earning volatility to plan tax collections, and thus reward predictability (in particular they do not want tax revenues to fall in recessions).

Collectively, these institutional factors in code-law countries, Germany included, create strong incentives to reduce earnings volatility—and, in particular, to hide very large losses. Correspondingly, public financial reporting and disclosure—including timely recognition of large losses—play a lesser role, and there consequently is less litigation-risk arising from failure to report or disclose losses in a timely fashion.

Large-sample academic studies confirm these tendencies. Ball, Kothari, and Robin (2000) report that earnings reported in code-law countries exhibit lower volatility, lower left-skewness (reflecting a lower frequency of timely loss recognition), lower timeliness in general, lower sensitivity to economic losses, and lower incremental timeliness relative to dividends.

4.4. Influence of taxation on German financial reporting

Code-law systems tend to generate similar or even identical rules for determining taxable income and “book” income for financial reporting purposes. In Germany, the Maßgeblichkeitsprinzip (“authoritative principle”) requires tax accounting to be based on the firm’s Handelsbilanz (“commercial balance sheet”). While this principle is applied at the individual-company level, not the consolidated group level that is relevant to financial reporting, it exerts a subtle but powerful influence. The effect is that for an expense to be deductible for tax, it must also be deducted on the firm’s books. The law in France, Japan, and most other code-law countries is similar.

There are two principal reasons for the similarity between accounting and tax in code-law countries:

1. Government is heavily involved in writing the accounting code as well as being responsible for taxation, so it tends to prefer a single set of rules for convenience sake; and

2. Code-law countries develop a “culture” of all stakeholders, including government, “sharing in the same pie,” described more fully below.
There is pressure for all distributions, including taxes as well as dividends, labor bonuses, and management bonuses, to be based on the same income number—that is to be the shares of various stakeholders in the company’s profits.

In contrast, common-law countries typically operate two parallel systems for calculating the incomes of public corporations: income for financial reporting purposes (book income), calculated under largely private sector accounting standards (e.g. U.S. GAAP); and income for tax reporting purposes (“taxable” income), calculated under public sector rules (e.g. the U.S. Tax Code and IRS regulations).

The effects of the code-law linkage of book and tax incomes include:

1. In addition to its roles in disclosure to external parties (chiefly shareholders and lenders) and in incenting and monitoring the performance of managers (a corporate governance function), reported earnings must also bear the burden of the firm’s and the government’s taxation policies (including tax minimization and smoothing).

2. Reported income also is influenced by the government’s taxation policies. For example, Japan historically has required its accounting rules and practices to conform to national macroeconomic objectives. The long-deferred loan loss recognition practices of Japanese banks are a prime example.

3. Firms have a tax-induced incentive to minimize reported income to minimize tax. This leads to conservative balance sheets (due to heavy past write-offs of assets against income, heavy past provisions for future expenses or losses against income, and underrecognition of past gains).

Paradoxically, tax-induced pressure to “manage” reported earnings does not necessarily lead to understatement of income in every year, for two reasons. First, all accounting adjustments are a matter of timing. Equivalently, accounting revenue and expense “accruals” tend to reverse over time. Thus, a firm with high tax deductions in the past has lower deductions in the present and the future. For some accounting accruals, it is only possible to reduce reported earnings over an extended period of time by generating uninterrupted growth. In other words, it is possible to be consistently conservative in the balance sheet, but it is difficult to be consistently conservative in reporting profits. Second, nonlinearity in tax rates (e.g. imperfect carry-forward of losses) gives an incentive to reduce volatility of taxable income, in all countries. In code-law countries, this
translates to reducing the volatility of reported income, which means that income tends to be overstated in bad years.

The connection between taxation and volatility of reported earnings is subtler than the above analysis suggests. Taxation in code-law countries generally (and Germany in particular) is based on company-level taxable income, not consolidated group income. This gives companies the option to uncouple tax and book income by reporting consolidated financials that are not based on the tax records. Few companies choose to do so, presumably because the tax system gives them greater reporting flexibility, including the capacity to hide losses. Taxation and other incentives to reduce the volatility of reported earnings therefore interact in a subtle fashion.

4.5. Who owns earnings: Shareholders or stakeholders?

In common-law countries, the earnings of a corporation are viewed as the property of shareholders. The amount of earnings certainly influences other parties’ decisions, including lending decisions, labor negotiations, and political intervention in the company’s affairs (Watts and Zimmerman 1986), but the primary ownership of earnings lies unequivocally with shareholders.

The stakeholder model substantially alters the economic role of earnings. In Germany, reported income is more analogous to an annually baked pie, to be divided among the important stakeholders, (government, employees, shareholders and managers alike). Consequently, the size of the pie each year is of direct interest to all stakeholders. Under the Vorsicht principle, the amount of earnings is determined with prudential regard for the financial stability of the corporation. This principle legitimizes generally conservative book values as a buffer for the protection of creditors, but it also legitimizes a German earnings variable that is low in volatility and late in incorporating economic gains and losses.

The primary accounting tool available to reduce earnings volatility is to fail to recognize economic gains and losses in a timely fashion; that is to base earnings more on current-period realizations of cash flows, and less on accounting accruals that capitalize changes in present values of future cash flows (Basu 1977; Ball, Kothari, and Robin 2000; Ball, Robin, and Wu 2001). Reported earnings then is a smoothed moving average of past economic income, and thus is less timely in incorporating information about the economic value of the firm.
One justification offered for prudence is the stakeholders’ mutual interest in the company’s financial stability. This is consistent with conservative book values. A more skeptical view is that stability in the size of the pie also is valued by the agents for intermediaries who gather around the Supervisory Board table, because earnings volatility translates directly into unwanted bonus, dividend, and tax volatility. This interpretation is consistent with the low sensitivity of German corporations’ earnings to economic losses (Ball, Kothari, and Robin 2000). It also is consistent with Daimler’s reporting behavior in 1993, when it reported a profit even though it was making losses.

5. Daimler’s 1993 events: Disclosing a loss, hidden reserves, NYSE listing, U.S. GAAP reporting, plant closings and employee layoffs

The sequence of events that unfolded around Daimler in 1993 was without precedent. It started with Daimler reporting a profit under HGB rules and ended with announcements of plant closings and involuntary employee layoffs. In between, Daimler announced it would list its stock on the NYSE, reported key financial information calculated under U.S. GAAP, revealed it actually was making a loss, and revealed it had substantial hidden reserves.

5.1. Listing in New York

On October 5, 1993, Daimler-Benz stock commenced trading as American Depositary Receipts (ADRs) on the NYSE. No German company had previously listed on a U.S. national exchange, in large part due to the various costs and consequences of meeting the SEC’s financial reporting and disclosure requirements. Subsequent events at Daimler revealed how substantial the consequences can be.

In recent years, Germany had been lobbying U.S. authorities for a “mutual recognition” arrangement, under which each would accept reports prepared under the other’s rules, but the United States would have none of it. Lawrence Malkin (1992) described the situation as follows:

Germany’s biggest companies have hit a brick wall in their drive to list their stocks directly on Wall Street because their accounting system, with its hidden
cash reserves, runs directly against the American tradition of disclosing to small investors.

Whether the impasse is the fault of the insularity of the Germans in sticking by the ways or the Americans in insisting on their more transparent standards is moot. Approximately 200 German companies were registered for trading in the illiquid over-the-counter market, which exempted them from U.S. reporting and disclosure rules. Daimler was the first German company to “break ranks” and apply for full listing.

5.2. U.S. GAAP reporting

On September 17, 1993, in preparation for NYSE listing, Daimler-Benz publicly announced half-yearly earnings that had been calculated under U.S. GAAP. This was the first time that any German public company had done so. The disclosure had widespread and long-lasting effects on Daimler-Benz and other German public companies.

The company’s release of earnings calculated under U.S. GAAP was required under Rule 20-F of the Securities Exchange Commission Act of 1934, which regulates U.S. securities markets. Rule 20-F reporting requirements apply to all firms issuing or listing securities on national markets in the United States. The rule requires a reconciliation of the company’s home-country financials to those that would be reported under U.S. GAAP. Daimler reported the major effects of differences between U.S. and German accounting rules on Consolidated Net Income and Stockholders’ Equity.

5.3. Loss announcement

Another “first” was the company’s first-ever reported loss. When calculated according to U.S. GAAP, the loss for the first-half ended June 30, 1993 was DM 949 (U.S.$575) million. This surprising outcome was due largely to a 16 percent fall in sales relative to the comparable period in the previous year, an unusual fall for such a stable auto company.

The reported loss was all the more surprising because the company previously had reported a profit—DM 168 (US$102) million—for precisely the same half-year period. This earlier profit figure had been computed under German accounting standards and had been reviewed and certified by the company’s auditors. Many international observers were left
shaking their heads about how the announced profit of a major international corporation could, when merely recalculated under U.S. GAAP, turn into such a substantial loss. Daimler-Benz later announced a U.S. GAAP loss of DM \(1839\) million for the full year 1993, compared with a German-standard profit of DM \(615\) million. The stark difference between the numbers—approximately DM \(2.5\) (US$\(1.6\)) billion—quickly attracted the attention of analysts, regulators, and accounting standard-setters worldwide. It drew considerable attention to the radically different German and U.S. models of financial reporting, disclosure, and corporate governance generally.

The largest source of difference between the 1993 U.S. and German earnings disclosed in the 20-F reconciliation is a DM \(4262\) millions reduction described as “Provisions, Reserves and Valuation Differences.” The precise nature of this enormous item was not made entirely clear by Daimler at the time, but the more astute analysts observed that DM \(4262\) millions equals the sum of two amounts reported in the company’s 1993 Consolidated Statement of Cash Flows, “Extraordinary Results” of DM \(2603\) millions and “Gain on Sale of Securities” of DM \(1659\) millions. The next-largest item in the reconciliation is the effect of these same items on income tax expensed under U.S. GAAP. All other differences between 1993 HGB and U.S. GAAP profits essentially netted out. The company’s motives for including the pre-tax gains of DM \(4262\) millions in its 1993 HGB-rule earnings are discussed below. Whatever its motives, the effect was to turn a loss into a profit.

### 5.4. Hidden reserves

To have hidden reserves, a company must have reduced earnings during better times in prior years by strictly accounting means, underreporting both earnings and book values. Creating hidden reserves requires (in accounting terms) an excessive debit charge against earnings. The corresponding accounting credit entry can take one or more of three forms:

1. **Provisions**: creating a notional liability for a specific or even a vague, general contingency such as “Provision for Future Losses”;
2. **Reserves**: crediting (essentially hiding the profits in) a Shareholders Equity reserve account; and
3. **Asset Valuation**: writing-down the book values of assets.
These are strictly bookkeeping adjustments, and (apart from their indirect effect on taxes and other payments based on earnings) do not create new reserves of real funds, because they do not require the company to invest in cash or any other real asset. They simply are book entries. However, they are reserves in two equivalent accounting senses. First, hidden reserves correspond to a deliberate underreporting of the real net assets of the company. For example, it might have deliberately undervalued its inventories, marketable securities, or accounts receivable. Second, hidden reserves are stores of future book profits. For example, undervalued inventory can be used to reduce the cost of inventory usage that is charged against earnings in subsequent years. To increase reported earnings at a later date—usually to cover up losses in a bad year—the company simply has its accountants reverse the entries that created the hidden reserves, debiting any combination of these accounts and using the corresponding credit to increase book income.

Daimler’s 1993 20-F reconciliation shows Shareholders Equity under U.S. GAAP as DM 26,281 millions, some 50 percent higher than the equivalent HGB number of DM 17,584 millions. The largest component of the difference was DM 5,770 described as “Provisions, Reserves and Valuation Differences.” This description is not very informative, but it does imply that in past years the company had made each of the above three types of journal entry to reduce book values and reported earnings.

5.5. Drawing on hidden reserves to cover losses in code-law and common-law countries

Subsequently, earnings can be inflated quite simply by transferring amounts out of the hidden reserves. A credit to earnings is accompanied by a debit entry—to reduce prior provisions for liabilities, or to reduce Shareholders Equity reserve accounts, or to increase the book values of assets. Daimler’s DM 4,262 millions of “Extraordinary Results” and “Gain on Sale of Securities” appear to fall into the second category, a transfer out of Shareholders Equity into the Income Statement for the year. Under U.S. GAAP, these items would have been included in earnings in prior years, but their inclusion was deferred until 1973. As previously noted, it seems no coincidence that they were not included in earnings during good years, that they were included in a year that otherwise would have shown a loss, and that the German public was not informed about either fact.
Conservative balance sheets and underreporting of earnings in good times is consistent with the important German *Vorsicht* principle, which allegedly is for the protection of creditors. A skeptical alternative view, discussed more fully below, is that it protects managers and stakeholders’ agent representatives. Companies and their creditors can be expected to “contract around” (i.e. effectively undo) balance sheet conservatism. “Prudent” earnings numbers allow managers to smooth earnings and reduce the volatility of bonuses and dividends tied to earnings. In addition, transfers *out* of hidden reserves allow managers to hide losses.

Managers’ ability to create and (more importantly) draw down on hidden reserves is severely constrained in common-law countries. The practice of drawing on hidden reserves to conceal losses effectively was common in England in the nineteenth century (Yamey 1962), but was extinguished effectively in common-law countries as a consequence of the 1932 Royal Mail case, *Rex v. Lord Kylsant* (1932 1 KB 442). This case law was codified in the 1948 U.K. Companies Act, which required companies to distinguish reserves from provisions, consequently “making the creation of secret reserves more difficult” (Nobes and Parker 1995: 103). In the United States, the accounting rule Statements of Financial Accounting Standards (SFAS) No. 5 does not allow reserves to be created by general charges for unspecified losses. It allows an accrued loss contingency against earnings only when it is *probable* that an asset is impaired or a liability is incurred and an amount of the loss can be estimated. SFAS No. 5 (para. 15) also prohibits transfers out of appropriated reserves into Net Income in any way whatsoever. In addition, the common-law obligation to disclose losses was codified in the U.S. Code of Federal Regulations, Title 17, Section 240.10b-5 (widely known as Rule 10b-5), which makes it unlawful “to omit to state a material fact necessary in order to make the statements made, in light of the circumstances in which they were made, not misleading.” This rule has provided the basis for private litigation as well as civil action against U.S. corporations for losses allegedly incurred due to misleading disclosures, including earnings disclosures.

Had Daimler been a U.S. company and reported a profit of DM 615 millions, and then subsequently revealed that it had made a loss of DM 1839 millions, there would have been an accounting scandal of major proportions. While it would have been eclipsed in magnitude by some subsequent accounting scandals (such as Worldcom and Enron), this would have ranked among the largest earnings restatements in history, and was an extremely large amount at the time. If Daimler had been
traded in New York at the time, possible consequences would have included:

1. A barrage of litigation from stockholders, lenders, creditors, employees, employee pension plans, and other parties, seeking substantial damages from the company, its managers, and its auditors;
2. SEC prosecution of the company, managers, and auditors under Rule 10b-5;
3. Damage to the company’s reputation from extensive, adverse press coverage, resulting in defection of customers, employees and other parties, and possibly severe political consequences;
4. Damage to the reputation of the company’s auditors.

As we see below, the reaction in Germany was precisely the opposite. The problem in the German system was not that Daimler initially failed to report a “bottom line” loss. The problem in Germany was that it subsequently reported the loss.

5.6. Initial German reaction

Public reaction was swift and furious. Protesters carried black coffins in the streets of Frankfurt, and the tabloids referred to management board chairman Schrempp as “Neutron Jürgen,” a reference to General Electric’s ruthless CEO “Neutron Jack” Welch (Vlasic and Stertz 2001: 129).

Among the company’s most savage initial critics were managers at other large German industrial companies, including Bayer AG and Siemens AG. German accounting is an integral part of the stakeholder system of corporate governance. For decades the reported earnings of German corporations had directly determined a smoothly rising stream of employee and manager bonuses, dividends, and taxes, like a steadily growing pie in which all parties shared. In many ways, the earnings of a company like Daimler were a microcosm of the postwar German economy, which had experienced steadily growing wealth that was distributed among political stakeholders under a pervasive social contract. Daimler’s abrupt departure from traditional German accounting practices therefore challenged a corporate and social governance system that seemingly had served all parties well, and of which Germans were understandably proud. This pride manifested itself in a type of competitiveness with
(and suspicion of) the U.S. system, and Daimler management was seen as breaking ranks in that competition.

A related complaint was that, in agreeing to comply with the SEC's insistence on U.S. GAAP information, Daimler-Benz had undermined Germany's prospects for negotiating mutual recognition of accounting standards with U.S. authorities. Mutual recognition was strongly advocated by the German authorities, for example Biener (1994). The concern was valid: Germany subsequently legislated to allow consolidated financial reporting under U.S. GAAP, but the United States has never recognized HGB rules.

The Daimler-Benz move also was seen as reducing the status of an accounting system that is rooted in the philosophy of *Vorsicht*, with its underreporting of book value and heightened creditor protection. How excessive balance-sheet conservatism is in the interest of either creditors or corporations is not obvious to the skeptical observer. The typical justification assumes that reducing credit risk is desirable per se. Dieter Ordelheide frequently made this argument, for example as a member of the Working Group on External Financial reporting (1995). The argument makes no sense in terms of the economics of debt finance. Both borrowers and lenders would be aware of any reduction in credit risk, especially considering the insider access of lending banks. Thus, credit would be priced at an appropriately reduced cost, with no overall gain to creditors. Further, given the firm's investment policy, the reduction in credit risk would be associated with more risk being borne by shareholders and a correspondingly increased cost of equity capital. There would be no net gain ignoring contracting costs, merely a reassignment of risk; this is merely an application of the well-known irrelevance theorem of Modigliani and Miller (1958). The dual to this theorem holds that any preference for particular provisions in financing agreements, including methods of accounting, must be due to reducing contracting costs. Viewed in this light, *Vorsicht* could well increase contracting costs and thereby generate economically inefficient financial reporting, by adding some uncertainty as to the amount of security being offered to lenders, who need to estimate the exact extent of the underreporting in order to price debt correctly. This conclusion is not altered by insider access to information by a closely affiliated bank, which merely displaces the inefficiency by limiting the company to one source of finance. How distorting reported earnings and book values is a more efficient way of contracting to raise credit and equity has never been made clear. I am unaware of any rigorous proof that it does.
Another claimed consequence of German companies adopting U.S. disclosure standards was the adoption of a shorter horizon by managers. Secret reserves were said to provide a buffer against reactions to short-term swings in German companies’ performance. A skeptical view here is that secret reserves serve the interests of insiders, not investors, by reducing the volatility of payouts to managers, employees, banks, and the government and by protecting managers from the immediate consequences of bad decisions (Ball, Kothari, and Robin 2000). For example, employee representatives are subject to annual reelection, and thus might care more about short-term bonuses paid to their constituents (and hence emphasize short-term profits) than about long-term firm value and bonus-generating capacity. By giving managers an accounting tool for disguising losses, secret reserves might well allow managers to delay taking painful decisions about their long-term loss-making investments and strategies, in the vain hope they will return to profitability or that the consequences of their decisions will be passed on to future managers (Ball, Robin, and Wu 2001). Furthermore, Vorsicht allows managers to disguise the extent of the resources they have invested in the firm, making them less accountable for their investments and more prone to size maximization, which is not necessarily in the long-term interest of the firm. Stock prices, on the other hand, look to the long term (hence the high price/earnings ratios of growth companies, and the sensitivity of share indices to changes in economic growth). While stock prices look to the long term with obvious error, there is no evidence that managers and stakeholders’ agent representatives do better.

Overall, the initial reaction in Germany to the Daimler moves was quite hostile. To an observer of these events from a common-law country, the surprising thing was the object of the adverse German reaction to Daimler’s disclosures. The problem was not that it had failed to disclose that it would not have made a profit except for some imaginative accounting, but that it subsequently confessed the deception. A series of simultaneous events helps explain why the confession—not the act—was the problem.

5.7. Plant closings, payroll reductions, and business divestitures

On September 17, 1993, the very day that it released the U.S. GAAP reports, the company announced it would abandon investments that were not
central to its core competence, focus its product line, close factories in Germany, and slash its payroll. The immediately announced payroll cuts were 35,000 jobs in Germany by the end of 1994, plus another 8000 jobs in other countries, and included some involuntary terminations. The company thereby revoked fifty years of postwar labor practices. Between the beginning of 1993 and the end of 1996, the number of Daimler-Benz employees in Germany was reduced from 302,464 to 222,821, during which time the total assets of the group increased by over 30 percent (Daimler-Benz 1997: 88). Managers were not spared: 50 percent of the jobs at the company’s Stuttgart headquarters were eliminated (Vlasic and Stertz 2001: 129).

In three years of Unternehmenskonzept, Daimler streamlined its operations, reinvigorated its product line, and disengaged from businesses that were taxing its core businesses by losing money and distracting management. It dismantled AEG, its century-old and much revered electronics business. It spun off its Energy Systems Division and Automation Division, requiring a DM 1600 million charge against 1995 earnings, with an additional DM 300 million in 1996. It discontinued financial support for Fokker, which then filed for bankruptcy under Netherlands law, causing a DM 2158 million loss to be recorded against Daimler’s 1996 earnings. During 2001–2, it sold its stake in the Debis Systemhaus information-technology joint venture to Deutsche Telekom, and part of its U.S. commercial-financing portfolio to GE Capital. In total, eleven of the company’s thirty-five businesses were eliminated (Vlasic and Stertz 2001: 129).

Within five years Daimler had merged with Chrysler, the number three U.S. auto manufacturer. Startlingly, within three years it was reporting financial statements prepared “from the ground up” under U.S. GAAP, and was openly espousing a modified shareholder value model.

6. Daimler-Benz’ motives

6.1. NYSE listing, U.S. GAAP, corporate governance, and bonding to transparency

The sequence of events raised many questions about the company’s motives. For example, why did they fail to disclose that they had used
two “one-time” gains to make up operating loss, and then reverse their position by filing in the United States? Indeed, why did they list in New York? Were any parties “fooled” by the German HGB-accounting profit? Did the company intend to deceive anyone when it covered up its loss-making status in its HGB report? The company’s problems in its core markets were widely known. Parties with insider access to information are unlikely to have been misled, including banks (as lenders, shareholders, and shareholders’ representatives), institutional investors, and employees’ elected representatives. Astute readers of the accounts most likely could have discerned that Daimler was making a loss. On the other hand, small investors, international lenders and investors, individual voting employees, and the German government might not have been aware of the full extent of Daimler’s actual losses. The German voting public—an important party due to the politics of job cuts and plant closings—was likely to have been misled by the company reporting a profit under HGB rules. Disclosure of the U.S. GAAP loss in its 20-F reconciliation attracted widespread public attention in Germany (and elsewhere) to the company’s problems, and made it politically less costly to undertake employment reduction and plant closing decisions.

From a disclosure perspective, it is tempting to conclude that the only reason for Daimler to report under U.S. GAAP was to inform the German voting public about its real losses. But this would ignore the fact that it had the option to report a loss under HGB rules. If the two one-time gains totalling DM 4262 had not been booked in 1993, the company would have reported a loss of approximately DM 1516 millions, calculated as DM \[615 - (1 - 0.5) * 4262\] millions. The amount is adjusted for tax, assuming the loss could be carried forward under German tax rules and assuming a 50 percent corporate income tax rate on undistributed profits. This is very close to the U.S. GAAP loss of DM 1839 millions, reported later. If the gains had been included in income but labelled as special nonrecurring items, the company would have been able to report an operating loss to the press. In my opinion, the disclosure perspective (in which the objective of financial reporting is entirely to inform external decision-makers and hence reduce the cost of capital) is much overrated in the accounting literature. Conversely, an underrated objective of financial reporting is its effect on managers’ decisions, including the effect of timely loss recognition on the propensity of managers to undertake new loss-making investments and to continue operating their existing loss-making investments (Ball 2001).
6.2. Listing in New York: Bonding to report losses in a timely fashion

Listing on NYSE involved costs and benefits to Daimler (see Radebaugh et al. 1995). One-time costs included legal and other fees for registration with the SEC, NYSE listing fees, the cost of altering the company’s accounting system to produce U.S. GAAP financial information, and the adverse political fallout in Germany. Ongoing costs included periodic accounting, legal and registration fees. Collectively, the costs of NYSE listing were thought to be substantial. Many analysts wondered whether the benefits were as obvious as the costs.

A long-term benefit of NYSE listing is diversification of the company’s shareholder base. Daimler-Benz’ earnings incorporate a component that involves a net-long position on the U.S. dollar, since the company generates more U.S. dollar-denominated revenues than costs. Another benefit is the enhanced liquidity and lower cost of capital, resulting from equity that is more actively traded. Some analysts thought there were public relations and even marketing advantages of the move.

One benefit of NYSE listing that is overlooked in the literature is the effect on corporate governance of the company binding itself to future transparency.¹ In particular, NYSE listing makes it costly to hide losses, as the company had been able to do under flexible German HGB accounting rules. Under the German governance model, decisions that would adversely affect the workforce are difficult to make, due to 50 percent employee representation on the Supervisory Board and political pressure on the company and on its affiliated bank. Their incentives appeared strong enough to have led Daimler to hide its 1993 losses.

But in a common-law country—particularly a litigious country like the United States—failure to disclose materially adverse information opens a company to the risk of stockholder litigation, with potentially severe consequences. Trading on NYSE (versus Frankfurt) is executed under U.S. (not German) law. Hence shareholders buying Daimler-Benz stock on NYSE have the right to litigate if they demonstrate losses due to material nondisclosure, and the SEC has the authority to enforce the disclosure requirements of its Rule 10b–5. The question then is: Did Daimler-Benz list on NYSE to bond itself to henceforth disclose—and take prompt managerial steps to correct—areas in which it is not acting in shareholders’ interests?

Untimely loss recognition allows managers to undertake ex ante negative-NPV investments, for example to maximize size or to acquire
“trophy” companies, and pass the earnings consequences on to subsequent generations of managers. Untimely loss recognition also gives managers an incentive to continue operating *ex post* negative cash flow investments and strategies, and avoid booking losses on sale or abandonment. Timely loss recognition thus can be viewed as a feature of efficient contracting between firms and managers (Ball 2001: 141).

The behavior of Daimler management is consistent with this hypothesis. Its disastrous diversification binge had been the brainchild of CEO Edzard Reuter. His successor, Jürgen Schrempp, had been responsible for the Fokker acquisition, which ended in bankruptcy after incurring several years of high losses. The decision to recognize the losses at Fokker is reported by Vlasic and Stertz (2001: chapter 7, 128) as follows:

Schrempp saw a bigger picture. Fokker was a painful chapter, but a valuable learning experience for Daimler. His predecessor, Edzard Reuter, had never admitted a mistake. Daimler’s corporate culture punished mistakes. Schrempp was taking a new path, putting himself on the line, and forcing the biggest company in Europe to look in the mirror when it failed. “This will be a great thing,” he said resolutely. “The chief executive made a mistake. He admitted it. . . . This is what must happen in the whole company.”

Daimler’s survival—in a mature, fiercely competitive industry with much excess capacity—was at stake in 1993. Poor corporate governance encourages poor decisions and discourages unwinding of poor decisions. Relative to the shareholder value model, the stakeholder model focuses more on dividing rather than maximizing the pie. It better enables managers and board representatives of labor and capital to hide behind poor public disclosure and avoid accountability for bad strategic decisions. Poor disclosure of losses allows managers to waste more resources, putting the company at a competitive disadvantage. Daimler’s motives in listing on NYSE were considerably wider than merely increasing liquidity, or reducing capital costs: they were focussed on corporate governance and, in turn, on the company’s investment and strategic decision-making and ultimately its ability to generate future cash flows.

7. Embracing shareholder value

In its 1996 annual report, Daimler-Benz (1997: 44–5) disclosed several radical changes to its governance. They were linked together under the intriguing title “Value-based management, U.S. GAAP, and new
controlling instruments.” Four notable features of these changes are noted below.

### 7.1. Shareholder value

Under the subheading “Understanding value-based management,” it described the version of the shareholder governance model that it had embraced as follows:

The permanent and continuous expansion of our company’s value is only possible when the interests of all groups that contribute to our success are given the appropriate degree of consideration. Our economic performance and satisfactory returns for our shareholders depend on motivated employees, satisfied customers, and reliable and innovative suppliers. On the other hand, only a profitable company is in a position to obtain the funds required for securing the future from the capital market at relatively favourable terms and to offer its employees secure and challenging jobs and thus earn their long-term commitment. Management at Daimler-Benz is therefore dedicated to increasing the value of the Company for the benefit of everyone involved.’ (Daimler-Benz 1997: 44).

Thus, Daimler management was firmly committed to a shareholder value model of corporate governance.

### 7.2. No stakeholders

The word stakeholder was conspicuous in its absence. Management was careful to give recognition to major parties, using terms such as “all groups that contribute to our success” and “everyone involved,” but these terms do not imply participation by the parties in the decision process, an important ingredient of the stakeholder model. There was not even an indication that shareholder value was one of several objectives, to be balanced against other objectives such as employment security or creditor security. It was stated as the objective.

### 7.3. External transparency

Transparent disclosure to the public, including the use of U.S. GAAP for financial reporting, was seen as central to the process of managing
against a criterion of shareholder value. For example, when the Chrysler side of the company was losing money in 2001, the response was a turnaround plan involving workforce reductions, asset write-downs, and supplier contract cancellations. Under GAAP, this required an immediate restructuring charge against earnings of €3.1 billion. Earnings thus incorporated the economic loss more quickly, and the losses were stemmed by managers more quickly. The contrast with covering up the 1993 losses under HGB accounting was stark.

7.4. Internal transparency

Under the heading “New controlling instruments,” and the subheading “Internal controlling on the basis of balance sheet values in accordance with U.S. GAAP,” Daimler gives the following description of implementing U.S. GAAP for managerial reporting throughout the company:

The U.S. GAAP not only made Daimler-Benz more transparent from an external perspective. Because the earnings figures as derived from American accounting principles reflect the economic performance of the company, we are now able to use figures from our external reporting for the internal controlling of the Company and its individual business units rather than relying on the internal operating profit used in the past. (Daimler-Benz 1997: 45)

There appear to be two reasons for changing to U.S. GAAP for internal reporting:

1. When it stated “we are now able to use figures [derived under U.S. GAAP] . . . for the internal controlling of the Company and its individual business units,” Daimler implied that its internal performance reporting needed reforming as well. It appears that managers of individual lines of business might have been using the wide discretion in accruing expenses and revenues under HGB accounting to smooth reported line-of-business profits, and possibly to hide operating losses, when reporting to their superiors. Their objective would have been to reduce the volatility of their unit’s performance, and hence the riskiness of their own human capital. One consequence would be disguising the true profitability of individual lines of business from Daimler’s corporate-level management.

2. Transparent disclosure to capital markets certainly changes the incentives of corporate-level managers. But incenting lower-level managers
to act in a manner consistent with the new incentives of corporate-level managers is another issue. One advantage of accounting earnings, relative to share prices in particular, is that total corporate earnings can be decomposed into the earnings of individual business units. Thus, earnings can be used as a company-wide and consistent measure for evaluating and compensating business unit managers. Daimler makes it clear that it has pushed U.S. GAAP earnings down through the corporation, so that business unit managers as well as the corporate office are better incented to focus on shareholder value. This in turn is assisted by the “new controlling instruments,” under which the U.S. GAAP earnings of business units are evaluated against the cost of capital for the assets they utilize. The linkage to shareholder value is described in these terms (Daimler-Benz 1997: 45): “The activities that exceed the minimum investment requirement of 12 percent increase the value of the Company because their income exceeds the costs for the capital employed.” Conversely, activities that fail to achieve the minimum over the long term decrease the value of Daimler-Benz.

The company therefore saw U.S. GAAP and the shareholder value perspective as being a “managerial” as much as a “financial” accounting issue. Lack of internal transparency was a corporate governance liability, reducing unit managers’ incentives to deliver profits, allowing loss-making activities to be tolerated longer, and reducing the ability of corporate managers to evaluate unit managers’ performances and allocate resources among them. It was a competitive disadvantage. Within three years, the Chief Financial Officer (Gentz 1999) was able to report “significantly risen transparency within the group.”

The company moved toward the shareholder value model in other ways as well. For example, in 1996 Daimler-Benz AG instituted a stockholder approved stock option plan for Management Board members and other senior executives. The plan was renewed in 2000.

8. Limitations, outcomes, and risks

While Daimler very clearly adopted elements of a shareholder value model, it equally clearly did not embrace it in its entirety. After the Chrysler merger, it chose to remain a German corporation and thus chose not to totally shed the consequential legal, economic, and other cultural
influences on its governance and reporting. For example, its Supervisory Board continued to contain 50 percent labor representation. In his report on “Value-based controlling at DaimlerChrysler,” CFO Gentz (1999: 6) described a company trying to evolve a more hybrid governance model than it had described in 1996, incorporating elements of both the U.S. and German systems. He now saw the need to merge the “common philosophies” of “shareholder value management at Chrysler” and “value-based management at Daimler-Benz.”

Subsequent indications reveal that merging the two governance models into a viable hybrid could be more difficult than initially envisaged. For example, there were substantial differences in management compensation structures: in 1997, Chrysler CEO Robert Eaton was compensated with $11.5 million, whereas Daimler-Benz CEO Schrempp received only $2 million. German CEOs spend more time developing and implementing consensus among members of their managerial boards, and less time acting as decision-makers, than their U.S. counterparts. The clash in management styles had almost immediate consequences: By 2002, only two of the thirteen members of the company-wide Management Board were from the Chrysler side of the business.

Initially, Daimler’s radical moves were not well received in the German corporate world, but over time they became understood as well as emulated. The reaction of Siemens AG is a notorious example. In 1993, its management bitterly criticized Daimler for listing on the NYSE and for reporting under U.S. GAAP, but by 2001 it had followed suit, and its CEO had been quoted in the Wall Street Journal (February 2, 2001) as saying: “My predecessor was a magnificent man, but I don’t think he knew the share price every day. The first thing we talked about when I came in this morning was the share price.” In July 2002, there were forty-six German companies listed on U.S. exchanges. Daimler was the first.

Notes

First version: October 1996. Dieter Ordelheide and I discussed this case, and the principles underlying it, many times over the years, typically when we co-taught on the European Accounting Association’s Doctoral Colloquium in Accounting. I like to think we both went away wiser on each occasion. Many valuable comments on prior drafts were given by students in my classes at London Business School, University of Chicago, and University of Rochester, by seminar participants at Melbourne Business School and University of New South Wales, and by conference participants at the 1999 Financial Accounting and Auditing Conference of the Institute of Chartered Accountants in England and Wales. I am
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1. Exceptions are Coffee (1999) and Stulz (1999), which postdate earlier versions of this chapter.

References


