

## Improving Corporate Governance Quality Through Modern Controlling - Integrated Reporting in the German Two Tier System

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### Abstract

**Purpose:** The purpose of this article is to describe the interdependencies between corporate governance and controlling for the German two tier system. In German listed corporations, the management board is responsible for the implementation and development of the controlling system, while the supervisory board has to review the effectiveness.

**Approach:** After a theoretical funding of corporate governance an impact analysis based on the area of auditing, supervision and control will be focused. The main implications of the international integrated reporting project are presented.

**Findings:** The analysis shows that the development of financial accounting and corporate social responsibility to an integrated reporting together with an increase in importance of controlling goes hand in hand. Controlling will form the central link between corporate governance quality and integrated reporting.

**Value:** After the financial crisis, integrated reporting can be classified as a key instrument to increase trust in the quality of corporate governance and accounting for global companies. This project will lead to best practice reporting standards to communicate sustainable financial, social and environmental values to the stakeholders.

Under the term of corporate governance, reform approaches, primarily from a legal point of view, will be discussed and transformed into standards, in order for capital market orientated companies to be managed more efficiently and to be controlled more effectively. In the two tier system of German corporate governance, corporate governance in public limited companies is primarily aimed at the rights and responsibilities of the management board, supervisory board and shareholder's meeting, which, as main entities, sustain the target-oriented management and controlling of the company. However, also in the Anglo-American board system, corporate governance has a central significance. The bundling of management and control tasks for inside and outside directors based on the board system admittedly provides a flexible allocation of powers and responsibilities, however, at the same time, contains risks with reference to the neutrality of controlling. The fact that neither the one nor the two tier model can be referred to as being an absolute supremacy has induced the European Commission to implement a company voting right between a dual and board system when introducing the "Societas Europaea (SE)".

This article is based on the interdependent relationship between corporate governance and controlling. The regulation tightness has also distinctly increased with regard to capital market regulation over the past few years, mainly attributable to internationalisation ambitions in the area of financial accounting and integrated reporting. Here an intensification of controlling by corporate management in particular is to the fore, which, alongside internal instances (internal audit, supervisory board), is carried out by external control bearers (external auditors, enforcement, market for corporate control).

In the next two chapters the article initially covers a theoretical funding of corporate governance, as well as an explanation as to why there is a necessity to implement a integrated reporting system. In view of the fact that corporate governance substantially determines the embodiment of controlling by companies, the question arises as to what the concrete effects from the corporate governance discussion are on the controlling practice of listed companies. In the following chapters the areas of auditing, supervision and control will be analysed separately, in order to clarify how the role of corporate governance from the point of

view of management theory and practice presently depicts itself, and in what shape they need to be in order adjust to future developments. The article concludes with a summary of the findings.

### Theoretical Implications of Corporate Governance

The historic development of the US-American economy (and thus also society) features different models of governance. The term of corporate feudalism is summarised by Liefmann [1] as the early voting trusts (owners transferred their shares to a trust in exchange for certificates) and the later holding companies in particular. The resulting (powers) owners were also named Captains of Industry. Later the managerial corporation with reference to the comments by Holmström and Kaplan [2] pointed to the ideal of a company controlled by management. Because of the increasing number of shareholders, ownership and the authority to dispose fell apart. As a result of this, the US-American discussion on the corporate problem arose. Eventually the endeavours of the creation of shareholder democracy and minority representation, summarised since the 1960's under the heading of shareholder activism, could be interpreted as reform approaches, which are geared towards improving corporate governance.

Against this background, the US-American literature from the 1960s and 1970s investigated the question of how management, in the sense of the objective of the owner, can be disciplined. The most

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popular approach by Jensen and Meckling [3] contains offering management incentives that exhibit the quality of the contract relationship. He finds the solutions in an optimal capital structure of the company. Today this theory of (incomplete) contracts still forms the starting point of the corporate governance discussion. If owners and management were able to conclude a contract in advance, in which the regulations for all future possibilities are determined and which is free from transaction costs (transaction cost theory), legal form specific problems could be avoided. All decisions would be made at the time of concluding the contract. In reality this does not seem possible due to the uncertain future development. The theory of contracts intensively analysed the thus incomplete contracts between principal and agent and therewith presented an important theoretical foundation for corporate governance. The latter referred to the question from Coase [4], as to why hierarchical structured companies are formed in empiricism, especially as the prevailing opinion assumes supremacy of the market-based framework. Moreover, the theoretical deliberations on the allocation of disposal right (property rights theory) are referred to, which, according to the form of certain behavioural assumptions (human factors) and environmental factors (environmental factors) in the scope of controlling activity, cause costs. Another essential influence on the development of corporate governance assumes the theory of accounting policy ("creative accounting"), which in the Anglo-American area is conducted under the designation of earnings management.

At the same time existing information asymmetry between the principal and agent acquired in favour of the agent is of particular significance. Dissolving this, forming contracts and controlling is the answer prescribed by Watts and Zimmerman's [5] positive accounting theory, which continues to concentrate on external accounting. Even though the positive accounting theory has been criticised numerous times, its input with regard to the pointing out of possible significances of accounting in the solving of contract and governance problems remains unchallenged.

With a view to the incomplete contracts of capital commitment and the existing information asymmetry it is the objective of corporate governance to protect shareholders' interests. Corporate governance, at the same time, means the targeted management and controlling of companies and includes mechanisms for regulating competencies, the creation of incentives, the installation of controlling processes and the coordination of the company's external relationships.

## Integrated Reporting as the New Challenge for Listed Companies

After the financial crisis, several corporate governance reforms, e.g. in the European Union, have substantially changed the controlling practice of companies. As a result of the increasing capital market orientation and globalisation of companies, external accounting (financial accounting), according to Freidank and Lachnit [6] is interpreted in a publicity policy that increases company value, which is shaped by a continual intensification of the communication relationship between corporate management and investors against the background of the successful implementation of an investor relations strategy. In the past, besides investor relations, creditor relations were strongly referred to, which concern the relationship management between corporate management and the finance providers. In literature, the (group) financial statement is also classified as a business card for the company, which takes up a central significance in public relations, whereby the publicity policy aims to make the specific corporate

culture and thus the corporate identity transparent to the addressees of the financial statement.

The publication strategy, which has to be characterised as honest, corresponds to the concept of value reporting according to Labhart [7]: "Do your best for the shareholder and speak about it". Furthermore the AKEU [8] points to the increasing importance of internet publicity as a design instrument for the improvement of investor relations. The increasing application of capital market-orientated corporate management concepts is the basic motive for a voluntary publication of information on the part of corporate management, which sometimes exceeds the traditional financial reporting. The essential objective of value reporting is the reduction of value gaps, which are formed between corporate management and the investor due to the asymmetrical information brokerage and the lack of capital market efficiency. The reduction of this should be caused by the strict compliance to the management approach. According to this, the external financial statement addressees will be equipped with the same information for the internal company control as the management.

The value reporting discussing has been updated in the last years through corporate governance reporting and integrated reporting. After the last financial market crisis, a short-dated shareholder value policy has been mainly criticized. The consequence of these failures was the implementation of corporate social responsibility reporting (CSR) and sustainable management remuneration systems. To lower the risk of information overload, the International Integrated Reporting Council (IIRC) has published an "Integrated Reporting Framework" last year to connect the traditional financial accounting and the CSR reporting.

Integrated reporting provides relevant information for valuation purposes so that all stakeholders can have an improved idea as to the estimation of the company's value. Taking centre stage of the approach is every piece of information that, from the company's view, has an influence on the value of the company. In connection to this, the change of reporting from the past-orientated financial accounting to the comprehensive future-related integrated reporting is seen as indispensable. Alongside financial data, which allows an assessment of the company's value performance, integrated reporting also includes information concerning the social and environmental aspects in line with the three lines concept, in order to provide the stakeholders with a transparent depiction of the situation of the company. However, the information transported by integrated reporting can only then bear reliable character for external financial statement addressees, if they are also subject to an inspection by external auditors. Potential investors are thus put in the position to make their investment decisions on the basis of increased, improved and safer (i.e. checked) relevant company information for decision making.

Integrated reporting and corporate governance can, in this respect, be seen as aligned, as in they are aligned towards the superior corporate objective, i.e. the winning of new investors and the strengthening of stakeholders' trust. In order to counteract the danger of the management having to bear difficult objectifiable value, general principles have been formulated in the IIRC framework to fulfil these information requirements. A positive effect of integrated reporting on the financial statement addressees is achieved, for example, in the scope of the description of the corporate measures in the area of environment protection, if the company is successful in credibly showing that it admits social responsibility. Since management's salary is more and more frequently linked to the company's performance on the stock exchange, the management board frequently also follows the

individual political objective of an increase of the market value. In this sense a cadence between individual and financial policy objectives can be achieved by integrated reporting.

Integrated reporting can be used as a management instrument, to influence the choice behaviour of the addressees through a voluntary disclosure of the legal minimum, because the data submitted is only completely checkable and objectifiable by the external addressees of the financial reporting in the rarest cases. The current reform measures for corporate governance accounts for this fact, in which it increases the reliability of the financial reporting information. Information about strategy and management performance (performance measurement) as a pillar of integrated reporting is expressed in the company practice by using dynamic figures, such as discounted cash flows. The management's target is to allow an accurate quantification of the market value of the company performance by means of an external report of these performance indicators (performance reporting).

At the same time, more and more legal norms impact on the company and are most notably traced back to upheavals in corporate governance. The legal norms penetrate the company sphere via specific "incident paths", which are represented in the controlling approach hypothesis by the elements of control, inspection and supervision. Control as – differentiating from investigation and supervision – a process-dependent control operation also integrates controlling alongside housekeeping measures of protection. Apart from these controlling measures the comprehensive corporate control system also contains external investigation as well as supervision.

### **Audit-Orientated Influences of Corporate Governance Regulation**

In the scope of the different varieties of company-related examinations, external auditing corresponds most notably to an outstanding significance because of its public benefit. Established as an academic discipline, auditing teaching initially dealt with the practical separate questions of different auditing functions, then with auditing company institution and, according to Wolfgang et al. [9], continues to look for a complete auditing theory. In practice, the implementation of accounting regulation in the scope of the reform efforts for the improvement of corporate governance has been strengthened again. According to the AKEU [10], enforcement predominantly acts preventative and corrective and thus should induce a quality increase of financial reporting.

Within the scope of annual auditing, financial accounting, i.e. the annual report as well as the status report, constitutes the essential auditing object. In groups this is valid for the group financial statement as well as the group status report. Furthermore, bookkeeping, cost accounting, as far as it provides information for the valuation of assets, and the internal control system are the auditing objects of the annual audit. For German listed companies the risk management system has to be subject to external audit. In the course of the efforts to improve corporate governance, financial reporting standards are exactly set out like the regulations for the annual audit amendments.

It is thus worth questioning, to what extent the legal norms in the field of financial accounting and annual auditing effect controlling, whereby in the following only those areas, which have become essentially important for the internal control of the company via the current reform upheavals, are addressed.

Through the EU-IFRS regulation, European capital market-orientated parent companies have, since 2005, basically been bound to

compile a consolidated financial statement according to International Financial Reporting Standards (IFRS). For non-capital market orientated companies the EU regulation includes a member state electoral law. The German legislator has passed along this option as a company electoral law. Furthermore the German law provides a right to vote for the individual financial statement of not only capital market-orientated companies but also all of the remaining companies regarding the production of this for the purpose of information also according to IFRS.

Across the board, financial accounting according to IFRS is considered more suitable than financial accounting according to traditional German accounting rules, due to the information provision of the addressees. Finally the information brokerage relevant for decision making (decision usefulness) constitutes the overriding objective of IFRS financial accounting, while national reporting procedure for the individual financial statement has to meet the task of profit distribution and tax assessment alongside the information function. Arising from this are essential discrepancies in the weighting of the accounting principles (in particular above the line income statement versus the dominance of the principle of prudence). The conflict between both targets experience, however, according to Coenberg [11], a certain relativisation due to the underlying objectified accounting principles of IFRS financial accounting. The information relevant for decision making from the IFRS financial statement should simplify the preparation of forecasts for the addressees (mainly regarding the company's future payment surpluses) and corporate decision making (fair presentation). As a result of this, it follows that an IFRS financial statement actually corresponds to the objectives and tasks of the management, rather than a financial statement according to German accounting rules.

All in all, numerous pieces of information from controlling are necessary for the IFRS financial statement. Alongside past (actual) figures, future forecasted figures also amount to an increasing significance, especially due to the consideration of the future corporate benefit and the identification of opportunities and risks of future performance. This is especially also valid, for the variety of pieces of (group) status report information that are related to the results of corporate planning. The (group) status report as a German mandatory publication instrument for corporations, is viewed in this light as an interface between financial accounting, management accounting and business reporting. In contrast, the IFRS management commentary is only a voting right.

Apart from the demands that are increasingly made on controlling on the part of financial accounting, this is itself, an object of German commercial law. On revision of risk reporting, the annual auditor has to provide an impression of the quality of the internal reporting structure, in particular the adequacy and the effectiveness of the risk and opportunities management system is to be critically acknowledged. Additional integrated reporting, which is disclosed outside of the obligatory auditing part of the annual report, is already presently an indirect element of obligatory auditing, as financial accounting and integrated reporting have to be harmonised. Moreover, a voluntary auditing of integrated reporting in line with the implementation of an auditing review is to be considered in order to give the annual report a higher significance versus the capital market players.

### **Supervisory Orientated Influences of Corporate Governance Regulation**

The supervisory board oversees the original managerial functions

of the executive board in the German corporate governance system. The function of the supervisory board should involve advising the executive board on general corporate management questions and bear the character of preventive, future-orientated surveillance. The consequence according to Scheffler [12] is that pure past-related supervision is not sufficient. Thereby the duty resides with the supervisory board to also oversee controlling across its ordinal, legal, purposeful and operating efficiency. For these purposes it may not basically use the internal auditing, which, as a rule, is subject to the executive board's instruction in the German system of corporate governance as a staff position, and which is exclusively reported to them. However, the supervisory board can, in the scope of its duties of overseeing the risk management system, call on, when required, specialists and informants to give advice in the supervisory board meeting, whereby company and group employees may be drawn on only on placement by the executive board.

In view of the supervision of the risk management system, the head of controlling as well as the head of internal auditing or accounting can be asked here. A duty which calls on this in the scope of supervision of the risk management system can only be relevant when there is an ascertained defect in the regular report, or when there is the existence of doubt in the adequate and orderly reporting of the executive board in the German two tier system. With this right, the supervisory board should – even when the significance of risk management is so high – be very careful. This is to avoid making a false impression on the internal experts – here the head of (group) controlling. It would represent mistrust against the executive board, which is why it is recommended summon the informant via the executive board.

A strengthening of the supervision activity or corporate governance should be generated in connection to this by the formation of special committees. In corporate practice these include, among others, nominating committees, compensation committees, disclosure and audit committees. This specialisation of supervisory organs within corporate governance, originally intended for the one tier charter, enjoy growing popularity in the two tier system. Here the independence of the surveillance bearer, like in the board model, is less to the fore than the increase in effectiveness of daily supervisory activities.

However, the supervisory board can only sufficiently fulfil its supervisory duties when it, according to Theisen [13], is supplied with corresponding information by the executive board. The German commercial law stresses in detail the ordinary and extraordinary reporting commitments of the executive board which have to be fulfilled vis-à-vis the supervisory board, e.g. fundamental questions about company planning (in particular about financial, investment and personnel planning) as well as variations of the actual performance against the previously reported objectives stating the reasons why underlie the reporting commitment of the executive board. Furthermore, the supervisory board has to be briefed on the profitability, revenue and the situation of the company.

Such provision of information as an active responsibility of the executive board requires the existence of a comprehensive controlling system, from which the required planning, control and supervision data can be gathered. Thus the company's strategic and operating goals, the implementation measures and finally corporate planning, inclusive of implemented control systems, are the important building blocks of future orientated supervision by the supervisory board. Hereby traditional function areas of controlling are addressed so that the controller provides essential reporting content to the supervisory board. Consequently, the reporting commitment influences controlling,

whereby its reporting has to be aligned to the specific requirements of the company addressees.

In recent times the aforementioned addressed value-orientated control concepts and the communication of (selected) key figures have increasingly gained in importance, particularly in listed companies. The aim of integrated reporting is the reduction of information asymmetry between stakeholders and management, as well as the accompanying avoidance of value gaps in the market. Because of the developments in the areas of integrated reporting and as a result of the supervisory board's supervision duties of the legally established reporting commitment for management, the supervisory board has, according to Ewert [14], been enabled to be in a position to assess the performance of the executive board with a view to increasing the value of the company. The corresponding integrated-orientated control system provides controlling.

A contribution for improving corporate governance, as well as an exculpation possibility for those responsible, can, thus, lie in the preparation of decisive documents to support management via controlling. This is also valid in respect of the executive board's reporting to the supervisory board.

## Control-Orientated Influences of Corporate Governance Regulation

In the corporate governance discussion the charter has prevailed, resulting in an essential contribution for avoiding corporate crises coming from internal early warning risk systems and the checking of internal auditing, flanked by external auditing measures. Research (e.g. Freidank and Paetzmann [15]; Freidank and Velte [16-19]) in proportion to corporate governance and controlling emphasise the central contribution of controlling in the targeted management and supervision of companies. If it is an advantage of the controlling systems vis-à-vis the external accounting, the supervisory board and the external auditors, without being able to work in the statutory framework, in order to be able to adjust more flexible and quicker to environmental changes, then it remains open nevertheless, as to how far legal norms act/impact on controlling and internal and external reporting. External accounting that supports legal norms is not traditionally the controller's domain. His field of activity refers to, among other things, the decision-orientated internal accounting. It is worth noting that both of these basis systems, influenced by worldwide attempts at harmonisation, are converging stronger and stronger, whereby international accounting norms also exert increased influence on controlling.

## Conclusion

Corporate governance covers all of the issues concerning the efficient management and controlling of companies. Controlling supports and complements the surveillance activity in the one and two tier system, as long as the management approach is followed and the existing information asymmetries between corporate management and stakeholders are dismantled. The explanations clarify that internationalisation efforts provide a decision making process for corporate management, in which they demand target-orientated control and supervision (harmonisation of in- and external reporting through integrated reporting). For this reason the requirements of the capital market for sustainable value based management and the connecting factors for the strengthening of corporate governance complement each other.

The internationalisation efforts towards controlling are gaining weight due to the current corporate governance discussion. A harmonised internal and external financial reporting is already obligatory for financial accounting crossing over to IFRS. Furthermore, these tendencies are accelerated by the increasing need by stakeholders for value-orientated corporate information. In this respect, the implementation of a sustainable corporate policy and the accompanied offensive publicity conduct by management does not only strongly influence corporate governance; this results in a further essential impulse for a standardisation of integrated reporting and controlling, in order to contribute to a higher timely and inter-company comparability of company information. Empirical insights of integrated reporting will be a central topic in future accounting and corporate governance research.

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