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German Corporate Governance Code and Unaccepted Recommendations

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GERMAN CORPORATE GOVERNANCE CODE AND UNACCEPTED RECOMMENDATIONS[1]

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Abstract

From 2002 the German Corporate Governance Commission introduced a Corporate Governance Code to companies listed on the German stock exchange. The Code provides blanket recommendations. Each company in noncompliance with one or more of the recommendations must explain in writing. The present study presents the first empirical analysis of compliance.

Regarding the 2003 amended Code, this study first identifies the Most Commonly Unaccepted Recommendations (MCURs). Next it uses the MCUR's to sort companies as either compliant or noncompliant. Thirdly the study measures each companies' level in EPS (Earnings per Share) and in average stock price. Finally it compares the overall results of the compliant versus the noncompliant companies of the 2003 recommendations. The results show no correlation between compliance and change in EPS. The results do show a strongly positive correlation between compliance and rise in stock price.

Keywords: Corporate Governance Code; Comply or Explain; Most Commonly Unaccepted Recommendations (MCURs); D&O insurance;

JEL Classification : G34, F21, M21

1. Introduction

Recent globalization has brought changes to Germany: notably increased emphasis on shareholder dependency and corporate ethics. Until recently, economists have described Germany's corporate system as bank-based system (Schmidt, 2001; Hackethal and Schmidt 2000) with only a minor shareholder dependency (Siebert, 2004). One systematic method of centralizing power was to hide profits. This was largely legal under bookkeeping rules known as continuance principle system (Kontinuitaetsprinzip). Moreover, because German regulations permit banks to invest in companies while making them loans, the banks could control companies. Thus, even Germany's indexed companies did not depend heavily on their shareholders. Relative to US or British companies, Germany's indexed companies tended to ignore their shareholders.

In recent years, however, indexed companies pursue the advantages a shareholder system provides. Economists cite four factors facilitating this shift: 1. competition for global capital, 2. competition for equity listings among stock markets, 3. influence of globalizing consulting and investment banking services and emulation of 4. generally globalizing US firms and their business practices (Useem, 1998; Yoshikawa and Phan, 2001, Yoshikawa and Phan 2003) In Germany too, a number of disastrous developments of mismanaging and failures in several German Companies like Holzmann and Manesmann were reported (Lange 2004)[2]. Especially the small and medium enterprises face tremendous problems; therefore, a special consortium for the small and medium sized companies was established, called: "Bremer Initiativkreis", (http://www.bremerinitiativkreis.de). There is support in Germany that companies should follow an ethical approach in regard to their clients, banks, to other companies and especially to their investors. For this reason, in 2002 German government commission established a Corporate Governance Code (the Code) for listed companies where recommendations were given for companies of how they should behave

[2] Manesmann was taken over by a hostile approach from British Vodafone where German public first time got acquainted with the impact of a hostile take over. In contrast to Manesmann hostile takeover, Holzmann company counts as a symbol for Corporate Governance problems (Lange 2004).

(http://www.corporate-governance-code.de)[3].

This paper points out which recommendations are noncompliant by many companies. In these Corporate Governance Code recommendations where companies are noncompliant, EPS and stock price impact for German companies will be explored. The author was motivated to do this study in order to see whether there is a relationship in EPS or stock price average for compliance of stock listed companies. According to Nobel Prize winner Michael Spence and his “Signaling Theory”, the good companies who comply to guidelines more accuracy should be rewarded by the capital market, the others, be punished by lower stock prices (Wirl and Braendle 2004, Nowak et al 2004b). In order to investigate this question, I use neo institutional theory.

2. Timeframe of Corporate Governance Code

The Theory of the Code can be drawn back of Weber’s thought about neo institutional theory. Rational organization leads to isomorphism through three ways. First through introduction of laws, second through mimetic structures also described as “best practice”. Especially when in unsecured situation, companies might copy the behavior of others. Third, isomorphism can be reached through normative similarity of their structure (Weber 1972). The commission, who was led by the reputable Dr. Cromme, Chairman at Thyssen Krupp company (Cromme commission) established the Code for many reasons e.g. to attract international investors.

The Code covers a wide range of issues, starting from juristically regulations up to institutional investors (Powell and DiMaggio 1991; Scott, 1995; Walgenbach and Beck 2003). It consists out of three parts. There are laws from several areas combined together to make it easier for a person concerned to see all the necessary laws in one volume (MUST-part). These laws had to be followed anyway, the only new point is, that one can see them now together in one volume. Second, there are recommendations (SHALL-part) to the companies. This is the part where I focus on in this study. Third, besides recommendations the Code also contains suggestions (CAN-part) of what companies can or could do.

Recently, in Germany many new laws concerning corporate governance got

[3] The German Corporate Governance Code was established through authorization of Ministry of Justice.

introduced. In the same year of 2002 when The German Corporate Government Commission introduced the Code, a new law "Law of Transparency and Publicity" was established. In the year 2003, reform plan from Baum's commission came into act (Baum's plan 2003). In 2004 several new laws were released, in Dec. 9th, 2004 BilReG[4] in Dec. 20th, 2004 BilKoG[5] and in Dec. 31st, 2004 APAG law[6]. The most important law for corporate governance the "Law of Transparency and Publicity" goes back to Anglo-American "comply or explain" rule (Oser et al. 2004). If a company does not comply to one or more of the recommendations made by the commission in the Code, it needs to be written and published. This should give pressure to companies in a sense that investors might change their mind in regard to investment if they see that companies do not comply with the recommendations (Strieder 2004).

3. Critical Points of the Code

According to Edelmann bigger organizations tend to follow public opinion better than smaller ones because they face easier public pressure (Edelmann, 1992). Oser et al. research at Dax, M-Dax and 32 other at prime standard listed companies and find evidence that the bigger the company the better the compliance of the recommendations (Oser et al., 2004). In another study Nowak et al. show that the compliance with the Code was by 33% of German companies who are listed at the US Stock Exchange in every point, in contrast to only 6.8% of non- US-listed German companies who complied with recommendations in every point.

Bigger listed stock companies follow almost all of the recommendations. Hereafter companies are separated, belonging to three separated stock exchanges. First, 30 DAX companies with the biggest trade volume listed. Second MDAX segment, there are the following 70 biggest companies are listed. Furthermore, In addition to this, I analyse Nemax, where 50 new companies were listed[7]. As can be seen in the table below, the Most

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[4] BilReG = Bilanzrechtsformgesetz from Dec. 9th 2004

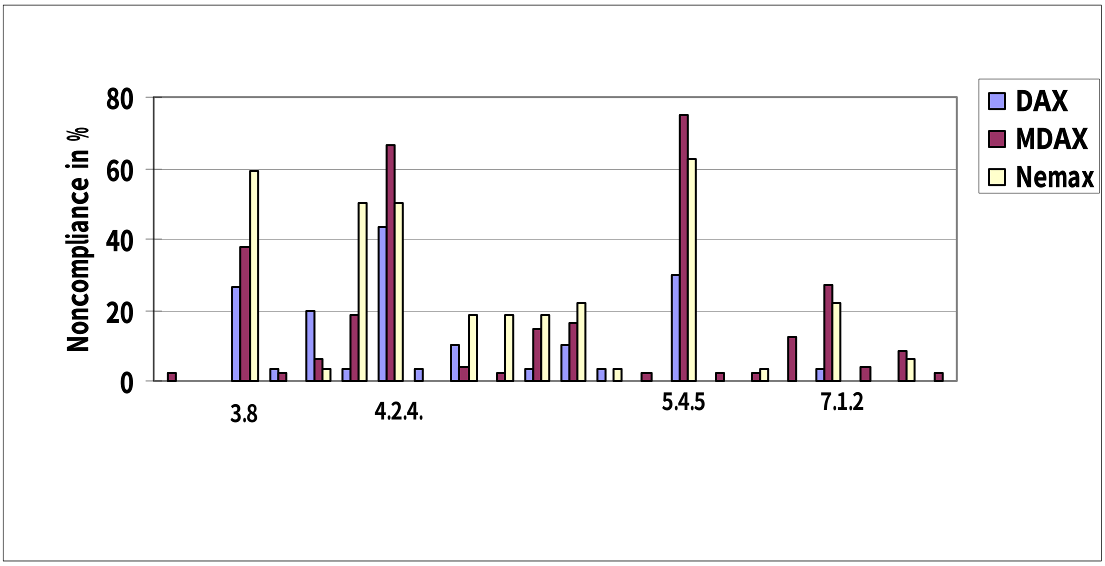
[5] BilKoG = Bilanzkontrollgesetz from Dec.20th2004

[6] APAG = Abschlussprueferaufsichtsgesetz from Dec. 31st 2004

[7] Nemax segment was stopped after bubble economy for new firms because of a low turnover of the belonging companies. However, the companies were changed into new segments of

Commonly Unaccepted Recommendations (MCUR's) are four points. All the other recommendations are full or almost full in compliance by the indexed companies.

Table 1. Most Commonly Unaccepted Recommendations (MCUR's) in year 2003



Source: 96 companies. Figures are obtained from several sources, Towers Perrin and directly from hompages of the companies

Looking at table 1, it is feasible that the biggest DAX listed companies comply mostly with the recommendations. Critical recommendations (MCURs) were 4.2.4 (individualized reporting of compensation) and 5.4.5. (performance orientated compensation). Smaller MDAX listed companies are in noncompliance with much more recommendations as DAX companies, in four recommendations at more than 20% rate. Regarding to non compliance of recommendations, somewhere in the middle are Nemax listed companies.

The Code contains four MCURs as flollows:

- 3.8: Director and Officer Liability. According to The Code, the company should not cover manager's risk to 100% but many companies do not comply with it (26,6% for DAX, 37,5% for MDAX and 63,3% for

German stock exchange, e.g. SDAX (Small enterprices, or Techdax (for technological companies).

NEMAX).

- Paragraph 4.2.4 recommends an individualized open compensation system for Board of Directors (Geschaeftsfuehrung) but many companies do not comply with it (43,3% for DAX, 66.6% for MDAX and 50% for NEMAX)
- Paragraph 5.4.5 recommends performance orientated compensation to Auditors (Aufsichtsraete), also many companies do not comply with it (30% for DAX, 75% for MDAX and 66,7% for NEMAX)
- Pargraph 7.1.2 recommends the release of accounting information 90 days after fiscal year is closed and 45 days after quarter fiscal year is closed. At least in MDAX and NEMAX there is a higher rate of non-compliances: (3,3% for DAX; 27,1% for MDAX and 20% for NEMAX)

3.1 Research Model

In accordance to neo institutional theory institutional factors influence strongly the whole system. My model suggests that companies who do comply with non 100% D&O insurance for their BOD directors, do comply to an open individualized compensation system for BOD directors to the public, do comply to performance orienting compensation of their auditors as well as to a disclosure of accounting information in time as the Code recommends will have higher EPS or higher average stock prizes.

In neo institutional theory rational organizations can be seen in contrasting views. A company with high corporate social responsibility will provide security for their managers. That means companies will buy D&O-insurance for their directors (Know, and Maklan 2004). In contrast to this, not having full scale insured managers might stimulate them doing a better and more responsible job. The Code recommends companies in paragraph 3.8. that they should <u>**not**</u> completely insure manager's behavior through D&O insurance. Thus:

H 1: Companies with a higher EPS or higher average stock prizes do not have full scale D&O-insurance for their managers.

In Germany Corporate Governance debate is dominated by the discussion that good corporate governance means compensation of BOD-directors should be individualized feasible to the public (Rheinischer Merkur 2005). Companies who open up their compensation system of their directors have more transparency to the public. The Code recommends in paragraph 4.2.4. the release of individualized compensation system for BOD directors to the public. Thus:

H2 a: Companies with a higher EPS or higher average stock prizes open up the compensation system of their BOD directors to the public.

As in German two tier system, BOD is divided in decision maker (Vorstand) and controlling auditors (Aufsichtsrat), in a similar way as the release of individualized compensation system of BOD-directors to the public, paragraph 5.4.5 recommends that BOD auditors (in Aufsichtsrat) should be motivated of checking the company through performance orientated compensation system. The Code recommends in paragraph 5.4.5 a performance oriented compensation system for auditors. Thus:

H2 b: Companies with a higher EPS or higher average stock prizes compensate their auditors according to their performance

Nowadays, release of proper accounting information is vital for investors where they can make their decisions about investments. Companies are recommended to disclose their accounting information after 90 days of fiscal year and their quarterly accounting information after 45 days to the public.

This recommendation is written in paragraph 7.1.2 and it is shared by European Union who came up with extra transparency rule where as European companies are supposed to disclose accounting information more frequently (Buchheim 2004). Thus:

H3: Companies with a higher EPS or higher average stock disclose their accounting information in line with the Code time table.

3.2 Data Sample of Recommendations

Dependant variables are EPS (earnings per share) and average stock price. EPS and stock prices both were taken for four years, from 2000-2003. The study compiles, for 96 German manufacturing companies where EPS data and stock price data could be received. 25 out of them are Dax listed (the biggest companies), 41 are M-Dax listed (the following biggest) and 25 were listed at Nemax (relatively new companies). The main of the Data was taken from company performance at print media of Hoppenstedt I-2004, Boersenfuehrer. In many cases, especially for companies listed at Nemax, missing values were found at their homepages directly. As statistical method Oneway Anova is used.

The "comply or explain" statement for Dax and M-Dax listed companies was partly received by Towers Perrin, for Nemax listed companies they were found directly at companies' homepages. In cases where companies did not give numbers but just words, it was sorted according to the paragraphs (like United Internet). Same was done when companies obviously did a mistake with the numbers (like TelesAG). Companies were given a dummy variable "1" if they followed recommendation, otherwise "0".

Average stock prize was divided by the highest and the lowest of every year. The code contains several recommendations which were split of in 32 parts. In research of Corporate Governance, however, recommendations can be divided into different numbers of subgroups. Recent research what has been done yet, e.g. Nowak et al. count 61 recommendations (Nowak et al. 2004), v. Werder et al. even come to 72 because they separate recommendations in every single part (v. Werder et al. 2004).

In the homepages of many companies in internet often times recommendations were not separated; therefore, I come up with a number of 32 main recommendations. Here in this study I focus only on MCURs, exactly four recommendations many companies do not comply with. These are 3.8 (D&O insurance), 4.2.4 (individualized reporting of compensation of BOD members, 5.4.5. (compensation of auditor) and 7.1.2. (time of disclosure).

4. Results

a. Results of EPS

Oneway Analysis of total EPS by 3.8 (D&O insurance)

	Difference	t Test	DF	Prob > |t|
Estimate	-0.06296	-0.133	422	0.8939
Std Error	0.47194			
Lower 95%	-0.99061			
Upper 95%	0.86469			

Means for Oneway Anova

Level	Number	Mean	Std Error	Lower 95%	Upper 95%
0	169	1.52320	0.36600	0.8038	2.2426
1	255	1.58616	0.29795	1.0005	2.1718

Oneway Analysis of total EPS By 4.24 (open payment of board dicrectors)

	Difference	t Test	DF	Prob > |t|
Estimate	0.896787	1.938	422	0.0533
Std Error	0.462833			
Lower 95%	?			
Upper 95%	1.806532			

Means for Oneway Anova

Level	Number	Mean	Std Error	Lower 95%	Upper 95%
0	235	1.96081	0.30901	1.3534	2.5682
1	189	1.06402	0.34457	0.3867	1.7413

Oneway Analysis of total EPS By 5.45 (perf. orientated payment to auditors)

	Difference	t Test	DF	Prob > |t|
Estimate	0.604252	1.280	421	0.2013
Std Error	0.472140			
Lower 95%	-0.32379			
Upper 95%	1.532298			

Means for Oneway Anova

Level	Number	Mean	Std Error	Lower 95%	Upper 95%
0	255	1.79282	0.29755	1.2080	2.3777

Level	Number	Mean	Std Error	Lower 95%	Upper 95%
1	168	1.18857	0.36658	0.4680	1.9091

Std Error uses a pooled estimate of error variance

Oneway Analysis of total EPS By 7.1.2 (discl. of accounting information in time)

	Difference	t Test	DF	Prob > |t|
Estimate	-0.64964	-1.142	422	0.2541
Std Error	0.56889			
Lower 95%	-1.76786			
Upper 95%	0.46858			

Means for Oneway Anova

Level	Number	Mean	Std Error	Lower 95%	Upper 95%
0	88	1.04625	0.50643	0.0508	2.0417
1	336	1.69589	0.25917	1.1865	2.2053

b. Results of stockprices

Oneway Analysis of total stockprice by 3.8 (D&O insurance)

	Difference	t Test	DF	Prob > |t|
Estimate	-5.5797	-1.987	352	0.0476
Std Error	2.8074			
Lower 95%	-11.1011			
Upper 95%	-0.0582			

Means for Oneway Anova

Level	Number	Mean	Std Error	Lower 95%	Upper 95%
0	133	28.5701	2.2182	24.207	32.933
1	221	34.1498	1.7208	30.765	37.534

Std Error uses a pooled estimate of error variance

Oneway Analysis of total stockprice by 4.24 (open payment of board dicrectors)

	Difference	t Test	DF	Prob > |t|
Estimate	-3.7648	-1.379	352	0.1686
Std Error	2.7293			
Lower 95%	-9.1326			

	Difference	t Test	DF	Prob > |t|
Upper 95%	1.6030			

Means for Oneway Anova

Level	Number	Mean	Std Error	Lower 95%	Upper 95%
0	184	30.2455	1.8914	26.526	33.965
1	170	34.0103	1.9677	30.140	37.880

Std Error uses a pooled estimate of error variance

Oneway Analysis of total stockprices by 5.45 (perf. orientated paym. to auditors)

	Difference	t Test	DF	Prob > |t|
Estimate	-9.4317	-3.466	352	0.0006
Std Error	2.7208			
Lower 95%	-14.7829			
Upper 95%	-4.0805			

Means for Oneway Anova

Level	Number	Mean	Std Error	Lower 95%	Upper 95%
0	204	28.0570	1.7711	24.574	31.540
1	150	37.4887	2.0655	33.426	41.551

Std Error uses a pooled estimate of error variance

Oneway Analysis of total stockprice by 7.1.2 (discl. of accounting information)

	Difference	t Test	DF	Prob > |t|
Estimate	-6.9707	-2.075	352	0.0387
Std Error	3.3589			
Lower 95%	-13.5768			
Upper 95%	-0.3647			

Means for Oneway Anova

Level	Number	Mean	Std Error	Lower 95%	Upper 95%
0	73	26.5202	2.9926	20.635	32.406
1	281	33.4909	1.5253	30.491	36.491

Std Error uses a pooled estimate of error variance

Results show that mean of EPS is only at 7.1.2 higher for companies who comply to this recommendation to disclose accounting information in time (mean of 1.695 to 1.046). In this regard, complying companies pay in average an EPS of 1.69 Euro to their shareholders, in contrary, companies who do not comply pay only 1.046 Euro to their shareholders. However, in t-test there is no significance with a probability of 0.2541.

In the recommendation of 3.8 (D&O insurance for managers) only a slight difference is feasible between complied and non complied companies. Complying companies pay EPS 1.58 Euro and non complying companies pay EPS 1.52 Euro (Recommendations 4.2.4 and 5.4.5). EPS payment is strongly in contrast to what was to expect. Non complying companies with the Code pay much more EPS to their shareholders than complying companies. In any case, t-test shows that there is no significance between EPS and compliance of recommendations.

Results of stock price to compliance of recommendations differ from EPS dramatically. In all four recommendations mean is higher for companies who comply with recommendations. In recommendation 3.8 (D&O insurance) the average stock price for companies without 100% D&O insurance was 34.1 Euro in average. Companies who covered their directors only reached 28.5 Euro yearly average stock price. Companies with individualized open compensation system of BOD directors had average stock price of 34.01 Euro, the non complied companies only 30.24 Euro in average.

Companies who complied with performance orientated compensation system for their auditors (Aufsichtsrat) come to 37.48 Euro whereas companies without compliance to performance orientation only have 28.05 Euro average stock price. Recommendation of accounting disclosure too shows higher stock prices for companies who comply to it: 33.49 Euro to only 26.52 Euro.

Measured by t-test, there is significance at recommendation 3.8 (D&O insurance) with probability of 0.047, at recommendation 7.1.2. (disclosure of accounting information) with a probability of 0.0387 and high significance at recommendation 5.4.5 (performance orientated compensation to auditors) with 0.0006. Just in 4.2.4. (Individualized open compensation system of BOD directors) there is no significance feasible.

5. Discussion and Implications

This paper examined the impact of EPS and average stock price to Most Commonly Unaccepted Recommendations (MCURs) of German corporate governance code recommendations. Companies were put into two groups, the once who complied with it, and the others who did not comply. As a result, I found that EPS has no significance in regard to compliance of recommendations. Average stock price on the other hand, is significant to compliance in t-test for three out of four MCURs recommendations.

The recommendations of the Code exist out of guidelines offered from scientists, politicians and other pressure groups. As it is not a law but recommendations, the foremost punishment for companies who do not comply with recommendations could be a stock price decline.

This is not in line with recent research of Nowak et al. who show in their research of 337 at Prime Standard in Germany that there is no correlation between listed companies who comply with Code recommendations and to their impact at the capital market. A reason for this outcome – so their finding – is a lack of transparency in the market. That is to say, it is a still early discipline of research and documentation, so that capital market might not yet take enough notice of Corporate Governance at all (Nowak et al. 2004). Another week point of there study could have been the fact that all recommendations were included. E.g. for smaller companies with only two or three BOD members it might not make economical sense to establish compensation committees like the Code recommends.

In accordance to neo institutional theory, corporations intend to incorporate socially accepted norms (Powell and DiMaggio, 1991; Scott 1995). In this line, neo institutional theorists argue that embedded formal structure rises through institutional expectations. Therefore, accepted norms can give legitimacy, resources and stability to environmental systems (DiMaggio and Powell, 1983). This saying, followers of the recommendations of The Code might be motivated to a less extend through performance for itself but through a gain in legitimacy of a shifting environment.

In recent years, in Germany political situation puts many companies in a spotlight. Especially bigger German companies like e.g. Siemens could have faced this pressure when individualized compensation scheme of BOD directors became public in Dec. 2000. The government is eager to guide companies to success through correct behavior. In this regard, some companies might accept the Code of not being in public critics even if it is not sure whether complying to these recommendations are helpful for companies economic success or not.

It is critically to ask, whether all recommendations by the German Corporate Governance Code Commission are helpful for companies in any case. Especially in part of transparency of income, e.g if companies release individualized compensation system from their BOD directors it might destabilize companies more than it serves for any good. Employees might loose many time and energy in discussion about other people's salary. BOD directors, on the other hand, might have to explain themselves in economic difficult times for what they receive the (high) amount of compensation.

This study relies on secondary data and attempts to measure recent events. There are some limitations on the data used. EPS data and stock prices as well as data about recommendations were recently released; however, as the impact of the Code in Germany becomes stronger every year, the result may be stronger if there are data available from this year.

6. Conclusion

In Germany corporate governance discussion is very active. With establishing The German Corporate Governance Code, companies can comply with recommendations or have to explain them. In latter case, according to 161 stock price company law (Aktiengesetz) they have to report in case they do not comply with it. There is hope from politicians and big support by labour unions that companies who behave in good faith through complying with the Code, that they will receive better economic success.

In this study, it was focused on the MCURs (Most Commonly Unaccepted Recommendations). In overall many companies did not comply to four recommendations. Companies were put into two groups, the complied and the non-complied companies. In the areas of D&O insurance, open individualized compensation system of BOD directors, performance oriented compensation to auditors and disclosure of accounting information in time it was asked to what extend EPS (earnings per share) and average share price has significance to compliance. Examined by t-test it was shown that EPS does not have any significance whether companies comply with recommendations or not. For stock prices three out of four recommendations show significance. It can be said, therefore, that index listed German companies who wish to have a higher average stock price should comply with recommendations of the German Corporate Governance Code.

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