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**Evaluation and Response to Risk in International  
Accounting and Audit Systems: Framework and  
German Experiences**

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# **Evaluation and Response to Risk in International Accounting and Audit Systems: Framework and German Experiences**

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## Abstract

This paper presents arguments with respect to the evaluation and response to risk, placing an emphasis on German corporate governance. It starts by discussing opportunities and limitations of the audit risk approach in detecting accounting and economic risks. Hereafter individual responses to material risks are analyzed by considering potential shortcomings arising from systematic deviations from rational behavior.

In the main part, it will be argued that German corporate governance stresses internal reporting duties, some of which could serve as models for future international standards on auditing. By internalizing the information flows regarding substantial risks, negative effects of publicizing this kind of information can be reduced (e.g. self-fulfilling prophecies and litigation risks). This also facilitates a more open communication with monitoring parties. But to ensure the effectiveness of such an internal control, it is essential that the reporting duties of the auditor and the management towards the board members are legalized and put into compulsory form.

In an appendix, legislative responses to audit failures in Germany since 1870 until today are summarized. Legal requirements and their development regarding the statutory audit in general, auditor independence, the auditor's report and the audit opinion are presented.

**Keywords:** corporate governance; behavioral economics; accounting; disclosure; Germany; statutory audit; law and economics; biases and heuristics.dr

## I. Introduction

It is widely acknowledged that auditors play an important role in corporate governance. However, recent audit failures raised doubts as to whether they actually played a *positive* role in corporate governance. An unfortunate series of (suspected) audit failures started in Germany in the nineties of the last century and led to a massive re-regulation of both the audit profession and the statutory audit. In retrospect, they were small compared with the scandals that followed in the United States, which also led to a massive new regulation of the profession, namely the Sarbanes-Oxley Act of 2002. Sarbanes-Oxley not only regulates audits and auditors in the United States but extends to foreign companies and foreign audit companies, as well.

The underlying economic events that lead to these crises and the business risks which endanger the existence of a corporation are universally true. They arise from entrepreneurial activities, changing environments and decisions taken all over the world. Therefore, it is widely accepted that, for instance, substantial risks which endanger the existence of a firm need to be identified in an early stage. What differs internationally, however, are the institutional mechanisms embedded in national corporate governance and market regulation to monitor these risks effectively and to bring about appropriate responses. As a result of corporate crises and audit failures, regulatory activities in both the U.S. and the EU aim to improve the statutory audit and corporate governance. Before further changing existing structures, an international assessment of arguments for and against certain elements of corporate governance may be of value.

This paper presents arguments with respect to the evaluation and response to risk, placing an emphasis on German corporate governance. It will analyze aspects of responses to material

risk from an individual point of view and review connected behavioral research in accounting and auditing. It will be argued that German corporate governance stresses internal reporting duties, some of which could serve as models for future international standards on auditing. Internal reporting duties reduce some effects that typically arise when information is disseminated to markets (such as, e.g., self-fulfilling prophecies). They also facilitate a more open communication with monitoring parties since at least some of the heavy incentives to litigate which may lead corporations to use strategies of legal liability avoidance in their public reports (e.g., MD&A) are reduced. On the other hand, “cheap talk” reporting duties need to be legalized and put into compulsory form.

## **II. Risk Types and the Statutory Audit**

### **A. Audit Risk and Audit Risk Approach**

The statutory audit shall detect material risks in the financial statements of a corporation, namely in the balance sheet, the income statement, and the accompanying notes. Material risks can be hidden in recognized assets and liabilities. Examples include overstatement of assets (e.g., real estates developed by the corporation or incorrectly capitalized costs for infrastructure), understatement of liabilities (e.g., provisions for compensations for damages), and earnings overstatement, which is certainly one of the most frequent types of error or fraud in accounting systems. Material risks can also arise out of underlying transactions, which should have been included in the balance sheet but were not as provisions for losses. As recent examples show, consolidation rules for special purpose entities’ in-group accounts hide risks even if the rules are correctly applied and the entities are not included in the consolidated accounts (group accounts).

The auditor has the duty to discover these accounting risks within the limits of the standards of the duty of care. Given the great number of business transactions in modern corporations, the audit strategy plays an important part. The auditor's aim is to minimize *audit risk*, which means "the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated" (ISA 400.3).<sup>1</sup> It is generally assumed that the risk of falsely qualifying or disclaiming the audit opinion can be neglected, since management has a strong incentive to correct the wrong judgment. Rather, the important audit risk is the possibility that the financial statements do not give a fair presentation of the corporation's financial position even though the auditor has (incorrectly) given an (inappropriate) audit opinion.

In order to cope with audit risks, professional practice has developed audit approaches that break down typical risks which have to be considered when assessing risk.<sup>2</sup> The first risk is the so-called *inherent risk*, meaning "the susceptibility of an account balance or class of transactions to misstatement that could be material, individually or when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls" (ISA 400.4). If internal control systems are in place, some of the inherent errors and misstatements will be detected and prevented. *Control risk* means "the risk that a misstatement . . . will not be prevented or detected and corrected on a timely basis by the accounting and internal control systems" (ISA 400.5). Both inherent risk and control risk are within the responsibility of management. They represent the information system risk.

Factors that influence inherent risks include the mobility of assets, valuation methods that

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1. INTERNATIONAL FEDERATION OF ACCOUNTANTS, INTERNATIONAL STANDARDS ON AUDITING (2003), ISA 400, § 3.

2. See, e.g., INTERNATIONAL FEDERATION OF ACCOUNTANTS, *supra* note 1, at ISA 400.

are dependent on assumptions, the general economic situation, and the technological development.<sup>3</sup> Inherent risk and control risk have to be estimated by the auditor and are thus subject to possible cognitive biases.<sup>4</sup> Based on his estimations, the auditor then has to consider the *detection risk*, meaning the “risk that auditor’s substantive procedures will not detect a misstatement that exists” (ISA 400.6). The auditor can directly influence the detection risk by adequately planning the audit strategy and increasing the audit efforts.

More formally, audit risk is defined as:

$$(1) AR = IR \times CR \times DR$$

where *AR* denotes the audit risk of a certain audit field, *IR* the inherent risk, *CR* the control risk, and *DR* the detection risk.

Suppose that the auditor estimates the risk of material misstatements in an audit field, assuming that there are no internal control mechanisms, to be 50% and the control risk to be 50%. If the auditor wants to have a level of assurance of 95% in the audit field (which is equal to an acceptable audit risk of 5%) the detection risk can be determined by solving equation (1) for *DR* as follows:

$$(2) DR = AR / (IR \times CR) = 0.05 / (0.5 \times 0.5) = 20\%$$

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3. See Wolfgang Ballwieser, *Was leistet der risikoorientierte Prüfungsansatz?*, in FESTSCHRIFT GÜNTER SIEBEN 359-74 (M. Matschke & T. Schildbach eds., 1998); EVA-MARIE STIBI, PRÜFUNGSRSIKOMODELL UND RISIKOORIENTIERTE ABSCHLUSSPRÜFUNG 65 (1995); REINER QUICK, DIE RISIKEN DER JAHRESABSCHLUSSPRÜFUNG 35 (1996).

4. See *infra* note 13.

The acceptable level of detection risk is thus 20%. It will certainly be difficult to quantify the probabilities in practice. But formula (2) shows the relationship between the different risks. If the auditor evaluates the internal control procedures to be ineffective (setting CR = 1.0) and still wants to hold the acceptable level of audit risk at 5%, he has to intensify the audit efforts, thereby reducing the detection risk:

$$(3) DR = AR / (IR \times CR) = 0.05 / (0.5 \times 1.0) = 10\%$$

Alternatively, a prudent auditor may want to raise the expected inherent risk to 100%, which evidently leads, *ceteris paribus*, to a 5% acceptable level of detection risk.

Some objections to the model may be taken into account by modifying the model. One criticism, for instance, is that the model assumes the same weight for all types of risk. Technically, the model can be extended by weight-factors that would lead to the following equation:<sup>5</sup>

$$(4) AR = IR^x \times CR^y \times DR^z \text{ with } x, y, z \geq 0$$

Other shortcomings of the model are more fundamental. It can be formally shown, for example, that equation (1) typically leads to an underestimation of the audit risk.<sup>6</sup> The reason is that the assumption that detected misstatements are actually corrected by internal control

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5. Ballwieser, *supra* note 3, at 367.

6. *Id.* at 369.



mechanisms and the audit procedures is not necessarily true.<sup>7</sup>

## **B. Economic Risk and Limitations of the Statutory Audit**

From a financial perspective the value of a firm is a function of capitalized expected future cash-flows.<sup>8</sup> Therefore, the economic risk can be defined as the risk that future events will lead to a variance of the value of the firm, namely the market value of equity.

The detection of all relevant economic risks certainly is beyond the scope of the statutory audit.<sup>9</sup> Even if auditors plan audit strategies, estimating industry risks and focusing on future events and resulting influences for corporations' financial positions and earnings, the analyses cannot encompass all significant risks.<sup>10</sup>

## **III. Individual Responses to Risk**

### **A. Cognitive Biases and Behavioral Law and Economics**

The standard economic model of human decision-making is based on strong assumptions. In the classical form, economic man maximizes the subjective expected utility of (uncertain)

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7. For problems in the estimation of inherent risks, see Robert Bloomfield, *Strategic Dependence and Inherent Risk Assessments*, 70 ACC. REV. 71 (1995).

8. See ADOLF MOXTER, GRUNDSÄTZE ORDNUNGSMÄßIGER UNTERNEHMENSBEWERTUNG 75 (2d ed. 1983); THOMAS E. COPELAND ET AL., VALUATION: MEASURING AND MANAGING THE VALUE OF COMPANIES (3d ed. 2000).

9. See, e.g., Jens Wüstemann, *Mängel bei der Abschlußprüfung: Tatsachenberichte und Analysen aus betriebswirtschaftlicher Sicht*, in DER WIRTSCHAFTSPRÜFER ALS ELEMENT DER CORPORATE GOVERNANCE 19-43 (Marcus Lutter ed., 2001).

10. For applications, see, e.g., Aasmund Eilifsen et al., *Application of the Business Risk Audit Model: A Field Study*, 15 ACCT. HORIZONS 193 (2001) (describing the changes made recently to the audit process and their practical impact).

payoffs.<sup>11</sup> Early critics to this normative model of decision-making included Allais, Simon, and, Ellsberg.<sup>12</sup> Since the seminal works of Kahneman and Tversky, behavioral decision science showed that intuitive decision behavior differed systematically from standard utility theories.<sup>13</sup> Effects that were identified include biases in the assessment of probabilities,<sup>14</sup> framing,<sup>15</sup> and reference points.<sup>16</sup>

Insights of behavioral research were successfully applied to legal issues and shaped the law and economics movement.<sup>17</sup> Behavioral law and economics was criticized, stressing both

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11. See JOHN VON NEUMANN & OSKAR MORGENSTERN, *THEORY OF GAMES AND ECONOMIC BEHAVIOR* 8 (3d ed. 1953).

12. See Maurice Allais, *Le Comportement de l'Homme Rationel Devant le Risque: Critique des Postulats et Axiomes de l'École Américaine*, 21 *ECONOMETRICA* 503 (page number) (1953); Herbert A. Simon, *A Behavioral Model of Rational Choice*, 69 *Q.J. ECON.* 99 (page number) (1955); Daniel Ellsberg, *Risk Ambiguity and the Savage Axioms*, 75 *Q.J. ECON.* 643 (page number) (1961).

13. See, e.g., Hillel J. Einhorn & Robin M. Hogarth, *Behavioral Decision Theory: Processes of Judgment and Choice*, 32 *ANN. REV. PSYCH.* 53 (1981); Eldar Shafir & Robyn A. LeBoeuf, *Rationality*, 53 *ANN. REV. PSYCH.* 491 (2002); KEITH E. STANOVICH, WHO IS RATIONAL? STUDIES OF INDIVIDUAL DIFFERENCES IN REASONING 1 (1999); FRANZ EISENFÜHR & MARTIN WEBER, *RATIONALES ENTSCHEIDEN* 357 (4th ed. 2003).

14. See Amos Tversky & Daniel Kahneman, *Extensional Versus Intuitive Reasoning: The Conjunction Fallacy in Probability Judgment*, 90 *PSYCH. REV.* 293 (1983).

15. See Amos Tversky & Daniel Kahneman, *The Framing of Decisions and the Psychology of Choice*, 211 *SCI.* 453 (1981).

16. See Daniel Kahneman & Amos Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 *ECONOMETRICA* 263 (1979).

17. See Christine Jolls et al., *A Behavioral Approach to Law and Economics*, 50 *STAN. L. REV.* 1471 (1998); Russell B. Korobkin & Thomas S. Ulen, *Law and Behavioral Science: Removing the Rationality Assumption from Law and Economics*, 88 *CAL. L. REV.* 1051 (2000); Donald C. Langevoort, *Behavioral Theories of Judgment and Decision Making in Legal Scholarship: A Literature Review*, 51 *VAND. L. REV.* 1499 (1998); Donald C. Langevoort, *Theories, Assumptions, and Securities Regulation: Market Efficiency Revisited*, 140 *U. PA. L. REV.* 851 (1992); Robert Prentice, *Whither Securities Regulation? Some Behavioral Observations Regarding Proposals for its Future*, 51 *DUKE L.J.* 1397 (2002); Matthew Rabin, *A Perspective on Psychology and Economics*, 46 *EUR. ECON. REV.* 657 (2002); Jeffrey J. Rachlinski, *The "New" Law and Psychology: A Reply to Critics, Skeptics, and Cautious Supporters*, 85 *CORNELL L. REV.* 739 (2000); Cass R. Sunstein, *Behavioral*

positive and normative aspects.<sup>18</sup> Some critical comments led to conciliation between the movements, although important differences still remain concerning both methodological questions and normative matters.<sup>19</sup>

An important field of application lies within issues of corporate governance.<sup>20</sup> Especially with regard to substantial risks that might endanger the existence of a corporation, behavioral research results are of importance. Overconfidence and existence of loss frames are obstacles

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*Analysis of Law*, 64 U. CHI. L. REV. 1175 (1997); Cass R. Sunstein et al., *Assessing Punitive Damages (with notes on cognition and valuation in law)*, 107 YALE L.J. 2071 (1998).

18. See Robert A. Hillman, *The Limits of Behavioral Decision Theory in Legal Analysis: The Case of Liquidated Damages*, 85 CORNELL L. REV. 717 (2000); Samuel Issacharoff, *Can There Be a Behavioral Law and Economics?*, 51 VAND. L. REV. 1729 (1998); Gregory Mitchell, *Why Law and Economics' Perfect Rationality Should Not Be Traded for Behavioral Law and Economics Equal Incompetence*, 91 GEO L.J. 67 (2002); Gregory Mitchell, *Taking Behavioralism Too Seriously? The Unwarranted Pessimism of the New Behavioural Analysis of Law*, 43 WM. & MARY L. REV. 1907 (2002); Richard A. Posner, *Rational Choice, Behavioral Economics, and the Law*, 50 STAN. L. REV. 1551 (1998).

19. See Jennifer Arlen, *The Future of Behavioral Economic Analysis of Law*, 51 VAND. L. REV. 1765 (1998); Jennifer Arlen et al., *Endowment Effects Within Corporate Agency Relationships*, 31 J. LEGAL STUD. 1 (2002); Stephen M. Bainbridge, *Mandatory Disclosure: A Behavioral Analysis*, 68 U. CIN. L. REV. 1023 (2000); Daniel A. Farber, *Toward a New Legal Realism*, 68 U. CHI. L. REV. 279 (2001); Mark Kelman, *Behavioral Economics as Part of a Rhetorical Duet: A Response to Jolls, Sunstein and Thaler*, 50 STAN. L. REV. 1551 (1998); Jeffrey J. Rachlinski, *The Uncertain Psychological Case for Paternalism*, 97 NW. U. L. REV. 1165 (2003); Tanina Rostain, *Educating Homo Economicus: Cautionary Notes on the New Behavioral Law and Economics Movement*, 34 LAW & SOC'Y REV. 973 (2000); Thomas S. Ulen, *The Growing Pains of Behavioral Law and Economics*, 51 VAND. L. REV. 1747 (1998).

20. For a general discussion of corporate behavior and governance, see Stephen M. Bainbridge, *Why a Board? Group Decisionmaking in Corporate Governance*, 55 VAND. L. REV. 1 (2002); John C. Coffee, Jr., *Beyond the Shut-Eyed Sentry: Towards a Theoretical View of Corporate Misconduct and an Effective Legal Response*, 63 VA. L. REV. 1099 (1977); James D. Cox & Harvey Munsinger, *Bias in the Boardroom: Psychological Foundations and Legal Implications of Corporate Cohesion*, 48 LAW & CONTEMP. PROBS. 83 (1985); Kent Greenfield, *Using Behavioral Economics to Show the Power and Efficiency of Corporate Law as Regulatory Tool*, 35 U.C. DAVIS. L. REV. 581 (2002); Donald C. Langevoort, *The Human Nature of Corporate Boards: Law, Norms, and the Unintended Consequences of Independence and Accountability*, 89 GEO. L. J. 797 (2001); Donald C. Langevoort, *Organized Illusions: A Behavioral Theory of Why Corporations Misperceive Stock Market Investors (and Cause Other Social Harms)*, 146 U. PA. L. REV. 101 (1997).

for effectively managing corporate crises. Biases in the estimation of probabilities will lead to inappropriate decision models.

## **B. Behavioral Accounting Research**

Behavioral decision sciences also influenced accounting research. The behavioral accounting approach focuses on the information processing aspects of accounting. If accounting information shall influence actions, then behavioral aspects of actual decision-making have to be taken into consideration. This can help to better explain and predict behavior of decision-makers, which is useful for both normative and positive considerations. The American Accounting Association's Committee on Behavioral Science Content of the Accounting Curriculum systemized behavioral science to accounting issues. It stated that "the objective of behavioral science is to explain and predict human behavior."<sup>21</sup> It identified different areas which could be included in the accounting curriculum such as perception, motivation, anxiety, conflict, and attitude. Behavioral accounting research deepened the understanding for, e.g., biases in the perception and evaluation of risk, aspects of memorizing important contents, and positive aspect of standards setting.<sup>22</sup> Riahi-Belkaoui summarizes the

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21. Report of the Committee on Behavioral Science, *Content of the Accounting Curriculum*, 46 ACC. REV., Suppl. 247, 248 (1971). See AHMED RIAHI-BELKAOUI, ACCOUNTING THEORY 302 (4th ed. 2000).

22. See ROBERT H. ASHTON, HUMAN INFORMATION PROCESSING IN ACCOUNTING (1982); AHMED BELKAOUI, BEHAVIORAL ACCOUNTING 19 (1989); Jacob G. Birnberg & Michael D. Shields, *The Role of Attention and Memory in Accounting Decisions*, 9 ACCT. ORGS. & SOC'Y 365 (1984); Thomas R. Dyckman, *The Ascendancy of the Behavioral Paradigm in Accounting: The Last 20 Years*, 10 BEHAV. RES. ACCT. Supp. 1 (1998); ROBERT LIBBY, ACCOUNTING AND HUMAN INFORMATION PROCESSING: THEORY AND APPLICATION (1981); Robert Libby et al., *Experimental Research in Financial Accounting*, 27 ACCT. ORGS. & SOC'Y 775 (2002); Laureen A. Maines, *Judgment and Decision-Making Research in Financial Accounting: A Review and Analysis*, in JUDGMENT AND DECISION-MAKING RESEARCH IN ACCOUNTING AND AUDITING (Robert H. Ashton & Alison H. Ashton eds.,

research work, stating that the “results indicated that alternative accounting techniques may influence individual decisions, and that the extent of the influence may depend on the nature of task, the characteristics of the users and the nature of the experimental environment.”<sup>23</sup>

#### IV. Institutional Responses to Risk in German Corporate Governance

##### A. Insider and Outsider Control in German Corporate Governance

German corporate governance has often been labeled as a governance system of “insider” control.<sup>24</sup> In a certain analytic framework of international corporate governance regimes, insider systems have specific characteristics. The financing of corporations is less dependent on capital markets; instead, corporations have close relationships with financial intermediaries, especially with house banks (*Hausbanken*). Long term financing (relationship lending) plays an important role that makes reputational effects of borrowers and lenders important. In addition, ownership is concentrated on both the side of equity capital and of debt capital. Other marking elements include crossholdings and concentration of ownership in the

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1995).

23. AHMED RIAHI-BELKAOUI, *supra* note 21, at 304. *See also* Michael Meyer & John T. Rigsby, *A Descriptive Analysis of the Content and Contributions of Behavioral Research in Accounting 1989-1998*, 13 BEHAV. RES. ACC. 253 (2001).

24. *See* J. FRANKS & C. MAYER, CORPORATE CONTROL: A COMPARISON OF INSIDER AND OUTSIDER SYSTEMS (Working Paper, London Business School, 1994); Erik Berglöf, *A Note on the Typology of Financial Systems*, in COMPARATIVE CORPORATE GOVERNANCE: ESSAYS AND MATERIALS 151-64 (Klaus J. Hopt & Eddy Wymeersch eds., 1997); Reinhard H. Schmidt & Marcel Tyrell, *Financial Systems, Corporate Finance and Corporate Governance*, 5 EUR. FIN. MGMT. 331 (1997); Raghuram Rajan & Luigi Zingales, *Financial Dependence and Growth*, 88 AM. ECON. REV. 559 (1998); F. ALLEN & D. GALE, COMPARING FINANCIAL SYSTEMS 36 (2000); Christian Leuz & Jens Wüstemann, *The Role of Accounting in the German Financial System*, in THE GERMAN FINANCIAL SYSTEM 447-78 (Jan P. Krahnert & Reinhard H. Schmidt eds., 2003); Jens Wüstemann, *Disclosure Regimes and Corporate Governance*, 159 J. INSTITUT. TH. ECON. 717 (2003).

hands of banks, insurances, and—mostly for historical reasons—families.<sup>25</sup>

These financing patterns have historically produced a complementary set of control rights and information rights: in the insider model a (small) group of persons, which is usually better informed than outside parties, exercises important control of management. The informational advantage of some shareholders led to the notion of “informed capital.”<sup>26</sup> The insider system is sometimes linked with elements of co-determination. In Germany, for instance, the *Aufsichtsrat* (supervisory board) of large corporations includes not only members sent by shareholders but also members sent by the employees of the firm. Obviously, an efficient functioning of mechanisms of insider control rests heavily on an appropriate distribution of control rights and, as a necessary prerequisite of informed decisions, corresponding information rights. Monitoring bodies like the supervisory board must be well informed about management’s actions and underlying motives and about the risks and prospects of the firm. Leuz and Wüstemann have collected selected institutional details, analytical arguments, and empirical evidence for Germany that show a system that efficiently disseminates value-relevant information to monitoring parties within the firm.<sup>27</sup>

## **B. Auditor’s Internal Reporting Duties and Gatekeeper Function**

As indicated, German corporate governance emphasizes internal information flows. The development of auditors’ internal reporting duties (as summarized in Table C in the appendix) gives corresponding institutional evidence. It shows that the auditor has oral and written

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25. See ALLEN & GALE, *supra* note 24; S. Prigge, *A Survey of Corporate Governance, in* COMPARATIVE CORPORATE GOVERNANCE 943-1044 (K. J. Hopt et al. eds., 1998).

26. Jean Tirole, *Corporate Governance*, 69 *ECONOMETRICA* 1, 8 (2001).

27. See Leuz & Wüstemann, *supra* note 24.

reporting duties toward the key monitoring party of management, namely the supervisory board, as a means to support it in his obligatory supervision.

The most important reporting duty affects corporate crises. Since a decision of the German Federal Supreme Court of Justice in 1954, the auditor must inform management and supervisory board about facts that endanger the existence of the enterprise being audited or that could hinder its development.<sup>28</sup> From a behavioral perspective, this makes sense, especially with regard to the reporting duties towards the supervisory board. Painter convincingly argues that due to the mentioned cognitive biases (e.g., loss frames) managers will tend to take higher risks than desired, particularly in situations of financial distress.<sup>29</sup> Therefore, he points out, responsibility should be shifted to those agents who are less affected by these biases.<sup>30</sup> German corporate governance puts this into practice.

Beside these duties, the long form auditor's report serves as the basic means to satisfy the internal reporting duties. The long form auditor's report, which is not known in the U.S., serves only internal purposes. Even shareholders at the general meeting typically do not have the right to have an insight into this report. In the first part of the report, the auditor has to comment on the present financial situation of the corporation and especially to evaluate the continuity perspectives and risks that may endanger the existence (§ 321 I HGB). In its main part, the auditor has to state whether bookkeeping, financial statements, management reports, and other audited documents comply with legal rules and regulations. Since the amendments of 2002, the auditor also has to inform about underlying material assumptions concerning the

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28. See Decision of the German Federal Supreme Court of Justice on 15 December 1954 (II ZR 322/53, 8 Wpg 138 (1995)).

29. See RICHARD PAINTER, JURISDICTIONAL COMPETITION, CONVERGENCE, AND THE AUDITORS IN THE U.S. AND EU (Working Paper, University of Illinois).

<sup>30</sup> See Id.

valuation of assets and liabilities. He has to show the effects of different assumptions on the financial position and the effects of accounting policies (§ 321 II HGB). Important fields of application include, e.g., sale-and-lease-back transactions. If the audited corporation is publicly quoted, the auditor has to evaluate the internal control system, in particular with regard to early warning systems. The respective duty to evaluate is accompanied by reporting duties in the auditor's report (§ 321 IV HGB).

It is the underlying idea of the extensive internal reporting duties to support the supervisory board in its supervision by giving a (written) detailed evaluation of the financial statements. Therefore, the legislature made clear that the contents of the auditor's report have to be presented in a problem-oriented way and that plain language is employed, which enables members of the supervisory committee to understand the important facts even though they are technically less skilled than accounting experts. Necessarily, the auditor's report exceeds the view of the financial health of a corporation given by public financial statements. It is some sort of private information which is disseminated via private information channels.<sup>31</sup>

### **C. Auditor's External Reporting Duties and Gatekeeper Function**

The only information given by the auditor that is passed to third parties (e.g., the capital markets) is the (internationally comparable) auditor's audit opinion. In all other matters, the legal information rights the auditor has are accompanied by duties of confidentiality. By giving the audit opinion, the auditor states to third parties that, within the limits of his duty of care, the financial statements give a fair presentation of the firm's position. Whereas the former audit opinion had a boilerplate formulation, the audit opinion now has an

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31. See Leuz & Wüstemann, *supra* note 24.



individualized form in which the auditor has to declare whether the financial statements give a fair presentation of the corporation's financial position and profit situation (§ 322 I HGB). Again, the explanations given must be comprehensible and risk-oriented (§ 322 II HGB). Risks which endanger the existence have to be specified and explained separately (§ 322 II HGB). In case the auditor qualifies or disclaims the audit opinion, reasons and details have to be explained.

## **V. Discussion and Comparisons**

### **A. First Dilemma: Whistle-Blowing or Death Bell-Ringing?**

An early discovery of substantial risks which endanger the existence of the company is essential to effective corporate governance. From a human information processing perspective this is even more so because, as indicated above, agents may be subject to systematic misperceptions of and resulting inappropriate reactions to risk. Therefore, as outlined, German auditors have important internal gatekeeper functions.<sup>32</sup> German Legislator has made it also very clear that substantial risks which endanger the existence of the company have to be disclosed by the corporation and discussed by the auditor in his report.<sup>33</sup>

However, a certain dilemma lies in the fact that an early *public* disclosure of *possible* material risks as, e.g., an impending insolvency can also become a self-fulfilling prophecy: Figuratively speaking, the whistle-blowing function of an auditor and his ringing of the alarm bell can thus unintentionally become a death bell-ringing for the corporation. Efforts from banks and management to jointly work on finance agreements in order to overcome temporary

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32. See also *infra*, Table C of the Appendix.

33. See § 289 I and § 321 I HGB.

liquidity problems can be impeded by hasty reactions of the stock markets to public disclosures of solvency problems. Public disclosure in these cases is contrary to the interest of the corporation; it can, however, be in the interest of (some) shareholders. In a financial system based on the above mentioned *Hausbanken* which serve important liquidity insurance functions for a corporation this is even more so. Therefore, case studies for Germany show that liquidity problems were in the past sometimes kept secret to the public in order to avoid the logic of a self-fulfilling prophecy.<sup>34</sup> The *normative* issue as to whether public disclosure in cases of *possible* substantial risks should be enforced by securities regulation nevertheless still remains.

### **B. Second Dilemma: Decision-Usefulness or Avoidance of Legal Liabilities?**

A second dilemma is closely related to the above mentioned disclosure problems, namely the problem of a somehow unfortunate interaction of the duty to disclose decision-relevant substantial risks and the risks of resulting shareholder litigations. Internationally, securities regulations require public corporations to disclose material risks, as it is promulgated for the U.S. in several rules (e.g., rule 305<sup>35</sup>, rule 503<sup>36</sup> of regulation S-K and in the MD&A<sup>37</sup>) and for Germany in the comparable *Lagebericht* which is codified in § 289 and § 315 of the German Commercial Code. These rules oblige corporations to identify potential risk factors which may affect the company's financial position and to disclose them to the public. In the U.S., some of these forward-looking information are subject to safe harbor rules which limit

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34. See Wüstemann, *supra* note 9 at 32..

35. See rule 305 of the regulation S-K (17 C.F.R. § 229.305).

36. See rule 503(c) of the regulation S-K (17 C.F.R. § 229.503(c)).

37. See rule 303 of the regulation S-K (17 C.F.R. § 229.303).

legal liability, some of them are not.<sup>38</sup>

From a financial perspective, these information are of course extremely decision-useful. However, evidence shows that disclosure of substantial business risks is at the moment rather driven by strategies of avoidance of legal liabilities. This is due to the fact that ex post (after a negative performance of the corporation or in a critical financial position) some risks that ex ante did not seem to have been material may prove to be decisive. This gives great incentives for shareholders to sue the corporation on the grounds of misleading statements.<sup>39</sup> In order not to “forget” any risks, corporations thus tend to give a catalogue of all possible industry and business risks. Anecdotal evidence shows, that this is particularly true in risk-exposed industries such as the high-tech industry. For investors, however, it would probably be better if corporations focused on a detailed analysis of the most important business risks.

### **C. Legalization of Internal Information Flows**

As I argued above, effective corporate governance is not only a question of public disclosure but also of internal dissemination of decision-relevant information to monitoring parties. This is especially true within a system of insider control, as the German corporate governance system. But it also proves to be more and more important in outsider control systems: Elements of “insider control” have thus been strengthened in the U.S. in the

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38. See, e.g., JANE CALDERON & RACHEL KOWAL, *Safe harbors: Historical and current approaches to future forecasting*, 22 J. CORP. L. 661 (1997); Gregory R. Roussel, *Securities fraud or mere puffery: refinement of the corporate puffery defense*, 51 VAND. L. REV. 1049 (1998); Suzanne J. Romajas, *The duty to disclose forward-looking information: a look at the future of MD&A*, 61 FORDHAM L. REV., 245 (1993).

39. See rule 10b-5 (17 C.F.R. § 240.10(b)-5) and rule 14a-9 (17 C.F.R. § 240.14a-9); see, e.g., LOUIS LOSS & JOEL SELIGMAN, *FUNDAMENTALS OF SECURITIES REGULATION* (4th ed. 2001).

aftermath of Sarbanes-Oxley, as, e.g., the requirement to establish independent audit committees<sup>40</sup> and their regular discussions with the auditors.<sup>41</sup>

One solution to at least some of the above mentioned dilemmas and to the problems of internal reporting duties may lie in a more compulsory form of the internal information flows between the “gatekeepers” and the relevant monitoring parties. In my opinion, the above sketched German auditor’s report may here lead in the right direction: It forces auditors to analyze in depth the firm’s financial position and performance and to explicitly express opinions on all important accounting issues. Since it remains subject to duties of secrecy it avoids the risk of becoming a self-fulfilling prophecy and it will be less driven by legal liability avoidance strategies.<sup>42</sup> In any case, to avoid “cheap talk” problems, internal reporting duties will have to be legalized.

#### **D. Audit Regulation in the Light of Behavioral Economics**

Behavioral research and the individual information processing perspective provide useful insights in the field of auditing and audit regulation as well. Auditors’ judgments, the role of knowledge and memory in judgments and the existences of biases and heuristics in decision making processes have been on the agenda of behavioral auditing research literature with

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40. See Section 301 of the Sarbanes-Oxley Act; SEC Proposed Rule: Standards Relating To Listed Company Audit Committees (Release Nos. 34-47137; 33-8173; IC-25885; File No.: S7-02-03; January 8, 2003) at <http://www.sec.gov/rules/proposed/34-47137.htm>.

41. See Section 204 of the Sarbanes-Oxley Act; SEC Finale Rule: Strengthening the Commission's Requirements Regarding Auditor Independence (Release Nos. 33-8183, 34-47265, 35-27642, IC-25915, IA-2103, FR-68; File No.: S7-49-02; Jan. 28, 2003) at <http://www.sec.gov/rules/final/33-8183.htm>.

42. See *infra*, Table C of the Appendix and *supra*, part IV.B.

important results.<sup>43</sup> Some limitations were however also addressed:<sup>44</sup> Shanteau for example emphasized as early as 1989 with respect to the cognitive heuristics and biases approach that there “is still not a general theory or even specific models of underlying processes”<sup>45</sup> and he questioned as to whether the “biases observed with naïve subjects also apply to experts” as auditors.<sup>46</sup> In a somewhat trenchant way one could say that despite the research done so far the line that separates rational behavior of the von Neumann-Morgenstern type from behavior that systematically deviates from it is still too fuzzy.

As a consequence, the impacts of behavioral research on *normative* issues that go beyond reasoning of the grounds of common sense are probably still very limited. One major contribution of behavioral research however is, as Lenz formulates, to have discussed the

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43. See, e.g., Alison H. Ashton & Robert H. Ashton, *Sequential Belief Revision in Auditing*, 63 *Acct. Rev.* 623 (1988); Thomas A. Buchman, Philip E. Tetlock & Ronald O. Reed, *Accountability and auditors' judgment about contingent events*, 23 *J. Bus. Fin. & Acct.* 379 (1996); Sarah E. Bonner, Bary L. Lewis & Garry Marchant, *Determinants of Auditor Expertise*, 28 *J. Acct. Res. Supplement 1* (1990); Jeffrey Cohen & Thomas Kida, *The Impact of Analytical Review Results, Internal Control Reliability, and Experience on Auditors' Use of Analytical Review*, 27 *J. Acct. Res.* 263 (1989); Robert Libby, *The role of knowledge and memory in audit judgment*, in *JUDGMENT AND DECISION-MAKING RESEARCH IN ACCOUNTING AND AUDITING*, (Robert H. Ashton & Alison H. Ashton eds., 1995); William F. Messier, Jr., *Research in and development of audit-decision aids*, in *JUDGMENT AND DECISION-MAKING RESEARCH IN ACCOUNTING AND AUDITING*, (Robert H. Ashton & Alison H. Ashton eds., 1995); Don A. Moore, George Loewenstein, Lloyd Tanlu & Max H. Bazerman, *Auditor Independence, Conflict of Interest, and the Unconscious Intrusion of Bias*, (working paper 2003), at <http://papers.ssrn.com/abstract=324261> (Social Science Research Network); Robert A. Prentice, *The Case of the Irrational Auditor: A Behavioral Insight into Securities Fraud Litigation*, 95 *Nw. U. L. Rev.* 133 (2000); James F. Smith & Thomas Kida, *Heuristics and Biases: Expertise and Task Realism in Auditing*, 109 *Psychol. Bull.* 472 (1991); Ira Solomon & Michael D. Shields, *Judgment and decision-making research in auditing*, in *JUDGMENT AND DECISION-MAKING RESEARCH IN ACCOUNTING AND AUDITING*, (Robert H. Ashton & Alison H. Ashton eds., 1995).

44. See James Shanteau, *Cognitive heuristics and biases in behavioral auditing: Review, Comments and Observations*, in 14 *Acct, Orgn, and Soc.* 165 (1989),

45. *Id.* at 171.

46. *Id.* at 172

right categories and to have raised the right questions.<sup>47</sup> With regard to German research done so far, Lenz in his critical appraisal also points out the lack of empirical studies in Germany that tackle the problem of theoretical approaches in detail.<sup>48</sup>

From a *positive* point of view the existing rules in the field of auditing can nevertheless be interpreted as a reaction to supposed biases of auditors: Rules that enforce independence of auditors, for example, can be explained as institutional solutions in order to avoid typical cognitive biases. Behavioral economics can also be applied to regulatory institutions themselves as, e.g., the SEC.<sup>49</sup> But, again, limitations of the approach remain: Choi and Pritchard conclude their analysis stating that “insights of behavioral law and economics are limited by the lack of a general theory to explain why human mind results in behavioral biases in decisionmaking. Without such a theory, assessing possible methods for ameliorating such biases is a murky at best”.<sup>50</sup>

## VI. Conclusion

In this paper I presented a set of arguments with respect to the evaluation and response to risk in international accounting and audit regimes. I argued that different types of risks exist, some of which can be directly addressed by auditors. The existence of persons that exercise gatekeeper functions is even more important because of possible misperception of and

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47. See Hansrudi Lenz, *Prüfungstheorie, verhaltensorientierter Ansatz*, in *HANDWÖRTERBUCH DER RECHNUNGSLEGUNG UND PRÜFUNG* (EDS. WOLFGANG BALLWIESER ET AL. 2002; 3RD EDITION), p. 1426-1438.

48. *Id.* at 1935.

49. See Stephan J. Choi & A. C. Pritchard, *Behavioral Economics and the SEC*, (working paper 2003), at <http://www.law.umich.edu/centersandprograms/olin/papers.htm>.

50. *Id.* at 85.

problematic reactions to risk by management, as behavioral decision science convincingly shows. International systems of corporate governance and securities regulation differ in the way they cope with these risks. In this article, institutional responses with regard to risk are shown with an accentuation on internal and external reporting duties of auditors in Germany. Revealed differences to the U.S. system of corporate governance and market regulation can be explained by the different financial systems in which they are embedded.

It is an underlying idea of the argumentation throughout the article that both the market based-system of corporate governance and the insider system have shown severe shortcomings in the past.<sup>51</sup> Therefore, one might want to adopt such regulations from each system which are successfully tried and tested. One example for an instrument from an insider system that may serve as a model can be the auditor's report. Especially in the field of evaluation and response to risk in corporate governance regimes, comparative institutional assessment seems to be a fruitful approach for the future.

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51. See, e.g., Wüstemann, *supra* note 24 at 724.

### Appendix: Legislative Responses to Audit Failures in Germany (1870-2003)

The following tables summarize important legislative measures in Germany from 1870 until today. Most of the Reform Acts were reactions to audit failures.<sup>52</sup> The Companies Reform Act of 1870 required the supervisory board to examine the annual accounts. It passed parliament during the *Gründerzeit* (period of promoterism), a period in the last third of the 19th century after the German unification when many firms were established in Germany. In the crises which followed, when some newly founded enterprises failed and capital markets suffered from speculations (*Gründerzeitkrise*), further important measures were taken. A second period of intensive regulation followed in the aftermath of the world economic crises of 1929. Notorious bankruptcies in Germany, e.g., *Nordwolle* and *Danat-Bank*, led to statutory audits for corporations. The Reform of the Companies Act in the sixties (*Aktienrechtsreform 1965*) codified important changes but was possibly a reaction to the German “economic miracle” (*Wirtschaftswunder*) rather than to crises.<sup>53</sup>

The Accounting Directives Act of 1985 transformed European Directives into German commercial law.<sup>54</sup> The European Directives were an important first step towards European harmonization, which was only recently intensified by the IAS/IFRS-Regulation, requiring capital market-oriented corporations to prepare their group accounts in conformity with

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52. See Herbert Brönner, *Geschichte der Revision*, in *HANDWÖRTERBUCH DER REVISION* 663-70 (Adolf G. Coenenberg & Klaus v. Wysocki eds., 2d ed. 1992); Jens Wüstemann *supra* note 9; Norbert Pfitzer & Christian Orth, *Die Berichterstattung des Abschlussprüfers Nach Neuem Recht*, in *REFORM DES AKTIENRECHTS, DER RECHNUNGSLEGUNG UND DER PRÜFUNG* 873-97 (Dietrich Dörner et al. eds., 2d ed. 2003).

53. See Herbert Brönner, *Geschichte der Revision*, in *HANDWÖRTERBUCH DER REVISION* 663, 668-670 (Adolf G. Coenenberg & Klaus v. Wysocki eds., 2d ed. 1992).

54. See Herbert Brönner, *Geschichte der Revision*, in *HANDWÖRTERBUCH DER REVISION*



International Accounting Standards/International Financial Reporting Standards.

Amendments to audit regulation from 1998 until today were made under the impression of recent audit failures in Germany.

After an overview of the development of the statutory audit (Table A), the tables concentrate on important stages in the development of internal reporting duties of the auditor (Table C) and external reporting to the public (Table D). Table B compresses information on some issues of auditor's independence and the regulation of the audit profession.

**Table A. Statutory Audit**<sup>55</sup>

1870	Companies Reform Act (Novelle des Aktiengesetzes vom 11. Juni 1870).
	The supervisory board has to examine the balance sheet, the income statement, and the profit distribution proposition.
1931	Regulation Concerning Corporation Law (Verordnung des Reichspräsidenten über Aktienrecht, Bankenaufsicht und über eine Steueramnestie vom 19. 9. 1931, RGBI. I 1931, S. 493).
	First statutory audit requirement for corporations. (§ 262a HGB 1931).
1985	Accounting Directives Act (BiRiLiG, BGBl. I 1985, S. 2355).
	Statutory audit for large and medium sized corporations. (§ 316 HGB 1985).
1998	Corporate Control and Transparency Act (KonTraG, BGBl. I 1998, S. 786).
	Auditors have to evaluate the appropriateness of a corporation's risk reporting. (§ 317 HGB 1998).
2002	Fourth Financial Markets Reform Act of 2002 (ViertesFinMarktFöG, BGBl. I 2002, S. 2316).
	Evaluation of the system of internal controls of capital market-oriented corporations. (§ 317 HGB 2002).

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663, 670 (Adolf G. Coenenberg & Klaus v. Wjsocki eds., 2d ed. 1992).

55. The translation of Tables A to D are to a certain extent borrowed from JEREMY BROOKS & MARTIN DIETZ, DEUTSCHES BILANZRECHTS, GERMAN ACCOUNTING LEGISLATION (2d ed. 1993).

**Table B. Regulation of the Audit Profession and Auditor's Independence**

1931	Regulation Concerning Corporation Law (Verordnung des Reichspräsidenten über Aktienrecht, Bankenaufsicht und über eine Steueramnestie vom 19. 9. 1931, RGBl. I 1931, S. 493).
	Only certified public accountants may audit large corporations.
1998	Corporate Control and Transparency Act (KonTraG, BGBl. I 1998, S. 786).
	Reduction of overall charges from a single client to 30%. (§ 319 HGB 1998). Supervisory board assigns the auditor. (§ 318 HGB 1998).
	Audit partner has to rotate internally (within the audit firm) at least after 6 years of signing the audit opinion. (§ 319 HGB 1998).
	Increase of auditor's legal liability in case of capital market-oriented corporations to 8 millions DM (4 million EUR). (§ 323 HGB 1998).
2000	Auditor Regulation Reform Act (WPO-Novelle, BGBl. I 2001, S. 1769)
	Introduction of a review system ("peer review"), corresponding to the former US-style. (§§ 57a-h WPO).
2003	Draft of the Accounting Legislation Reform Act (BilReG-Referentenentwurf)
	The auditor of a company is forbidden to perform certain consulting activities for the same company (internal control, management and financial services, valuation services). (§ 319 HGB-E 2003).
	The auditor of a listed company is also not allowed to perform special tax services and appear for the company in court. (§ 319a HGB-E 2003). Reduction of overall charges from a single listed client to 15% (§ 319a HGB-E 2003).

**Table C. Internal Reporting Duties: Auditor's Report**

1931	Regulation Concerning Corporation Law (Verordnung des Reichspräsidenten über Aktienrecht, Bankenaufsicht und über eine Steueramnestie vom 19. September 1931, RGBl. I 1931, S. 493).
	The auditor must document in writing the results of his examination. The report must state whether the accounting documents comply with legal regulations and whether the legal representatives have supplied the information and explanations required. (§ 262e HGB 1931/§ 139 AktG 1937),
1954	Decision of the Federal Supreme Court of Justice (BGH-Urteil v. 15.12.1954 II ZR 322/53, BGHZ 1955, p. 17).

	The auditor shall inform management and supervisory board about facts which endanger the existence of the enterprise being audited or which could materially hinder its development.
1965	<p>Reform of the Companies Act (AktG, BGBl. I 1965, S. 1089).</p> <p>The items included in the financial statements must be analyzed and adequately commented upon. (§ 166 AktG 1965).</p> <p>If, during his work, the auditor becomes aware of facts which endanger the existence of the enterprise or which could materially hinder its development or which indicate serious violations by the legal representatives against the law, the articles of association or the by-laws, then he must report on it. (§ 166 AktG 1965, based on the above decision).</p>
1985	<p>Accounting Directives Act (BiRiLiG, BGBl. I 1985, S. 2355).</p> <p>Focusing on improved reporting to administrative and supervisory board. Negative variances compared with the prior year in the net worth, financial position and results and losses (the so-called true and fair view) which are material to the net income of the year must be included and adequately explained. (§ 321 HGB 1985).</p>
1998	<p>Corporate Control and Transparency Act (KonTraG, BGBl. I 1998, S. 786).</p> <p>Focusing on problem-oriented reporting, the Act specifies the structure and the contents of the auditor's report.</p> <p>In the first part of the report, the legal representatives have to comment on the present situation of the corporation. A special judgment has to be given about the continuity and the prospective development, considering the statements given in the management report (Lagebericht). (§ 321 HGB 1998).</p> <p>The main part is dedicated to assure that all regulations concerning the preparation of the financial statements have been followed. The auditor has to judge if the financial statements present a factually accurate picture of the corporation's net assets, financing, and results of operations according to generally accepted accounting principles. The entries in the annual financial statements shall be classified and adequately discussed to give a true and fair view of the corporation's situation beyond the information given in the notes. (§ 321 HGB 1998).</p> <p>Among other things, the report informs about the extent and the manner of the audit and determines potentially necessary actions to improve the internal monitoring system (applicable to officially quoted corporations only). (§ 321 HGB 1998).</p>
2002	Transparency Act (TransPuG, BGBl. I 2002, S. 2681).

	<p>Focusing on problem-oriented reporting, the Act also specifies additional contents of the auditor's report.</p> <p>In the main part the auditor's report informs about material assumptions concerning the valuation of assets and liabilities. The auditor shall evaluate how accounting and valuation choices affect the financial position. (§ 321 HGB 2002).</p> <p>Objections which do not lead to disclaim the audit opinion shall be explained if it is relevant for monitoring the management. (§ 321 HGB 2002).</p> <p>Determination of potentially necessary actions to improve the internal monitoring system shall be made for all listed corporations. (§ 321 HGB 2002).</p> <p>The auditor has an oral reporting duty to inform about the main results of his audit in the course of the negotiation about the balance-sheet of the supervisory board. (§ 171 AktG 2002).</p>
2003	<p>Draft of the Accounting Legislation Reform Act (BilReG-Referentenentwurf)</p> <p>The written long-form report of the auditor to the supervisory board may be disclosed to the public in the case of an insolvency. (§ 321a HGB-E 2003)</p>

**Table D. External Reporting Duties: Audit Opinion**

1870	<p>Reform of the Companies Act (Novelle des Aktiengesetzes vom 11. Juni 1870).</p> <p>Supervisory board has to report the results of its examination to the annual general meeting.</p>
1931	<p>Regulation Concerning Corporation Law (Verordnung des Reichspräsidenten über Aktienrecht, Bankenaufsicht und über eine Steueramnestie vom 19. September 1931, RGBl. I 1931, S. 493).</p> <p>If no objections are found upon completion of the examination, the audit opinion must show that bookkeeping, the annual financial statements, and the management report are in accordance with professional standards and comply with legal rules. (§ 262f HGB 1931).</p>
1965	<p>Reform of the Companies Act (AktG, BGBl. I 1965, S. 1089).</p> <p>Static formulation of audit opinion, defined by law, if no objections have been found upon completion of the examination: "The accounting, the annual financial statements, and the management report which I (we) have audited in accordance with professional standards comply with the German Law and the company's statutes." (§ 167 AktG 1965).</p>
1985	<p>Accounting Directives Act (BiRiLiG, BGBl. I 1985, S. 2355).</p>

	<p>Static formulation of audit opinion, defined by law, if no objections have been found upon completion of the examination: “The (consolidated) financial statements present in compliance with generally accepted accounting principles a true and fair view of the net worth, financial position, and results of the corporation.” (§ 322 HGB 1985).</p> <p>The audit opinion must be modified in appropriate fashion if additional comments appear necessary in order to avoid a wrong impression concerning the nature of the audit and the scope of the opinion. Compliance with the articles of association and the by-laws must be referred to if they contain permissible, additional regulations relating to the financial statements or the consolidated financial statements. (§ 322 HGB 1985).</p> <p>If there are objections, the auditor must qualify or disclaim his opinion. The disclaimer must be explained in an opinion on the financial statements or the consolidated financial statements. The reason for qualification and disclaimer must be explained. Qualifications must be expressed clearly. (§ 322 HGB 1985).</p>
1998	<p>Corporate Control and Transparency Act (KonTraG, BGBl. I 1998, S. 786).</p> <p>Dropping of boilerplate formulation. If no objections are found, the auditor states this in his audit opinion and judges that based on the information he got during the audit the (consolidated) financial statements give a true and fair view of the company. (§ 322 HGB 1998).</p> <p>Explanations concerning the judgment of the audit results shall be comprehensible and problem-oriented. (§ 322 HGB 1998).</p> <p>Risks which endanger the going-concern of the company have to be specified separately. (§ 322 HGB 1998).</p> <p>The auditor has to suggest if the management report (Lagebericht/Konzernlagebericht) imparts a correct idea about the situation of the company. Additionally, he has to suggest if future risks are presented correctly. (§ 322 HGB 1998).</p>
2003	<p>Draft of the Accounting Legislation Reform Act (Referentenentwurf des BilReG)</p> <p>The auditor’s opinion may be disclaimed if the auditor is not able to give a judgment. (§ 322 HGB-E 2003).</p> <p>A qualified opinion may only be given when the financial statements together with the explanation of the auditor give a true and fair view of the company. (§ 322 HGB-E 2003).</p>

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