German and British Accounting – A Comparison

Significant differences in accounting principles and reporting requirements still remain after implementing the Fourth and Seventh EC Company Law Directives. These result from the existence of a different commercial environment which has developed over time and has had a major and long lasting influence on accounting practices in the respective countries. The major influential factors in generating a different commercial environment include the legal and fiscal systems, the nature of corporate ownership and company funding. These differences have in turn led to differences of emphasis and priority in the application of the underlying fundamental accounting concepts of prudence and accruals, stemming from a different interpretation of what accounting treatment produces a true and fair view.

In the United Kingdom annual financial statements are required to present a true and fair view of the state of the company's affairs at the balance sheet date and of its profit or loss for the year then ended and to have been properly prepared in accordance with the Companies Act 1985. Guidance on how to achieve this is given by financial reporting standards which set out general principles and objectives and contain fewer detailed rules. In order to use the standards appropriately it is important to understand the spirit and reasoning behind them. They are formulated with the objective of ensuring that the information resulting from their application faithfully represents the underlying commercial activity. According to the Companies Act 1985, directors of companies, other than most small or medium-sized companies, must state whether the financial statements have been prepared in accordance with applicable accounting standards. In exceptional circumstances, a departure from the requirements of the law or of an accounting standard will be necessary in order for the financial statements to give a true and fair view. This departures, called "true and fair view override", is required by law and must be explained in detail in the notes to the accounts.

In Germany, annual financial statements must, in compliance with generally accepted accounting principles, present a true and fair view of the net worth, financial position and results of the company. In addition to this general requirement, the German Commercial Code contains many detailed provisions on the content of financial statements. If the application of these provisions and generally accepted accounting principles results in the financial statement not showing a true and fair view, then additional information has to be disclosed in the notes; a departure from the requirements of the law is not permitted.

Generally accepted accounting principles should be consulted to explain the legal requirements. They contain a set of rules which underlie all accounting principles. The most important of these rules is the principle of prudence. This principle requires full provision to be made against all probable losses incurred up to the balance sheet date and permits profit to be recognised only when it has been realised.

According to the German understanding of the prudence principle, attributable profit and related turnover can generally only be recognised for example on a long-term contract when the contract has been completed. In the UK, the prudence principle also exits but is interpreted differently: relatively more weight is given to the accruals principle. UK views on what is a probable loss, or a realised profit, may differ. Under UK rules, for example, the attributable profit and related turnover on a long-term contract are considered to be realised as the contract proceeds if the outcome of the contract can be assessed with reasonable certainty. Likewise in the UK, exchange gains on monetary assets and liabilities are taken to the profit an loss account. Gains arising on short- term monetary items are treated as realised as it is reasonably certain that the gain will soon be reflected in cash flow. Those arising on long-term monetary items are recognised even though considered unrealised - a departure from the realisation principle which is considered necessary in order to give a true and fair view. In Germany, exchange gains can only be recognised when the accrual exchange of foreign currency into the local currency has taken place. Gains resulting from revaluation at rising exchange rates are not recognised. This is called the realisation and imparity principle: imparity because unrealised losses which are likely to crystallise must be provided for whereas the recognition of unrealised profits is not allowed. However, the recognition of foreign exchange gains on translating short-term receivables in foreign currencies at year-end rates is more and more acknowledged.

In Germany, according to the “Maßgeblichkeitsprinzip” – an authoritative principle without UK equivalent – the financial statements form an authoritative basis for the tax accounts. This means that the accounting principles used in the financial statements are those which prevail for tax purposes. There is no independent set of tax accounts. In addition, many tax incentives may only be claimed if the same treatment is adopted in the financial statements. This is known as “umgekehrte Maßgeblichkeit” which is a reversal of the authoritative principle and leads to tax driven financial statements. Therefore, the company’s individual financial statements are often prepared in a manner acceptable to the German tax authorities. Consequently, in a lot of cases, few adjustments are required to a German company's financial statements when preparing the related tax computations. German group financial statements are generally not concerned with the tax treatment, and consequently, bases chosen for the preparation of consolidated accounts may differ from those used to prepare the individual companies' financial statements. In the UK, accounting rules have developed separately from tax rules. This results in the need for a number of adjustments between the income reported in the audited financial statements and that subject to tax.

The emphasis on the prudence concept and the use of differing tax rules often leads to the perception that profits according to German rules are lower than those according to UK rules of a comparable company. In fact, this generalisation is not borne out in practice. It is rather the application of the accruals concept which is different in both countries; profits are often recognised later and expenses are often taken to the profit and loss account earlier in Germany than in the UK. One example is the profit realisation on long-term contracts which has already been mentioned. Another example is the commonly used reducing-balance method of depreciation which, when compared to the straight-line method commonly used in the UK, leads to higher depreciation in the earlier years a d to lower amounts thereafter. Thus in some years the profits according to UK rules can be higher than in Germany and vice versa.

Another aspect to bear in mind when looking at UK and German accounting principles is the way in which the businesses are funded. In the UK a large proportion of commercial activity is funded by resources raised through the stock market and therefore form the shareholder community. As a result, in the UK commercial and accounting environments greater emphasis has been placed on the requirements and demands of the capital markets and thus there is greater emphasis on the profit and loss account. In Germany, still comparatively few companies are listed, although the amount significantly increased subsequent to the introduction of the "Neuer Markt". However, the great majority of enterprises are still funded by loans. This inevitably leads to greater emphasis on the balance sheet and more importance being given to the so-called "Gläubigerschutzprinzip", the creditors' protection principle.

The differences in corporate financing have also been influential in the development of reporting requirements, in particular the disclosure of financial information in the respective jurisdictions. Historically, the capital of German companies has been provided to a considerable extent by the banking sector This often means that banks already have access to financial information. It explains why there has been comparatively less pressure on companies to publish financial information. However, large German companies fund their growth more an more by resources raised through international capital markets. This has also been reflected in the new German accounting legislation permitting listed companies to prepare consolidated financial statements according to Generally Accepted Accounting Principles in the United States (US GAAP) or International Accounting Standards (IAS).