Notes on the Equity Revolution and Accounting Systems:
A Comparison of Germany and the United States

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Draft: January 20, 2002, Not to be quoted without permission of the author.

“The foundation for creating investment capital from national wealth was the popularization of securities, highly developed exchanges and banks; the foundation of international investment capital is international banking houses and exchanges.”
K.v. Reibnitz, Staatsminister, in Der Wirtschaftsprüfer, May 1932.

“We do not have the time in Germany to repeat all the developmental steps of the United States and England. We can spare ourselves many difficulties by carefully following and accepting the development in the United States … .”
Dr. Fritz Mezger, in Der Wirtschaftsprüfer, May 1932.

Abstract: This paper exams the different paths taken by American and German accountants. It argues that the more widespread acceptance of equity investment in the United States helps explain why the accounting professions in the two countries took different paths after World War I, even though the German accountants look to Anglo-Saxon countries as models for how the profession should be organized. The greater need in Anglo-Saxon countries to inform equity investors about income-statement flows led to changes in American accounting that were far less prevalent in Germany. The paper also suggests several explanations for why the equity revolution was slower to take hold in Germany.
I. Introduction.

Much has been written about the revolutions in transportation, communication, production, and marketing – which are viewed as the building blocks of the modern corporation and managerial capitalism. Considerably less attention has been paid to the revolution in capital markets and an accompanying revolution in accounting systems.

Not all national accounting systems followed the same path, however. At the turn of the century, the German and American accounting reports and accounting theory, for example, were very similar. The accounting principles, on which public accounting statements were based in both countries, were vague at best regarding the requirements for the contents of financial reports and disclosures. In both countries, moreover, there was little in the way of auditing standards and liability to shareholders. Insofar as there was a philosophy about what to present, it was more focused on the interests of debtors as opposed to shareholders. Neither country had developed a professional class of specialists as a standard-setting body. Germany may even have been more advanced in all of these areas than the United States, but this changed abruptly during the interwar period.

In the United States, for example, tax and book accounting were separated, a shift occurred from asset and capital valuation to income flows and the distinction between liabilities and owner’s equity, a series of principles for income and balance sheet valuation rather than fixed but vague rules (laws) were developed, and a professional accounting body, responsible in large part to shareholders, was established. The experience in Germany was very different. Until very recently, the German system was largely focused on tax issues, asset and capital valuation – neglecting the income statement and the flows in and out of the firm – and accounting experts exerted little influence on setting accounting principles.

The purpose of this paper is to set the contrasting responses of Germany and the United States into the context of the historical development of both countries. It exams the different paths taken in the twenties and thirties in reforming the accounting systems of these two countries in light of the historical cultural, economic, and political circumstances that shaped business behavior and each country’s system of corporate
governance. Accounting systems entail many aspects of a financial system, not just the specific and general rules for financial reporting. These include but are not limited to the how rules are established, the status, education and attitudes of accountants, what role accounts play in creating financial information and monitoring company reports. In short, during this crucial period for changes in modern accounting theory, a broad range of political and cultural obstacles prevented Germany from fully participating in what some authors have called the “equity revolution.”¹ My sole objective here is to compare some of the differences in how equity markets developed in the United States and England, on the one hand, and Germany, on the other, and to outline how these different financial paths may have influenced the development of accounting and the accounting profession in those countries.

II. Germany and the Equity Revolution.

Equity financing is probably the oldest form of investing. While capital markets only started to develop in the 17th century, we have evidence going back 3,000 years for venture capital investments in highly risky undertakings. Most of the civilizations and religions that influenced Western Europe and North America’s cultural, political and economic development, however, shunned charging interest and encouraged capital investment in which the providers of funds shared the risks of those who were using the money and took an active part in the management of those enterprises. Borrowing and lending was clearly a part of ancient and medieval society, but passive investing – that is, as Aristotle put it, the pure “making of money from money” – was tainted with a host of socially undesirable attributes. Nevertheless, governments and private interests found many ways of evading society’s social and at times legal prohibitions. The 19th century growth in business activity, associated with the Chandlerian revolutions in transportation and communication, were accompanied by an enormous increase in debt financing, with most of the equity capital coming from the founders of businesses and their families. Banking houses such as the Rothschild family turned their attention from financing governments to big private projects with debt. Although equity markets in many respects

in many respects out of debt markets, the transformation was not frictionless and entailed some false starts until the institutional and attitudinal framework for investing caught up with financial interests. Indeed, the first crises in equity markets were connected with government efforts to trade its debt for equity in private companies. Governments’ sloppy control of that transformation contributed to retarding interest in and controls of equity financing.²

Well into the nineteenth century, many investors and managers had a great preference for debt rather than equity, that is contingent claims on the residue of earnings from an enterprise. In the mid-nineteenth century, the English government had to statutorily limit the percentage of rail financing that could come from debt. Most of the large rail projects in the United States, for example, were financed by heavy investments of debt from the United Kingdom. In 1913, English debt financing alone was USD 5.0 billion, roughly 50 percent of the total value of U.S. equity markets. (Reference)

Late in the nineteenth century, the mode of financing in most countries, to various degrees, began to change enormously. This was caused by several factors. The first was the desire of many of the founding families of the new industries to exit their companies, which, as it were, transformed privately held companies to public companies, increasing the supply of public shares. Banks could directly absorb these new shares to some extent, but most of them recognized that this tied up too much of their equity and entailed unwanted risks. They needed to offload those new shares to foreign investors, large private investors, some of whom who had been enriched by the sale of their family businesses, and even to smaller domestic retail clients. The second was in some countries the regulatory pressure to consolidate companies, rather than to allow smaller companies to coordinate supply and demand conditions. This regulatory predilection was clearly more pronounced in the United States, where the Sherman Anti-Trust Act set the tone for decades of court decisions that tended to tolerate consolidations that produced economic efficiencies but rejected collusion among independent companies. As a recent article in Foreign Affairs pointed out, continental European anti-trust thinking has always been oriented around protecting smaller, less competitive companies from larger, more powerful ones, rather than looking for economic efficiencies that might

lower customer prices. Many of the mergers, during the early phases of mergers in the United States, for example, were financed with new equity capital. Lastly, the great increase in new technologies – electrification and electrical appliances, automobiles, and chemical, to name just a few – requiring large amounts of upfront investment and entailing a great deal of uncertainty, tended to be financed with equity capital. All of this, contributed to increased interest in, appetite for, and need to understand equity capital. (Note)

Although broad, anonymous markets for equities were prevalent in many countries, America set the pace. There, especially, a growing number of middle class investors were enticed by the promise of high dividends and capital gains to commit significant amounts of their savings in industrial and utility shares. Total share turnover on the New York Stock Exchange (NYSE) grew in 1900 from 159 million to 1.1 billion in 1929. The value of common and preferred shares underwritten jumped from USD 405 million in 1910 to USD 9.4 billion in 1929. The Standard and Poor’s Composite Index shot up from 6.15 in 1900 to 26.02 in 1929. Corporate managers enticed investors to buy shares with high dividends, loosening the hold of creditors and banks over corporations. From 1921 to 1929, corporations tripled their net cash position, financed in part by the floatation of USD 19.0 billion in new equity issues.

In contrast, Germany’s equity markets never fully recovered from World War I. In 1928, the peak year of the German recovery in the 1920s, stock were 11 percent below their average levels from 1900-1913. Between 1907 and 1929, the value of German equity capital increased from USD 6.6 to 7.2 billion. In the same period, nominal capital grew by only 61%. In the heyday of equity investment, between 1925 and 1929, Germany increased the nominal value of share capital by approximately 25%. Many Germans recognized the problem. In May 1932, at the height of the Depression, businessmen and government pointed to the lack of investment in Germany as one of the

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4 Baskin and Miranti, 167.
7 Calculated from the tables, 294, *Deutsches Geld- und Bankwesen in Zahlen, 1876-1975*, ed. Deutsche Bundesbank (Frankfurt am Main: Fritz Knapp Verlag, 1976)
root causes of the Depression. Even in 1913, investment in securities accounted for only 20% of national wealth, far less than in England (42%), France (51%), and the United States (30%).

The great increase in equity financing required institutional and attitudinal changes. Investor appetite for and understand of risky equity financing, with its less predictable cash returns, had to increase substantially, along with sufficient confidence in management’s competence and shareholder control, to forgo immediate dividend cash flows for capital gains, one of the principal advantages of equity over debt financing for companies and investors.

These economic changes paralleled many changes in the attitude about equity that were the basis of many changes in accounting principles. Common equity in the mid-nineteenth century, as it was used in England, Germany, and the United States, still had much more in common with debt instruments than its more modern variant. Par values were high and resembled a bond’s face value in many ways. The par value of common equity was supposed to provide security and to indicate the value of underlying assets. Companies paid out most of their “earnings” in dividends. Actual dividends seemed to be only way of measuring future earnings. Investors had little patience for leaving earnings in a company (retained earnings) – only earnings that could be hidden in the form of reserves were kept by the company. They counted little on capital gains and tended to measure the company in terms of the dividend earning power of the company, which in all countries was talk about as a percentage of nominal capital (paid in capital), like a bond’s coupon rate.

Whereas Germany shared some of these patterns of development in financing, its history, culture, and organization of industry differed significantly in some other respects. Began with stronger attachment to artisanal origins of business and anti-finance capital; reinforced by Panic of 1873; fear of lost companies allowed for keeping many small companies (no need for raising new capital for reorganization); corporate governance structure encouraged treating equity as quasi-debt, and inflation emphasized value of

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certain fixed assets; lack of capital and dependence funneled capital into debt rather than equity and national projects, which had always been an important corporate responsibility.

German attitudes about capitalism and reactions to the Panic of 1873 contributed to Germany’s reliance on a corporate governance system, in which a close relationship between banks, especially large, universal money center banks, and companies played a central role in monitoring corporations and avoiding the ravages of speculative capitalism. Whereas the central role played by large banks may have created some inefficiencies by over centralizing economic power, it did restore public and private confidence in equity financing, probably giving commercial companies greater flexibility in their financing activities. Indeed, there is much evidence that the German managers found financing their projects with common equity easier than their British counterparts did. But the German system, in which the large banks played such an important role, stressed stability over other economic virtues, undermining the association of risk taking and equity investment, and concentrated ownership and control removed much of the raison d’etre of public financial reports. Moreover, as has been often discussed, German banks had a wide-range of financial interests in their client companies, which may have created a conflict of management interest in the companies’ activities and reporting, but also at the same time, gave those who invested their funds through the bank a diversified portfolio in commercial companies.

III. Accounting Response in Germany and the United States in 1920s and 1930s.

Ironically, the turmoil in capital markets and measures to re-establish stability after World War I, had for different reasons that greatest impact on Germany and the United States, an effect for which neither country was particularly well-prepared and one which would contribute to the severity of the effects of the Depression in both countries. Both countries lacked a unified accounting profession, and a unified set of accounting

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10 See Tilly, 102. Although Tilly does not give the figures on a comparable basis for English firms, German companies between 1880-1911 were getting over half of their external financing from new equity.
and audit standards approved by regulators and clients. Even investors were look warm
to the importance of accounting standards and rigorous audits. Nevertheless, even before
the Crash in 1929, American accountants had begun to make significant changes in
accounting theory. In the aftermath of the Crash, moreover, in both countries the
accounting profession served as a cornerstone in government efforts to monitor business.
But the position of the professions, and the social and economic conditions in both
countries made the specifics of this role very different.

Although many of the profession’s chief allies in America lost some interest in
accounting and audit reform after World War I, the advisory role of accounts grew
immensely in the 1920s. The expansion of activities and of the number of
professionals, as well as the proliferation of professional organizations led to many
conflicts among accountants. Heated battles occurred about a whole host of ethical and
professional issues – for example, admission standards to the profession, advertising, and
contingent fees – but for the most part they were contained within the profession. The
purpose of the profession was transformed from merely monitoring business to one in
which CPAs (Certified Public Accountants) worked “ with businesses and federal
regulatory agencies to collect and disseminate data so that business could earn a ‘fair
return’ on their investments. This idea of “fair return” helped revolutionize the idea of
equity and accounting. Understanding “fair return” required a clear understanding of
what costs were and how they could be controlled. Long before the crash, accountants in
and outside of corporations were leading the way in categorizing costs, determining
direct and indirect costs, creating flexible budgets, full-cost and cost plus income
statements and Return on Investment (ROI) calculation, which helped drive changes to
financial accounting in the 1930s.

While many issues such as taxes, replacement cost accounting and par value
preoccupied accountants, in the 1920s, the importance of the income statement and a
manager’s right to hold on to retained earnings became much more accepted aspects of
accounting theory. These two ideas were not unconnected. The emphasis on the balance

(he does not distinguish between common and preferred) and over half of all their overall financing needs
from internal sources, a kind of equity financing.
12 Previts and Merino, 239.
sheet (primarily conservative asset valuation for creditors) and the view that income is what should be distributed to shareholders, contributed to sketchy income statements with overly conservative charges, which made determining what returns were actually be made on the value of assets employed impossible. The balance sheet was still at center stage of accounting, but the emphasis was shifting to the valuation of equity capital. Although not all of the ideas of accountants were accepted in the 1920s, more and more recognition emphasis was place on the income statement as a measure of managerial effectiveness in the use of assets entrusted to them and as an indicator of expected future earnings, which might eventually be distributed to shareholders. The accounting profession was not only moving toward the entity view of the firm, which focuses on inflows and outflows, but to economic theory to further development.

The recognition of the need for segregation of income into tow distinct flows (financial and operating) by accounting theorists in the twenties seems to have been the result of the increasing sophistication of economics literature dealing with income determination, not, as some have suggested, a natural result of the adoption of entity theory.14

By 1929, the accounting principles of realization and matching were well accepted.

One of the many innovations in American accounting during the interwar period was a rigorous distinction between Liabilities and Owner’s Equity, without which understanding the position of the shareholder is almost impossible. As shareholders were predisposed to take possession in the form of dividends anything that belonged to them “outright,” most accounting systems did not highlight that retained earnings as opposed to third party liabilities and paid in capital. Often the term “reserves” was used for a kind of nebulous sort of liability for amounts that should be segregated for future investment. Indeed the American system used the word equities, for both third party liabilities and owners equity into the 1950s. In many national accounting systems, the distinction between what belongs to third parties and what belongs to the holders of common equity is not clear. The basic accounting equation in most continental countries is expressed as assets=passives.

13 Previts and Merino, 251-253.
14 Previts and Merino, 261.
German accountants were troubled by many of the theoretical accounting, ethical, and educational standard-setting issues of the Anglo-Saxon counterparts. In comparison with English and American counterparts, German accounts were few in number and fragmented in their organizations. In 1930, England had 17,172 qualified accountants, who belonged to three accounting associations. In contrast, Germany in 1932 possessed 457, who, despite their lower numbers, were divided into five main organizations and a lot of smaller ones, which combined with lawyers and others who provided business services.\(^{15}\) Conflicts between sole practitioners and larger firms (Treuhandgesellschaften), many of which had been established by banks, contributed to the profession’s inability to mount a united front against government regulators and companies. In Germany, the audit function was considered part of the Aufsichtsrat’s (Supervisory Board) responsibility. Unlike the United States and England where auditing was well known around the turn of the nineteenth century, in Germany, it was still a novelty and considered “a sign of financial instability.”\(^{16}\) While several universities and specialized business schools (Fachhochschulen) gave instruction in accounting, professors and their course offerings were very general, focused on the economics of the firm, not accounting theory or practice. Like in England, most of the professional training was on the job, but in Germany the lower number of practitioners limited the number and training of new entries. By 1917 England and nearly every state in the United States, where much of the regulation is still controlled by the individual states, had licensing procedures overseen by a professional body. A controlling body for the profession was first created in 1931, which established the first rigorous testing and admissions procedures for licensing auditors.

The establishment in 1931 of an auditing control body and the audit requirements for joint stock companies came after nearly two decades of political and economic turmoil for Germany. The war and hyperinflation, which followed it, had destroyed an enormous amount of economic value and, perhaps for the accounting profession even more important, it had made pre-war economic comparisons nearly impossible. The

inflation boom was quickly followed by a deep recession, credit shortages, and an influx of foreign investment, the likes of which Germany had never seen before. Though no one knows for sure how much, most of the capital that came into Germany at this time was in the form of debt. By 1930, Germany 26 billion RM in foreign debt – mostly foreign denominated and much of it in the form of short-term instruments – at a time when the German national income was 75 billion RM. Between one-third and fifty percent was to American individuals and institutions. Numerous financial scandals highlighted the shortcomings of the financial control system.

By 1931, the financial and political crisis had reached such proportions that normal democratic institutions and procedures had been shelved. The very law that gave the accounting profession its new stature and structure, by mandating audits for public companies with more than RM 3.0 million in capital (later extended to smaller firms) and by creating the Hauptstelle für die öffentlich bestellten Wirtschaftsprüfer (Controlling Body), was not passed by the Reichstag, but rather, like all of the acts of the period, enacted by presidential decree. In short, even before 1933, the profession was weak and dominated by political issues. As one historian of the profession put it,

Unlike the other professions (in other countries, my note) which evolved in times of economic growth, the German profession was created barely a dozen years after a lost world war, some seven years after the worst inflation of modern times and in the midst of the catastrophic world economic crisis; all of these conditions led to a high degree of political instability, the consequences of which were to hang as a dark cloud over the new profession for more than the first decade of its life.

German accounting theory, while in some ways very innovative, did little in the 1920s and 30s to adapt to the equity revolution. It hardly even adapted to the two great shocks to the German economy in the 1920s, the inflation and monetary stabilization. Although accounting theory was dominated by “business economists,” and the post-war

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16 Markus, 9. The German financial system is often characterized as one with more trust than the Anglo-Saxon. Attitudes about auditing companies seem to fit into this view. You only audit, if you have some reason to believe something is wrong.
18 Markus, 29-33.
inflation and currency stabilization dominated Germany’s economic environment in the early 1920s, oddly, accounting rules adapted little to the new economic circumstances. There were, for example, no rules developed for inflation accounting or the creation of the post-inflation balance sheets. Although some accounting theorists highlighted the *Scheingewinne* (fictitious profits) of the inflation period and recommended that companies and tax authorities move to some form of replacement cost accounting, their proposals were rejected by the government and business leaders as being too complex and not in the national interest. Companies were, by and large, left on their own to value their post-inflation balance sheets. In order to attract capital, companies were tempted to give exceedingly high valuations to fixed assets and inventories to raise the value of their capital to attract investors, especially the great number of new foreigners who were very enthusiastic about the equity and debt of German companies during the early days of the stabilization. The degree to which the new shareholders were with inevitable losers was evidenced by the great number of companies that had to right down the value of their paid in capital in 1925 and the paucity of shareholder returns throughout even the best years of the Weimar Republic. The average market value of industrial shares were 20 percent lower between 1926 – 1929 than they had been from 1905-1913; Dividends for the same period during Weimar were 28 percent below their prewar level. Financial reports just after the stabilization and even into the mid-20s suggest that managers and even the accounting profession were still focused on the value of tangible assets, the *Sachewert*, which so dominated economic thought during the inflation, and less interested in the future flows of corporate earnings as a measure of value.

During this period, Eugen Schmalenbach, Professor of Business Economics in Cologne and advisor to the Krupp and Flick families, stands out among his colleagues. He developed many ideas, designed to free accounting from its cost-based, segmented approach, which he called Dynamic Accounting, that also put more emphasis on the income statement. Like other thinkers of the period – Oswald Spengler, for example – Schmalenbach’s work was full of organic metaphors. For him, the accounting system

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21 Feldman, 842-843,
must be treated as a holistic system; no part could be understood in isolation. The various aspects of costs and prices fit together as a whole. His terminology is full of terms like ‘organs,’ ‘cells,’ and ‘systems.’ He pushed for more focus on the inputs and outputs of the firm (income statement), and substituting market for historical values in accounts. Understandably given the inflation period, he even advocated moving away from money as a measure of those flows, because it was too effected by economic oscillations and crises, focusing more on activity and prices, which would some how be adjusted, held constant, over time. Although Schmalenbach encouraged more emphasis on the income statement, like most economists, he preferred marginal to full costs.22

Unfortunately, much of his thinking did not translate well into an operational system of accounting principles. How could accounts create financial reporting based on non-monetary inputs and outputs? Moreover, government rules, not professional standards, determined financial reporting. The profession, despite Schmalenbach’s pleas, also remained wedded to the balance sheet as a “presentation of the reservoirs of power for the firm.”23 Many accountants even questioned the necessity of double-entry bookkeeping, because the recording of the assets was by far the most important element of value, not the source of the additions to assets, which we call liabilities and owner’s equity. They were convinced that single entry accounting had served nineteenth century businesses well. Single entry ledgers were advocated by many accounting teachers and persisted well into the 1930s; the guidelines of the Göring Plan permitted its use by smaller firms. Even Schmalenbach focused on the ledger, the statistical database for analysis, which in continental countries is mandated for companies. Additions to assets ostensibly revealed progress for the firm.24 The balance sheet was central, because it brought together all the aspects of and most of the stakeholders of the firm, the creditors, entrepreneurs, and society at large. As one of the most important theorists of the day put it, the balance sheet reflected:

The economic motive, the furtherance of public well-being, the welfare of the totality as well as of each individual, and yet must deal justly with special interests … the creditor interested approach from

22 David Forrester, 
23 Forrester, 117.
24 Forrester, 144-146.
commercial law, and the entrepreneur interest … (all viewed from) the business unit, its longest possible life and greatest economic effectiveness.25

There was a very strong social component, as Osbahr goes on to say. The business unit was “both dividing line and connecting line between the national economy and the entrepreneur of the moment.”26

In 1932, soon after the expansion of audit requirements and the founding of a united accounting professional organization, accountants established a journal, in which they began to address systematically their own history and accounting issues that were vital to understanding the value of equity. The author of the first introductory article acknowledged that German accountancy was behind the English Chartered Accountants.27

In the second issue, one article outlined the elements of income and expense calculation in accordance with the new commercial law. Although the praises the new law for its new categorization of revenues and expenses, he admits that it ignores important issues about production and other overheads, concluding that the regulations are only sufficient for the simplest of firms. But he himself neglects many issues that a modern reader would expect to see. First is any theoretical discussion of why certain items should be included and others not. Second, as he admits, there is nothing about how the numbers should be presented. While large American companies like Anaconda, Bethlehem Steel, and American Telephone and Telegraph began income statements with revenues and moved through operating expenses and then other charges, German companies at this time were listing only gross profit and charges categorized by time of expenses. Neither the law nor his article remedied this. Lastly, he does not discuss how cartel payments should be included income.28 Several later articles discussed the failings of the code to define more clearly certain kinds of tricky expenses, but none proposed

26 Ibid.
principles for doing so, none addressed the issue of inter-cartel payments, and only one the booking of and the reporting of sales.

In the same issue, the question of Stille Reserven (hidden reserves) was addressed. The subject of hidden reserves played an important role in the debates about corporate reforms. Nevertheless, the new law was silent about to what extent companies could book silent reserves that manipulate profits and were hidden from shareholders in order to reduce demands for higher dividends. Thus the practice of booking hidden reserves is based on the long-standing notion that assets and capital values should be based on management’s judgment of what dividends they will generate with a high degree of certainty. Although the author believes that hidden reserves were necessary, he bemoans the new law’s failure to set limits on their use. Acknowledging the arbitrariness of hidden reserves, he proposes no principles for their use other than they should be booked in special accounts and appear as extraordinary items in the income statement, which would make them more transparent to shareholders and less capable of manipulating earnings.29

Other articles over the following months discussed such critical questions for German accountancy such as consolidation, the relationship between public, statutory financial statements (Handelsbilanz) and tax filings, and the proposed creation of a mandatory chart of accounts. The profession also bemoaned its frailty compared with its counterparts in other countries. Dr. Fritz Mezger wrote in May, 1932: “In English speaking countries yearly audits are not demanded by the State.” In those countries, the stock markets and economic actors themselves recognized the importance of regular audits. For a hundred years, English auditors have played an important role; in the United States, their role dramatically increased since World War I. In both those countries a huge literature was developed about both audit and accounting principles, from which German accountants could learn a lot.30 The profession seemed to recognize also that part of the cause of its weakness lie in the weakness of capital markets. In an article in that same issue, it was reported that German investment in securities as a

percentage of national wealth was substantially below that in England and the United States. What is never addressed directly, however, was the exclusion of professional accountants from the process of creating accounting rules, which was still an activity restricted for government bureaucrats.

In contrast to German that had for decades mandated the form of accounting reports, accounting rules in the United States, not without criticism, were formulated by accountants. The criticism of capital markets that accompanied the Crash and Depression brought government into the rule making process for the first time, but with an approach that still relied heavily on the accounting profession. The Securities Act of 1933 mandated severe penalties for misstatement of fact in financial statements and empowered the newly-created Securities and Exchange Commission (SEC) to create regulations for publicly traded companies. Although the accounting profession feared the new sanctions and powers of the state, leaders of the SEC wisely convinced the profession to draft new accounting principles that had, through the SEC, the force of law, thereby, giving them independence from the corporate masters. Quickly, the American Institute of Accountants organized itself to create rules that would provide regulators with the transparency, consistency, and economic reasonability that they felt market makers needed to avoid the follies of the 1920s.31 Within a few years, the SEC in close cooperation with the profession started issuing Accounting Series Releases about the reporting of sales, matching expenses, consolidation, the valuation of assets, the recording of liabilities, that would become the backbone of American accounting and audit procedures.32

What seems to be missing in the description are the interests of small, passive shareholders. Also, Cartel arrangements, nationalization of the railroads, bank control, foreign share holdings, inflation worked against some basic components of the income statement.

Like requirements for the organization and powers of boards of directors and the frequency and powers of shareholders meetings, accounting rules were vague and established by – actually incorporated into – federal Corporation Law (Aktiengesetz), first in 1870 and then amended several times (prior to World War Two in 1884, 1897, 1931, 1937) and to some extent embellished in the Commercial Codes (Allgemeine Deutsches Handelsgetzbücher). With the removal of state permission for creating a joint stock company in 1870 – the boom in the formation of new companies (from 1870 to 1873 the number of public companies grew from 203 to 843) was quickly followed by a stock market panic in 1873 – the necessity of outside audits and the oversight of financial reports was given to the Aufsichtsrat (Supervisory Board, or outside directors), which was expected to a large extent to use “good judgment” in determining what information to give shareholders and how to test the veracity of information provided by the Vorstand (Inside Directors). Despite the Crash of 1873 and the ill feeling it caused toward equity investment, there was little change in the nature of accounting rules and the powers of auditors, until the 1930s.33 As mentioned, although banks supported new legislation calling for mandatory audits of public companies, until the 1930s audits by external examiners were less frequent than in the United States and England, and usually associated with fears that the company was already insolvent.

Much of the pressure for outside audits came from foreign investors and was associated with foreign intrusions that had unwelcome political and economic consequences. Some of the conflicts involved challenges to the German corporate governance system and provided a foreshadowing of attacks on globalization and economic imperialism. With German assets appearing cheap during the inflation period and the only source of capital coming from Germany’s recent foes, many Germans during the 1920s were desperately afraid that the jewels of German industry would be sold to hostile, greedy foreigners. As the president of one company that tried to avoid being

taken over by a foreign firms wrote as early as 1919 about the risk of Germany losing control of its economy, “The greatest possible participation of German firms in sale of German assets was in the general German interest is beyond question.”

Moreover, many investors demanded changes in the structure and nature of German boards. They doubted the capacity of the Aufsichtsräter, dominated by banks, to adequately oversee companies. Even with the influx of American capital, there was little enthusiasm for German equity in the 1920s. Despite high payout ratios, share prices in 1926 were only 10 percent above their lows in 1924. Most sectors were already significantly below their 1928 highs when the crash came in New York in October 1929. Many critics had been calling for clearer accounting standards to better assess the value of assets and the quality of earnings. As The Economist pessimistically concluded on the eve of the Crash in New York about Germany’s efforts to reform its corporate governance,

On the whole, the outlook should be regarded as very uncertain. The suggested reforms, if carried through, might make for greater activity, but could scarcely be expected to influence upward or downward movements in prices.

Many American and English investors were only willing to lend money to companies that had outside audits.

Doubts about the reliability of German accounts and controls were reinforced by several scandals with failed firms and accounting irregularities, even during the heydays of the 1920s culminating in the collapse in August 1929 – two months before the crash in New York – of the Frankfurter Allgemeinen Versicherung-Aktien-Gesellschaft (FAVAG), one of Germany’s largest and most respected financial institutions, whose board included representatives of the leading banks in Germany. Two months before its collapse, at FAVAG’s annual meeting, shareholders had been presented accounting statements, which recorded a profit of 3.1 million RM and a dividend on the nominal

36 The Economist, October 19, 1929, 721.
37 Quick, 228.
value of shares of 12.5%. Although members of the Vorstand went to jail, blame was laid squarely on lax accounting rules and audit requirements.\textsuperscript{38}

Ostensibly because of the higher professional standards of the English and American firms, the investors preferred non-German firms for the audits, creating economic pressures and resentment among German accountants, which further exacerbating resentment of foreigners and led to economic hardship, especially for young accountants entering the profession during the Depression.\textsuperscript{39}

This may help explain why the accounting profession adapted itself so quickly to National Socialism assumption of power on January 30, 1933. Criticisms of audit and accounting standards, as well as conflicts between sole practitioners and larger firms, contributed to the creation of the Institut der Wirtschaftsprüfer in February 15, 1932. Its membership consisted of individual auditors and auditing companies. Within 18 months, the Institut, like many similar organizations in other professions, was transformed into an arm of National Socialist polices.\textsuperscript{40} In some sense, the Machtergreifung (Nazi Seizure of Power) did much for the profession. In the spring of 1933, ostensibly to quell disputes among members about the policies of the Institut (even among some members of the party), the Reichsministry of Economics established the Institut as the sole recognized and authoritative professional organization for auditors and began steps to create statutes for the Institut that would be based on the Führerprinzip (Leadership Principle) and to make membership in the Institut obligatory for all auditors.

The Institut's last meeting free of Nazi-ideology was in late February, 1933. A week later the Reichstag was burned and the Enabling Act gave the new government extraordinary powers. The accounting association succumbed to party pressure for Gleichschaltung, the process of bringing all phases of national life under party control, faster than most other professions and big business. On April 3, 1933 the leaders of the accounting profession expressed their support for the new government and announced that three recently-elected Jewish members of the Institut’s Council, would resign. All the Jewish members of the Admissions and Examinations Committees were asked to resign. Within a few months, they had been replaced by staunch Nazis. The Council

\textsuperscript{38} Quick, 229.
\textsuperscript{39} Markus, 14-15, 53.
took an active role in quelling the anti-German feeling that Jewish pogroms had stimulated with professional groups outside Germany. In order to speed up *Gleichschaltung*, the Council established a working committee, made up of long-time party members to oversee the party’s adaptation to party expectations. Not only did the working group recommend that Jews no longer be included in the profession, it also pushed for more auditing requirements for companies. With at least one of these goals, the committee was relatively successful. From January 30, 1933 to the end of the Third Reich, only six Jews were admitted to the profession (there were a total of 432 new admissions in 1933 alone), and they were front line soldiers or children of soldiers who had died in the First World War. By May 29, 1933, the accounting *Institut* joined the *Bund of National Sozialistischer Deutscher Juristen* (The Federation of National Socialist German Lawyers, BNSDJ), a Nazi umbrella organization for judges, lawyers, notaries, senior tax inspectors, economists and business economists. It also recommended that its members join as individuals. Nevertheless, it fought successfully to keep the *Institut* as an independent body, which helped the stature of the profession after the war at the cost of maintaining good relations with the National Socialist regime.\(^{41}\) For this compliance, audit requirements were extended to more and more companies.

The *Institut* elected a new president in June of 1933, one of the few members who had actually joined the party before January 1933.\(^{42}\) By May, 1934, nearly 40 percent of all the *Institut*’s members were also members of the party, one of its affiliate organizations or the right-wing group Stahlhelm.\(^{43}\)

By the mid-thirties, German accountants were playing a vital role in government efforts to keep tighter control on companies, especially in their pricing and investment decisions. A detailed chart of accountants was established to enhance auditors’ ability to verify that entries were correctly made and classified. By January 1936, the accounting

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40 Markus, 50.
41 Markus, 83-93. Markus delineates the ideological positions taken by the *Institut* in support of the new regime between 1934 and 1937, and the Jews who were expelled from the *Institut*.
42 Markus, 64-70.
43 Markus, 78. It should be noted that only 10 of the 167 party members had joined before January 30, 1933. Roughly nine percent of the *Institut*’s members were Jewish as of this date (nearly half of these had served on the front line in World War I). These statistics should not be misinterpreted. Although 16 percent of Germany’s lawyers were Jewish, they could only practice their profession with severe constraints. See Saul Friedländer, *Nazi Germany & the Jews* (London: Phoenix, 1997) 29.
profession’s main journal had changed its name to Der Wirtschaftstreuhänder (The Economy Trustee) and was espousing Nazi doctrines. Although accountants were still not determining accounting principles, in the lead article, ironically entitled, “The Independent Auditor,” the journal praised the accountants’ newly found role within the Third Reich. It stressed that auditors should not serve capitalist stockholders and bank interests. Rather,

The audit today is a fundamental part of the new economic vision of National Socialism. Audit standards can only develop from the principles of National Socialism.44

IV. Conclusion.

The basic contours of the German accounting system were carried forward into the post-World War Two period. These included a strong influence from tax law, a multitude of options and valuation methods, the opportunity to control net income with silent reserves, a lack of full consolidation, and an accounting profession that, unlike the United States and Great Britain, that is not the main standard setting body. In 1937, Germany established a uniform chart of accounts for industry segments (Richtlinien zur Organisation der Buchführung), which with amendments is still required of German companies.45 Until 1985, German commercial law and tax rules supplemented by accounting practice governed how corporate accounts were presented.46 Most accounting rules are proscribed by the Commercial Code (Handelsgesetzbuch, HGB) and although membership in the Chamber of Accountants is required, only 80% of the 7,800 Wirtschaftsprüfer in Germany belong to the Institut.47

The two decades has witnessed many changes in German accounting. In 1986, German companies were forced to have full consolidation for the first time. In the early 90s, in search of equity capital, many of Germany’s most prestigious companies shocked the German business world by listing on American stock exchanges and preparing their financial statements in accordance with US GAAP. Under pressure from the European Union, companies are adopting more open financial accounting standards, including

44 Dr. Otto Mönckmeier, Der Wirtschaftstreuhändler, January 1936, Vol. 5., No. 1, 1.
International Accounting Standards Committee (IASC). Though the IASC has no direct way of enforcing its rules, over the last decade it has had a noticeable impact on German accounting rules and on several of the European Directives (1983), especially number seven, which calls from more Anglo-Saxon consolidation rules. Full consolidation along the lines of a compromise between the older parent company concept, which basically allowed for subsidiaries treated on a cost basis, and the entity concept, full consolidation, was finally implemented in Germany in 1990.48

German professionals are still highly influenced by the accounting theories of Herman Veit Simon (statistical theory), Eugen Schmalenbach (dynamic theory), and Fritz Schmidt (organic theory), which emphasized that the primary mission of accounting was to accurately record asset values and owner’s equity and that accounting records should somehow interpret the economic significance of what had occurred to the enterprise. None of these men were professional accountants and their principles are very hard to operationalize for the profession. The creation of accounting principles and rules in Germany have never evolved out of professional experience and are not directed by professional bodies.49

The role of equity markets to the German economy remains relatively weak compared with England and the United States.50 There is no definitive answer as to why German accounting took the path it did in the inter-war years and why the accounting profession remained relatively weak. But if my hypothesis is correct about the role of equity in Germany as an explanatory factor, the question remains: What in German history might account for the reduction in the importance of equity financing? There are several plausible explanatory factors. First, Germans have a long tradition of discomfort with capital markets that was reinforced early on by the Panic of 1873. Second, the nationalization of the German railroads in the late 1870s and 1880s removed a major industrial sector from equity markets. Third, the cartelization movement that began during the end of the 19th and continued in the 20th removed the necessity of equity

47 Nobes and Parker, 224.
48 Nobes and Parker, 310-311.
50 In 1998, the market capitalization of equities in the United States was approximately 120% of that country’s Gross Domestic Product. In Germany, the figure was approximately 50%. Adapted from Richard Roberts, Inside International Finance (London: Orion Business Books, 1999) 140 and 161.
transaction in the consolidation of industry as it had in the United States. Four, the inflation that followed World War I was perceived to have an adverse impact on equity shareholders. Finally, in the aftermath of World War I, liberalizing equity investment was associated with the risk of foreign investors “buying up” German and, therefore, clashed with national passions.