Psychological impacts on Risk Reporting in German Public Sector Companies

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Candidate's Statement

I hereby certify that in the compilation of my work I used the literature listed below under References. In addition, I used as sources the interviews I conducted as well as the annual reports of the companies studied. Unfortunately, it was not possible to include these sources in the references because this material is confidential and, at the instruction of my interview participants, is not to be disclosed. They agreed to the interviews only on condition that they remain anonymous and that it would not be possible to identify them or their companies. I was therefore under an obligation to comply with this requirement.

I confirm that this thesis is my own work. I want to thank the following person for their support, obligation in discussion and motivation:

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Abstract

This study uses an approach of grounded theory with mixed methods and sources. The aim is to start and inform the debate about psychological influences on risk reporting in public sector companies and develop some reform proposals for risk reporting which can also inform the debate about Corporate Governance Code. The part of this work devoted to cognitive theory explores psychological impacts on managers' risk reporting, specifically in times of stress. It considers cognitive influences on compliance or non-compliance with management contracts with regard to risk reporting in risky situations, and so provides insights into the impact of important factors which have so far been largely neglected.

By taking a psychological and situational approach it highlights the relevance of normal cognitive structures for managers' reporting practices during times of crisis, and therefore informs current corporate governance debates focusing on pecuniary incentives to enforce managers' best practice risk reporting.

The research focus was drawn from the author's work experience as a manager in public-sector firms, and is concerned with risk reporting specifically in the public sector. This is distinguished from the private sector mainly by the almost total "absence" of the owner, i.e. the citizens. Instead, public firms are characterized by multiple agent relations, persons contracted for specific tasks, namely public managers, public shareholders, boards, and auditors. This constellation increases the possibilities of non-compliance with tasks – in this case delay or distortion of risk reporting – because even if this type of behaviour might contribute to firms being financially harmed, the agents will not lose their own money as they are not the owner of public firms.

These specific features of public firms are as yet under-researched – especially the psychological influences on risk reporting in public sector companies – had not been researched before at all.

Because of the lack of sources, in accordance with grounded theory new data was generated through interviews with managers of public real estate firms in Berlin as well as public shareholders, high-level board members, and auditors, providing information on their viewpoints on risk reporting and its control as well as main issues encountered. This interview outcomes from different viewpoints were triangulated with each other, with relevant literature and analysis of the company corporate disclosure.

The combination of field research with new approaches from Behavioural Economics contributes to a more thorough understanding of practices of risk reporting, the psychological impacts and control. By taking resilient psychological issues into account reforms can be reviewed to find more practical solutions to deal with the remaining challenges.

Keywords:

Risk-reporting, psychological impacts, CEO, Board, Auditor, public shareholder, politician, behavioural economics, cognitive theory, cognitive decision theory, cognitive conservatism, biases, heuristics, corporate disclosure, embellishing, manipulating, Corporate Governance Code, reform proposals.

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1. Introduction

Features of risk reporting scandals

Since the early 2000s, we have witnessed worldwide - including in Germany - many huge risk reporting scandals in private and public companies and banking institutions involving their CEOs, as well as indirectly their boards as the managers' controllers; these have resulted in damages in the millions and sometimes even in bankruptcies.

Because of the sheer number of huge risk reporting cases, only a few can be referred to here. The most infamous are Enron (2001, US), WorldCom (2002, US), Parlamat (2003, Italy), and Lehman Brothers (2010, US). In Germany they included LBB (State Bank, Berlin, 2001), IKB (German Investment Bank, 2007), and SachsenLB (State Bank of Saxony, 2008).[1]

Due to their scope as well as their contribution to severe financial crises in many economies, these scandals affected many people. Although governments saved some private firms from insolvency by providing financial aid (state

[1]For an academic analysis of the Enron Case see Utzig (2002), Aurich (2006) for reform initiatives after Enron and McLean and Elkind (2003) as a popular report. Swartz and Watkins (2003) give an insider account. For the WorldCom scandal see Computerwoche, Anon., 2002. Worldcom-Skandal: Die Hintergründe, die Folgen. 27.06.2002.http://www.computerwoche.de/a/worldcom-skandal-die-hintergruende-die-folgen,531070. [26.03.2012]. For the Parlamat Case in Italy compare Ferrarini and Giudici (2006). For the large scandal of the LBB see Rose (2003); for the IKB see Der Focus,Anon., 2009. Anklage gegen Ex-IKB-Chef erhoben. 01.07.2009. Available at: http://www.focus.de/finanzen/news/ortseifen-anklage-gegen-ex-ikb-chef-erhoben_aid_413205.html. [12.11.2011]. For SachsenLB see Spiegel online. Anon., 2007. Schwere Vorwürfe. Anklage gegen Ex-Vorstände der Sachsen LB., 10.09.2011. Available at: http://www.spiegel.de/wirtschaft/unternehmen/schwere-vorwuerfe-anklage-gegen-ex-vorstaende-der-sachsen-lb-a-785556.html [12.12.2011].

money) if they were considered "too big to fail", in the case of distortion of corporate disclosure in public (i.e. government-owned) firms, the taxpayer always has to bear the often large financial losses. Obviously, this makes risk-reporting scandals, particularly in public firms, an important public issue.

I became especially interested in this subject because I have worked throughout my working life of 28 years in private and public companies in the banking and real estate sector, as CEO of a public real estate firm for three years and for a state-owned controlling company for another three years, both being in charge of a saving operation of the federal state Bank LBB. Its financial damages resulting from late risk reporting amounted to an estimated € 21.4 billion.

This led me to my research question: Why does risk reporting does not work proper and / or on time?

Interestingly, all the scandals showed similar features. In all cases, the top management misrepresented the financial position of their firms to such an extent that they provided a positive outlook on the firms' development even when losses were already immense and/or threatening the firms' survival. Only when the system inevitably broke down were actual losses and risks published. Even then this was often only done in a piecemeal, hesitant manner.

Misrepresentation of firms' financial situation was caused by managers starting high-risk businesses with huge expectations of high returns (sometimes also on the initiative or agreement of boards and shareholders). After initial losses managers took more, increasingly risk-taking steps to recover them. This type of risk-seeking behaviour was not abandoned even when losses continued and increased further. Instead, this led to a spiral resulting in increasingly severe financial difficulties which were not disclosed until this became inevitable.

So, one universal trait of corporate accounting manipulation can be identified: self-interested managers tried to increase their benefits and those of their associates (Ferrarini and Giudici, 2006). When faced with increasing losses and increasingly severe crises where they might lose their reputation, job, and property they invested even more effort in distorting the firm's actual financial position.

The second universal trait concerns the main controller of risk reporting, the auditors. In all cases, auditors failed to detect the considerable manipulation which had often been visible long before crashes occurred. One of the main reasons for the frequent inefficiency of audits is the dependence of auditors on managers, who assign lucrative consultancy contracts to them – far more lucrative than audits. This dependency is reflected in frequently weak control practices.

The high degree to which managers' reporting departed from the actual situation of their firm and apparent carelessness about the consequences for others (shareholders, banks, business partners, customers, and the public) shocked many people, and raised the question: ‘Why did they do that?’

Conventionally, it was either argued that these were only individual or rare cases - even though the increasing number of cases contradicts this interpretation - or that the managers concerned were particularly hubristic.

Research Focus

On the basis of my extensive work experience in firms, including as CEO,I was not satisfied with these answers. Based on numerous experiences of my own I felt that important aspects influencing management behaviour in these types of situations were neglected. First, I did not assume that managers are a specific species suffering from hubris; rather, I assumed that specific situations where risks developed considerably encouraged this kind of behaviour, which is rooted in the human need to protect one’s self-interest. According to this assumption, psychological factors drive almost anybody in this type of situation to tend to behave in this way. In short, this behaviour is not regarded as pathological, but as normal.

The impact of psychological factors on corporate disclosure distortion is a subject which has so far been neglected in research. Until now research on management behaviour in relation to reliable risk reporting (meaning "true and fair" disclosure and to report early enough that losses can be effectively prevented) has concentrated mainly on financial incentives to make managers comply with their task. However, it has been proved that pecuniary incentives are often inefficient in ensuring compliance in times of crisis.

The failure of these incentives suggests that there must be stronger incentives which promote manipulation of risk reporting when faced with stress. This further encouraged me to focus my research on the role of psychological factors and how they might impact on management's risk reporting practices. So far there has been very little research on this aspect of risk reporting and its control, so that my work is a contribution to start dealing with it in more depth.

I chose to confine my research to situations of risky and uncertain outcomes such as times of stress and crisis because disclosure distortion is most likely to occur in these types of situation, when bad news might inflict losses on managers. Referring to principal-agent theory, non-compliance of agents - persons contracted for a task (such as managers, public shareholders, boards, and auditors) - is well explained. Based on the model of the *homo economicus* humans are rationally profit-maximizing individuals who always pursue their self-interest even if this results in violation of their contracts. Consequently, pursuance of self-interest is central to human behaviour. Not being company owners, the agents' self-interest will always depart to some degree from the goal of their contract to first and foremost ensure firms' welfare because it is not the agent's money that will be lost. Accordingly, the importance of the protection of self-interest increases in times of crisis when managers are highly likely to suffer personal losses if they admit failures. This suggests that they will tend to prevent this. One means is distortion of corporate disclosure.

Having worked for a long time in both private and public-sector firms, I have experienced the differences between them in practice and in considerable detail. The main difference is that generally in private firms the owner is close to the business and has a deep knowledge about the firm. He also is very much interested in his firm's welfare, because he has invested his own money into it.

In contrast, the shareholder in public-sector firms is only a representative of the owner (the citizens), an elected politician. Usually, he is not only far removed from the business of his firms, but his role might change after elections and, most crucially, he may not be as interested in the welfare of public-sector companies as private owners because he will not lose his own money if the firm has problems.

So far the lack of interest by politicians (boards and public shareholder representatives) in the welfare of their firms and reliable risk reporting has been a topic only taken up briefly in the media in the wake of scandals. However, little academic research has been done on these issues despite it being an obstacle to the establishment of best practice risk reporting (for current research see Ganske, 2005, and Scholz et al., 2009).

Another complicated matter specific to public firms is the specifically heterogeneous interest groups with diverse interests (managers, politicians of different parties, lawmakers, employees) in the public sector. This high number of participants and interests in decision-making processes makes coordination and consensus-building difficult. All this contributes to difficulties in implementing best practice risk reporting. There are some more facets to the attitudes of public shareholder representatives to their firms which I take up throughout this work; however, we can summarize here: Public firms are more complex than private ones, including with regard to reliable risk reporting.

Unfortunately, neither the significance nor the complexity of risk reporting in public firms is mirrored in research. For this reason, I focused my research on risk reporting in public firms. As there is a lack of sources, I decided to generate new data by conducting field research. When information is scarce and the field has yet to be thoroughly explored, a grounded theory approach is suggested as it is designed to generate data of "the real world". This was important for me as I was interested in finding practical solutions for the problems which exist. Grounded theory further suited my research focus because of its openness to eclectic selection of research methods and approaches, so that I could integrate my psychological approach as well as borrowing concepts from economics, sociology and cultural studies.

Grounded theory suggests using observations or conducting interviews as research methods. Because of my work experience I had already made many observations, and to gain more insight from other actors, I decided to conduct interviews. As case studies I chose public firms that are 100% owned by the public shareholder, but are organized on the model of private firms.. Having worked in the public real estate sector in Berlin, I selected four public real estate companies in Berlin. To ensure homogeneous conditions in my case studies I chose as interviewee's boards, public shareholders, and auditors also working in Berlin.

In grounded theory, open interviews are usually conducted. As my research topic was highly sensitive, especially for people holding important positions, it was difficult to find interviewees, and the people who were willing to be interviewed prohibited any questions on internal company affairs or other investigative questions. This reaction is neither unusual nor surprising. Research on the business world, particularly on the top management, is difficult because of the lack of available sources. Enterprises as a unit are highly protected by law to ensure market efficiency. Therefore, firms are by law protected against full disclosure of company data so as to create an environment most advantageous for their viability. It is companies' free choice whether or not to give insights into their business conduct. In the vast majority of cases, managers are not willing to do this because it gives their competitors an advantage, and disadvantages themselves. Because of my interviewees' reluctance to talk, I chose to conduct semi-open interviews to make sure that important topics were not left out at all, while providing enough room for the interviewees' own input.

When I started planning my research, the former Finance Minister of Berlin, Thilo Sarrazin (2002-2009) promised to obtain for me full access to internal risk reports and complete board minutes of firms. However, after he resigned his successor went back on this promise because he considered the information too sensitive. Risk guidelines, incomplete IT risk matrices and excerpts from board minutes some firms provided were too general in content to be valuable. So, besides the data from interviews, the only additional research material I could use were the annual reports containing management and risk reports of the firms which acted as my case studies.

These have to be published. As a rule they do not provide very detailed information. Fortunately, however, the annual reports of the firms provided some valuable insight into risk reporting practices. Nonetheless, these sources were insufficient to conduct a detailed analysis of reporting practices; this would have required more extensive information on internal company affairs than was available. Therefore, I focused my field research on the viewpoints of the various actors on risk reporting and its control, what issues they encountered, and how their actions impacted on each other. I validated these findings with secondary sources. The field research part of my work was confined to these topics.

The main goal of my research was to draw attention to neglected psychological factors impacting on corporate disclosure distortion in times of stress. Because of the shortage of sources, which limited new field research, this part of my research was based solely on literature analysis. The limited sources led me to confine my main research goal to *starting a discussion* about the normal nature of embellishing or manipulating corporate figures in times of crisis, and how this should be incorporated into risk reporting and control regulations.

It is significant that managers had the opportunity to misrepresent their companies' actual financial situation because of weak control regulations (Skeel, 2006: 151). Top management reporting is only controlled by plausibility checks by auditors (Langenbucher, 2003: 65). Crucially, it is only managers who have access to the most current and complete company data, so it is relatively simple to manipulate data and pass these types of checks.

Nevertheless, controllers are allowed to demand further information or to investigate further. We have also seen that often misrepresentation was suspected long before the final corporate crash and full disclosure of risks. Therefore, manipulation of disclosure was also made possible because insufficient effort was put into monitoring. Boards are the main controlling body of companies, including as regards risk reporting, and they contract auditors for the purpose of monitoring risk reporting. Yet, both are monitors, and in the scandals both failed in their task. Part of the problem, then, is the behaviour of boards and auditors.

As already mentioned, low effort input by agents is well explained by the principal-agent theory. As the effort input of controllers is significant in whether or not disclosure distortion is practiced, I have included them in my analysis. This concerns their attitudes towards risk reporting and control, the nature of controlling practices, and how all the actors involved interact.

Given the assumed normality of protecting one's self-interest, it seems that embellishing or manipulating risk reporting in situations where there is much to lose is normal and not due to particular management hubris, as conventionally assumed. This suggests that the situation rather than the individual is the focus of analysis. As indicated, it can be assumed with some confidence that risk reporting is not such an issue during good times when the news is positive. Consequently, it can also be assumed that the worse the news is, the more challenging their reporting becomes. Therefore, I have confined my analysis to risk reporting specifically in times of stress.

New research (Langevoort, 2000 and 2006, Sunstein, 2000) has found that, especially in these types of situations with uncertain or risky outcomes, people do not always act rationally, but systematically misinterpret situations or do not act on estimations made. These findings point to the relevance of 'bounded' rationality for behaviour in these types of situations. 'Bounded' rationality refers to normal cognitive biases impacting on decision-making and actions which are not pathological even though they are not rational in their nature (not naturally in their use, see Chapter 5).

In this work, I look more closely at these cognitive mechanisms and heuristic means, and how they are likely to impact on corporate disclosure in times of stress. Situating my work in cognitive theory I try to find out which types of reporting and embellishing practices in times of crises are normal and which are not. This new academic contribution is intended to be used to find practical solutions to the weaknesses of risk reporting and control regulations which still exist.

The contribution to knowledge of this research is to start a debate about psychological factors and tendencies influencing risk reporting in public sector companies because this wasn´t done before in research – and to offer potential solutions and reform proposals for risk reporting in public sector companies and improvements of Corporate Governance Code.

Context

In the following section I outline the context of risk reporting and its control in Germany with a focus on public-sector firms, pinpointing the main problems to give the reader an understanding of the relevant matters.

Ever-increasing risk-taking by managers was promoted by the working conditions of chief executives in large companies. Compensation packages designed to produce high returns at any cost gave managers extremely high-powered incentives to focus on the increase of share value (Skeel, 2006). This contributed to their willingness to misrepresent financial affairs to please analysts and investors (Skeel, 2006). In other words, problems of manipulation were caused by a combination of a culture in which risk-taking by executives was linked to reward, together with excessive market competition. This encouraged managers to take ever-increasing gambles.

In public firms, generally, the situation is a little different. Although, in risk reporting scandals, public firms' or banks' high-risk business was pursued by managers for whom these firms had no capability, usually this is not widespread. In public firms, the greatest danger comes from the public shareholder who might push for uneconomical and thus risky business. These types of projects serve first and foremost prestigious or political goals, exemplifying a lack of interest in public firms' welfare by public shareholder representatives. The costs of these types of business are consciously underestimated in the beginning to make sure projects are launched (Lane 2005). For Berlin, one example is the Berlin Brandenburg Airport, the cost of which was severely miscalculated from the beginning of the planning process, even though many voices gave early warnings (Welskop, 2009). Finally, after the project's implementation huge risks developed that were not reported until very late in the day, causing severe financial damages.[2]

Current reforms

The severe financial damages resulting from the risk reporting scandals mentioned above caused wide-spread popular outrage, because they inflicted damage on many individuals. Among other factors, this popular outrage

[2] Handelsblatt, Anon., 2013. **Flughafen Berlin Brandenburg.** Der Geisterflughafen. (23.03.2013). Available at: http://www.handelsblatt.com/politik/deutschland/flughafen-berlin-brandenburg-der-geisterflughafen/7958010.html. [28.03.2013].

successfully demanded stricter legislation because it shook up the balance of interest groups which was in general dominated by the manager and auditor lobby. Both lobbies are reluctant to accept stricter rules, and may even oppose them outright.

In the early 2000s, as a response to seemingly wide-spread rather poor levels of business conduct, particularly in the area of risk reporting, many governments introduced Corporate Governance Codes (CGC) to enforce and strengthen managers' adherence to 'reliable' risk reporting. In Germany a Corporate Governance Code was introduced in 2002.

Reliable risk reporting should prevent huge financial losses and bankruptcies. The establishment – or, rather, the re-establishment - of these norms was necessary to restore trust in the market, especially shareholders' trust whose continuous investments in firms are essential for economies.

The unusual promptness in passing laws was on the one hand due to the exceptionally large scope of scandals and popular critique. On the other hand it was the enactment of the US Corporate Governance Code, the Sarbanes-Oxley Act, in 2002 that pushed the EU, including Germany to quickly introduce similar regulations (Davies, 2006).Corporate Governance reform initiatives already existed before the scandals, but no consensus was reached because of the dominance of the belief that stricter rules and their standardization hamper business because firms need to stay flexible. The scandals neutralized the opposition to pre-existing reform initiatives. Nonetheless, this move was also provoked by former negotiations between the EU and the US over the extraterritorial reach of the Sarbanes-Oxley Act and the allowance of freedom of choice between corporate forms of the countries involved. The EU had a strong interest in making its corporate forms competitive and attractive (for shareholders), and therefore passed similar Corporate Governance regulations quickly.

So, in the end, the scandals were not overly decisive for the formulation of Corporate Governance reforms, and there is no real indication of a change of mind on the part of the lawmakers on this issue. This is reflected by the risk reporting regulations which are still considerably weak and mostly voluntary.

Interestingly, it appears that not only managers and auditors are often averse to stricter rules, but also the state to which the public shareholder belongs. Nonetheless, the main corporate governance reforms enacted in Germany in 2002 included a number of changes (clearly inspired by the Sarbanes-Oxley Act: see Armour and McCahery, 2006:20). Primarily, this concerned the obligatory establishment of risk management and reporting systems. Moreover, it referred to professionalization of boards by including at least one financial expert from the industry, collective responsibility of boards for financial statements including increased liability, rotation of audit partners or audit firms to ensure their independence from the management, and stricter disclosure rules for auditors in the form of a mandatory inspection report.

The voluntary nature of many risk reporting and control regulations proves that establishing business regulations is not at all easy. The argument that firms need flexibility constitutes a widespread consensus in both the business and political world. This is a subject I followed up in my interviews with public shareholder representatives and political board members (see Chapter 7).Some research on the implementation of boards' increased liability for failures showed that the argument that stricter regulations hamper business does, indeed,, have some validity. As one side-effect of boards' increased liability it is feared that they will become risk-averse, which in turn negatively impacts firms' development. In addition, research has demonstrated that the actors in the business world might often be in a strong position to defy regulations, for example disciplines. New research has found that, in countries where boards are increasingly being sued, they were mostly covered by wide-ranging Directors-and-Officers insurance (D&O insurance) (Black, Cheffins and

Klaussner, 2006). Thus, lawsuits had few effects. In countries with fewer and less-encompassing D&O insurances the number of charges was fewer. Consequently, an international comparison of the actual liability of boards revealed that it seems to be at nearly the same level despite different arrangements. One reason for this might be that it is difficult to find agents who are willing to take the risk of being held liable with their personal income, and they demand appropriate D&O insurances. This significantly minimizes the effect of stricter implementation of liabilities.

The fact that where there are fewer encompassing D&O insurances fewer charges occur suggests that there must be some reluctance to sue people who are not sufficiently covered. Obviously, the job market for managers allows people to reject these kinds of work conditions.

All in all, the establishment of effective control of risk reporting is a rather complicated matter.

Structure of the study

First, I explain in Chapter 2 my research methodology and methods and describe the essentials of my grounded theory approach for the field research part of my work. I also describe my field research process including my reflections, to make it clear to the reader how I approached my subject and how I came to my conclusions.

Then, in Chapter 3, I give as a background a brief overview about corporate risk reporting processes and their control, with a focus on public firms. Here I highlight the main issues of regulations for risk reporting and its control (mainly the Corporate Governance Code), as well as the role of the different actors involved (managers, boards, public shareholders and auditors). I focus on the main structural weaknesses of regulations and structural conflicts which impact on compliance to reliable risk reporting and effective control.

After having set the background, I proceed in Chapter 4 to introduce the theory I used to analyse conflicts within firms, namely the principal-agent theory. I am most concerned to highlight how this model theorizes conflicts inherent in contractual relationships because of the dominance of protecting one's self-interests. Besides explaining why and how agents might resort to non-compliance with their contracts I transfer these findings to the specifics of public firms where all actors are agents, which makes this problem there more prevalent than in private firms.

Having provided all the necessary information about non-compliance, I turn in Chapter 5 to my main academic contribution: the impact of psychological factors on non-compliance in corporate disclosure. This chapter is devoted to highlighting how managers are likely to behave in uncertain and risky situations, and how this might influence their reporting practices. Most important are normal cognitive biases for risk assessment and accounting manipulation when losses are feared. In contrast to the principal-agent theory, which assumes that human beings always act rationally, I refer to new research highlighting that 'bounded rationality' in business decision-making in general, but more so in uncertain situations, is more prevalent than conventionally assumed. With this chapter I complete the part of my work where I give the reader an understanding of the context as well as the theories applied, so as to better grasp the findings of my field research.

In Chapter 6 I analyse the annual reports of the companies studied, including their management and risk reports, with a focus on risk reporting practices and their deficiencies. In Chapter 7 I present the analysis of my interviews, focusing on the most relevant topics of risk reporting and its control raised by my interviewees. These topics roughly guided the structure of my work: namely the efficiency of risk management systems and risk analysis, management reporting practices, the perception of the public shareholder being "the biggest risk" for his companies, as well as control practices of boards and auditors.

Based on the findings of my interviews as well as secondary sources I then present in Chapter 8 a rough outline of a theory of action of managers, boards, and auditors in the risk reporting process and its control. From these findings I draw my proposals to solve agency problems for risk reporting and its control in public firms which I present at the end of this chapter. These are followed by my conclusions.

2. Theoretical approach and methodology

Research methodology and methods essentially determine the focus, framework and finally results of scholarly work. Therefore, I introduce at the beginning of my work a short introduction describing how a researcher's world view, the methodology and methods chosen influence research outcomes. New academic standards demand that scholars be self-critical regarding the conduct of their research and its findings. This demands that they engage the reader by providing detailed information about research work procedures. I follow this approach and first outline my research methodology and methods, to give the reader an understanding of how I approached my subject and to make the research process transparent.

Clarity about the academic process is particularly important if grounded theory is applied, because research is based not only on already available literature, but on new field data, which needs an explanation as to how it was generated. With respect to this aspect, transparency of research methods is all the more important as the focus of my work is not yet dealt with in depth either in academia or in practice.

I based my research design also on my personal experiences because, as a manager of a public firm, I am part of the research target group. I briefly present my experiences to make clear how they influenced my research and contributed to the development of the interviews (see 2.3.). This *a priori* knowledge was helpful as my interviewees were sometimes reluctant to talk about their own experiences frankly and critically because they did not want to implicate themselves. So, in this chapter I introduce my research methodology and methods for the field research part of my work for which I used a grounded theory approach. In my work I used a mixed approach combining grounded theory - generating data on the perspectives of managers, public shareholders, boards, and auditors of risk reporting processes and their control and the problems encountered - and a psychological approach based on literature research. I decided on a mixed approach because field research on the impacts of cognitive mechanisms on corporate disclosure would have needed the consent of participants to get deep insights into the internal affairs of companies as well as of political board members and public shareholders. This kind of willingness is extremely hard to find in the business and political word because the secrecy of internal affairs is strictly guarded. Because of the limits on research – managers declined in advance to answer inquisitive questions – I do not conduct a detailed analysis of their risk reporting practices. Rather, based on the findings of my interviews on the interviewees' viewpoints on risk reporting and its control, in combination with secondary sources with a focus on psychological theory, I want to start a discussion on normal behaviour impacting on these processes.

There are no ethical reasons to be considered in this research. I am not working with people who need special protection. All interviewees and companies are anonymized. All material (sources, interview transcriptions and corporate disclosures) is saved on password protected computer and therefore save.

2.1. World view and research approach

The term methodology describes a set of methods. In this study, it refers to the underlying principles of the conduct of my scientific inquiry. Generally, it is the researcher's belief about the nature of knowledge and the criteria for validity that determines the chosen methodology and methods (MacNaughton, Rolfe and Siraj-Blatchford, 2001:32).

Methodology specifically refers to the analysis of how research should or did proceed (see for the following Blaikie, 1993:6-7). This includes how theories were generated and tested, what they looked like, and how their particular theoretical perspectives enlightened particular research goals. Thus, methodology deals with the specific logic of explaining reality. This in turn concerns epistemology, the theory of knowledge and its production. In other words, epistemology defines the assumptions of the researcher about ways in which it is possible to gain knowledge. In turn, the applied theory about the production of knowledge, the accessibility of reality touches on the question of which world view the researcher has - how he perceives the constitution of reality, how it can be made comprehensible and to what extent it can claim objectivity and truth.

In this study, I did not want to enter into philosophical debates about the rather complex issues of claims of objectivity and (single) truth; this is a topic that requires a different scholarly focus and scope. Instead, I was interested in finding practical solutions to my research problem. Nevertheless, because the chosen methodology and perception of social reality affects research outcomes, I give below a short overview of my conceptions of objectivity and the social world.

In economics, the discipline I come from, until very recently the theoretical approach of positivism (developed in the early 20th century) was still prevalent. Very briefly, positivism in social sciences holds as its main premise that there exists one objective social world (reality) that is governed by universal laws similar to the natural world (for the following see Blaikie, 1993:126). Furthermore, positivists (including classical economists) claim that laws are objectively observable by researchers and that their explanation is neither influenced nor interpreted.

Because of these basic assumptions about the social world and its explanations, positivism was sometimes referred to as 'scientific method' or 'science research', "based on the rationalistic, empiricist philosophy that originated from Aristotle, Francis Bacon, John Locke, August Comte and Immanuel Kant" (Mertens, 2005:8). It is widely regarded as reflecting "a deterministic philosophy in which causes probably determine effects or outcomes" (Creswell, 2003:7). This basic assumption of positivism, that the social world can be studied in the same way as the natural world, implies that there is a method for studying the social world that is value-free. Thus, positivists argue that explanations of a causal nature can be provided (Mertens, 2005:8). From that it follows that positivists aim to test theories through observation and measurement in order to predict and control forces that surround social actors (O'Leary, 2004: 5).After World War II, stronger criticism of the positivist approach emerged (Mertens, 2005). I summarize the main arguments of the positivists' opponents, but do not go into deeper detail as this is beyond the scope of this work (for the following see Halfpenny, 1982).

One of the main criticisms of positivism targets its perception of a social world and social "facts". Critics of positivism principally argue that an objective social world does not exist 'out there', independent of actors. Instead, they maintain that the social world (or more precisely in the plural, social worlds) is a product of human consciousness. Thus, social "facts" are socially (and historically) mediated and essentially a *re*presentation of the social world. This proposition also implies that there is no single form of mediation. By this argumentation the positivists' critics strongly doubt the positivists' claim that there is a single truth. Instead, they advanced their perception that the social world is a product of socially and historically mediated human consciousness. Consequently, critics accuse positivism of ignoring the role of the researcher, i.e. the observer in the process of the constitution of social reality; according to them, this results in the specific historical and social conditions affecting the *representation* of social ideas being ignored.

The context in which these criticisms developed was an increasing elaboration of the social sciences together with increasing dissatisfaction at the predominance of positivism in the social sciences, mainly from the 1960s on. Positivism's claim to truth and objectivity is a rather conservative stance regarding the development of sociological theories. After World War II (and more so in the 1960s), the desire emerged among many social scientists to challenge existing social structures. This was accompanied by a more critical understanding of the social world and the emergence of more elaborate methods of studying society. Thus, these new developments challenged the hegemony of positivism.

A ground-breaking book was Thomas Kuhn's 'The Structure of the Scientific Revolution' (1962). His main arguments were that theories are provisional and thus change. Indeed, the whole theoretical framework of theories could be challenged by new understandings. This argumentation strongly advocated that theory highly influences or even determines the outcomes of research. This included not only the specific theory applied. Indirectly, it also referred to theories in general as they might have some influence on the perceptions of researchers (Cook and Campbell, 1979:24). In contrast, emerging post positivists - very broadly speaking - pointed to the world as being ambiguous, variable and multiple in its realities. For them (though to different degrees) "... what might be the truth for one person or cultural group may not be 'the' truth for another." (O'Leary, 2004: 6).

In contrast, most post-positivists advanced a more holistic research approach by considering the multiplicity of perceptions and observations of the (same) social world (O'Leary, 2004: 6-7). However, post-positivism remained distinguished from post-modernism and relativism which emerged in the 1980s. Taken to the extreme, the latter holds that the social world might not be observable as a whole. Hence, truth cannot be established because there would be always something missing in the picture. Further, and quite importantly, there are no adequate theories to objectively observe and analyse 'the' social world(s) as the 'logics' of the theories would always be tainted by the 'biases' of scientists (O'Leary, 2004: 6-7).

In short, it was acknowledged that causality in the social world is always contingent as opposed to the natural world (Johnson and Duberly, 2000: 32). This perception spread widely in the social sciences. Even Popper, who was a defender of scientific inquiry, held to the 'uncertainty' principle that called positivism into question (Crotty, 2009: 29). As there would be never an absolute accuracy in research results, future developments would not be predictable (Crotty, 2009: 30).Additionally, 'the observed' depends to a greater or lesser extent on the 'observer' (Crotty, 2009: 30). From this Kuhn concluded that it is not appropriate for social scientists to submit to theoretical concepts because these set boundaries to research (Crotty, 2009: 30). Instead, he held that social science was "more sloppy and irrational" than its methodological image suggested. According to him, there is no 'objective existence' of a 'meaningful reality' that is value-neutral, a-historic and cross-cultural.

By criticizing the current use of social sciences Kuhn as well as Feyerabend did not reject science in its totality (Blaikie, 1993). Rather, they called on researchers to be more flexible in their approaches; not to adhere to 'one right way', but to use theoretical concepts more creatively.

I followed their critique of social sciences using theoretical concepts and methods in a rather eclectic way as I indicated above and demonstrate below. Additionally, I followed their premise that a detailed description of research processes including problems arising is necessary to justify the logic and validity of research results (see below). Before I turn to this description, I introduce my understanding of social reality as this greatly influences the way the researcher studies his subject.

Although I acknowledge that society is interpreted by researchers, I hold – similar to the realist school - that social reality exists even if not all aspects are always observed (Blaikie, 1993: 58). Broadly following mainstream realism, I emphasize that society is both produced *and* reproduced by its members and is therefore a *condition* (i.e. a reality) and an *outcome* of their activity (Blaikie, 1993: 59). These members of society are "products" of their history, experience, traditions and knowledge. Therefore one information can create different and multiple truths for different people – which is not predictable. It is my premise that, in contrast to the natural world, the social world is constituted by subject-subject relationships, not by subject-object relationships. In consequence, though social reality is interpretive, it is still accessible if the researcher is conscious of the methodology and methods used and makes them transparent. I made my philosophical background clear and transparent. Therefore the reader is able to understand and handle my research outcomes. And my subjective understanding of social reality leads me to qualtitative research and further to grounded theory.

Furthermore, research is enriched by carefully considering the broader context, i.e. the use of a variety of data and perspectives on the subject. Therefore, in my research I interviewed not only one group, but all the groups involved in the risk-reporting process. Moreover, a closer look at the language used by the interviewees to grasp the meaning attributed to the interactions and things in focus completed the picture of the analysed social reality. As the theoretical premises I present show, I broadly locate myself in a paradigm which is open to multi-perspectivity and a variety of methods. Reality is not only multi-perspective but also processual. Therefore, the chosen research methodology followed this paradigm, as grounded theory decidedly does (Strübing, 2008: 39; for grounded theory see below).

The "form of knowledge" produced by investigations depends on the theoretical approach applied, I chose an empirical-analytical approach leading to technically exploitable knowledge (Blaikie 1993: 53-4).As summarized by Blaikie, Habermas defined the principal premise of the empirical-analytical approach that human social existence is based on 'work', i.e. the ways in which individuals control and manipulate their environment in order to survive (Blaikie 1993: 54). Therefore, this approach was appropriate to study how risk reporting was influenced by defending and negotiating conflicting self-interests between managers, shareholders and board members, and auditors.

2.2. Field research: Methodology and methods of Grounded Theory

As already indicated, I opted for a rather eclectic set of methods and methodology. The main reason why I chose grounded theory for part of my work was that I knew from my own experience that some aspects of the problems and challenges which CEOs encounter in reliably fulfilling their risk-reporting duty have not yet been studied in depth, or have been neglected. So it was my aim to generate new data to contribute to the discussion risk reporting in public sector companies. Therefore, conducting in-depth interviews which were sufficiently open to explore underlying problems of managers as well as of the other groups are a useful tool to detect issues and conflicts influencing agents' behaviour and motivation. Grounded theory offers a methodology that is first and foremost based in newly-generated empiric data and not in established theories, so, it provides suitable methods, e.g. qualitative open interviews or observations, to explore as yet neglected aspects of 'social reality'.

Grounded theory was developed in the late 1960s mainly by Strauss and Glaser against the background of the dominance of positivist methods in the social sciences (Blaikie, 1993: 191). Interpretive methods were still in their infancy and more or less descriptive. For that reason both scholars tried to overcome the lack of dynamic in theory development by emphasizing the importance of data as a source for theory, rather than vice versa. In short, grounded theory, in its early stages, asked the researcher to collect data without having first chosen a theory or theoretical framework. The reason for this strict approach was to achieve the highest possible degree of objectivity on the part of the observer so that he would not be influenced *a priori* by any theories or favour certain perspectives while disregarding others.

The process of theory generation

Glaser and Strauss (see Glaser and Strauss, 2008: 47) dealt mainly with problems of theory building, particularly relating to issues of adaption, relevance, force and richness. Both scholars believed they could contribute to solving these problems through grounded theory.

As already indicated above, in the early stages of grounded theory development they advised radically ignoring any literature on theory as well as former case studies at the start of research. By this means they intended to ensure that researchers would look for new aspects, indicators and explanations. In short, grounded theory's main goal was to generate, not to test, theories. By grounding the development of theories in newly collected data Glaser and Strauss tried to effectively solve one of the major problems of social sciences, the gap between theory and practice. For that reason, theory testing was not their main goal; rather, they stressed over and over again that theories were always changing as their subjects, the social world, did. Continuous change also implied that scientists have no lasting authority, but have to submit to possible refinement by new research.

The first step in theory generation is to collect as many different pieces of data as possible. This process should be open to all sorts of data and perspectives on the subject matter to ensure the richness of the theory (Strübing, 2008: 30). From the collected data, concepts must be formed (Glaser and Strauss, 2008). Importantly, scientists should develop different concepts and synthesize them on as many levels as possible to reach the most complete picture of the topic. By this method Glaser and Strauss aimed to avoid one major pitfall of theories, namely the assumption that pure concepts exist in reality.

The focus of grounded theory is on research concepts which emerged during, not before, the research process. Ideally, no research agenda and research questions are to be formulated *a priori* (Glaser and Strauss, 2008: 46). Glaser and Strauss wanted to ensure that fieldwork was the only source from which the most relevant concepts would emerge.

As a first step the concepts which emerged should be formulated rather generally. However, in their significance to the research topic they had to be specific. Then, they should be analysed with regard to if and how they were relevant to theory (Glaser und Strauss, 2008: 46).

In the second step, similar concepts should be grouped into categories. At that point it is permissible to examine existing theories if they fit the categories which have emerged, not vice versa. This is also the last stage of research, the phase of generating a theory by looking for different explanations. Glaser and Strauss called this 'qualifying' the relations between the categories (Glaser and Strauss, 2008: 45-6). This refers to extracting the specific qualities of categories. The goal is to 'integrate' the theory, i.e. to connect the different levels of the different hypotheses (in my work, how they contribute to the research question) – thus fostering multi-perspectivity. In my study this meant connecting the various perspectives of and on management, shareholder, board, and auditor (Glaser and Strauss, 2008: 50). Multi-perspectivity and abduction are tools for finding the most relevant theories. Especially Strauss emphasized the value of interviews in generating new -maybe even unexpected - information that would foster new ideas. As already mentioned, for Glaser and Strauss it was most crucial to avoid the formerly (and even current) shortcoming of social research practice to 'fit' collected data to theories and thus distort social reality (Glaser and Strauss, 2008: 46).

For the choice of concepts, Glaser and Strauss (2008: 48) laid out some main criteria. On the one hand, concepts should be specific to the extent that they were able to describe the *main* characteristics of the research or data units. On the other hand, their specificity had to allow their transference to other research and should not be limited to the specific research topic. Furthermore, the reader (not only specialists) had to be able to make sense of the research and its explanations (Glaser and Strauss, 2008: 48). Therefore, one important criterion for the choice of concepts was their ability to 'sensitize'. This means that, ideally, the research had to be made so vivid that the reader is able to 'imagine' the issues through his own experience.

With these research criteria Glaser and Strauss aimed to engage the ordinary (and sometimes only imaginary) reader in the scientific process. Consequently, they opened up social sciences to the public and to greater scrutiny than before. To ensure this goal, they advised against developing too many theories so as not to neglect the 'sensitizing' aspect. In other words, they cautioned against too much theorizing, as this would not help to get a clearer picture of social reality (Glaser and Strauss, 2008: 48).

Hence, the research process of grounded theory is mainly characterized by simultaneous and interactive collection of data, forming of concepts and categories, and generating the theory. The dissolution of separate research stages distinguishes grounded theory from 'traditional' research methods (Strauss, 1991: 34).

Practical example – how did I generate and developed my data:

During my first CEO Interview the interviewee (see Chapter 7.1, from Page 174) explained, that risk reports are discussed with the board every 3 months. The information in this sentence can be coded (according to Grounded theory) in two parts.

1. Risk report every 3 months to board

2. Reports are discussed with the board.

This part-information has to be noticed not only in the interview transcription but also in the memo written beside to organize all data.

The data 1 (above) can be compared with literature by the Corporate Governance Code. What does it mean to the research topic / question? Is it timely enough? Is a period of 3-months for risk reporting suitable? It is.

In a later interview with a CEO I was told that reports are presented to the board. From these I have to go back to data 2 (above). Is presenting or discussing the suitable kind of interacting with the board about risk reporting? The literature informs us to discuss with the board – presenting and "waiving through" is not good enough.

This data informed the concept "communication between management and board". Together with the concept "involvement of the board" it developed to the category "Communication between management and board".

The above showed breaking-up of sentences / information into data (coding) and triangulation of this with literature and (if possible with the case study outcomes) the data can be analysed. How does this data inform the research goal or research question (selective coding).With the triangulation of data the interview outcomes can be verified and the validity of research outcomes can be increased.

Practically I did 2 triangulations:

- Between the interview-outcomes of the different stakeholders in the process (about one topic / aspect) like CEO, board, auditor and shareholder
- Between the different sources (interviews, Literature and case studies)

The research process:

Interviews, Lit-Research and case studies were done at the same time as an interactive process. The case studies were done for the companies, which

CEO´s or RM´s were interviewed. Personal reflections of the interviews were taken and Memos written to organize the outcomes.

The iterative Process (incl. Theoretic Sampling): I started with some general questions (see line Interview 0 in table below). After the very useful first interview I modified and added questions due to the information I got and to follow upcoming concepts (from the gathered and sorted data), categories and theories. I also did the Lit-research with focus to the upcoming information and the analysed the case studies due to the former outcomes. For new concepts and categories I stepped also back to the "older" interviews and data to check. <u>The upcoming concepts and categories were elaborated and refined and therefore guided the further process</u>. I followed these concepts / categories until they were saturated and no new concepts emerged. Later interviews confirmed the data (esp. the Shareholder-representative from the government). For detailed information coming up see Chapter 7.1, for the interactive process and category development see table below.

The Triangulation brought all outcomes together and sets interactions, reflects the outcomes, qualifies and samples them.

Interview			**Lit-Research**	**Case Study**	**Special outcomes of Triangulation**
	Discussion / Interview-Topics / Concepts occur	Categories			
0	experiences of changes after the introduction of the Corporate Governance Code		P.-A.-Theory and grounded theory (esp. Martimort, Glaser & Strauss, Strübing)	None	
1 Board HW	'the public shareholder's risk attitude towards his companies'	The public shareholder being "the biggest risk" to his companies. (topic turned out to be so important that I followed it up	P.-A.-Theory, Risk-Reporting, Psychological impacts (esp. Martimort, Lane,	None	Interview shows Status quo-bias
	internal conflicts on part of the public				

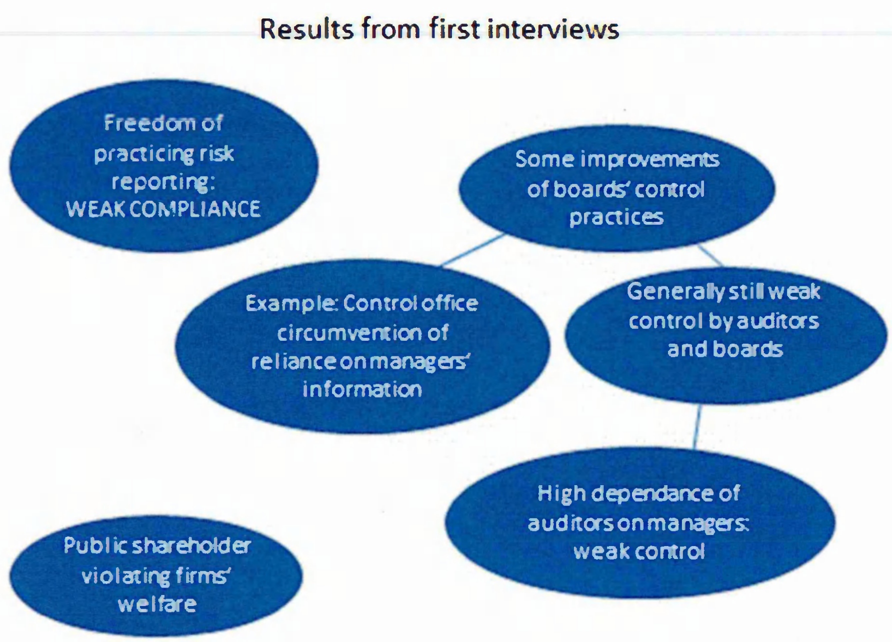
	shareholder	until the 8th interview when the category was saturated)	Langevoort, Kahneman and others)		
	No consensus among public shareholder representatives on clearly defined business goals				
	Lack of coordination of decision-making power				
	collusion between managers and auditors in embellishing	Collusion between managers and auditors in embellishing (topic turned out to be so important that I followed it up until the 8th interview when the category was saturated)	P.-A.-Theory, Risk-Reporting, Psychological impacts Low effort input by boards to control		
	Auditors control practices				
2 RM KJ	organization of risk management and reporting systems risk analysis methods	Risk reporting practices (it was impossible to ask direct critical questions. Subject was taken up in connection with related issues until 8th interview)	P.-A.-Theory, Risk-Reporting, Psychological impacts	Done	Case Study shows overoptimistic reporting, Report showed “smoking gun” – a revised corporate disclosure 3 months after the interview due to not reported legal / financial risks
3 Board JH	Communication between managers and boards/Boards' control practices	Communication between managers and boards/Boards' control practices	Risk-Reporting, Psychological impacts	None	Interview shows psychological impacts to distort corporate
	Involvement of the board / liability				

		(followed up until 7th interview)			disclosure
4 CFO CB	Discussion of concepts above, saturating	Informed the concepts above	P.-A.-Theory, Risk-Reporting, Psychological impacts	Done	
5 Auditor WW	Discussion of concepts above from the view-point of the auditor	Informed the concepts above	P.-A.-Theory, Risk-Reporting, Psychological impacts	None	
6 CFO JM	Discussion of concepts above, saturating	Informed the concepts above	P.-A.-Theory, Risk-Reporting, Psychological impacts	Done	
7 Auditor TK	Discussion of concepts above from the view-point of the auditor	Informed the concepts above	P.-A.-Theory, Risk-Reporting, Psychological impacts	None	Interview shows Status quo-bias
8 CEO UK (Bank)	Discussion of concepts above, saturating	Informed the concepts above	P.-A.-Theory, Risk-Reporting, Psychological impacts	None	Interview shows "smoking gun". Corporate disclosure had to be revised after banking control audit.
9 Shareholder DS	Discussion of all topics above from the standpoint of the shareholder	Informed the concepts above, Shareholder is not interested in standardization of risk reporting	P.-A.-Theory	None	Interview showed very strong biases (Status quo)
10 CEO US	Discussion of concepts above, saturating	Informed the concepts above	P.-A.-Theory, Risk-	Done	

			Reporting, Psychologic al impacts		

One further important aspect of grounded theory is constant comparison of findings by continuously looking for new data until the topic seems to be ‘saturated’ or ‘replete’, i.e. no new results are to be expected. I followed my upcoming concepts and later categories during the interview unless no new data came up – then these concepts or category was saturated. Glaser and Strauss (2008: 53) called the comparison of research results ‘theoretical sampling’. Its goal is to add to and broaden existing knowledge.

After concepts were found and saturated I analysed and draw relationships between concepts to develop categories and understand their interaction. By qualifying the relations between categories theories are generated (see at least the assumption in the theory of action Chapter 8.1). As an example please sees the following picture (which only shows a small part):



The emphasis on comparing data from a wide variety of sources resulted from the goal of finding the right indicators and not simply and uncritically transferring indicators from former studies. Thus, Glaser and Strauss (2008: 46-7) tried to educate researchers to be critical of established social sciences and not to seek 'direct', simple explanations. In essence, they tried to instil a critical consciousness in social scientists not to take things for granted, but to consider as many perspectives as possible, including ones that did not occur to the mind at first glance.

In consequence, they suggested some 'slowing down' research processes by not immediately adopting a research paradigm as this is likely to pressure scientists to 'fit' their data to the selected theory. Instead, categories and their characteristics should be tested with different cases and different evidence. However, even though Glaser and Strauss (2008: 49) advocated anchoring hypothesis in empirical material, they also cautioned against collecting material in an encyclopaedic way, as they associated this with the goal of proving a theory. Instead, they pointed to the danger of extensive data collection constricting the generation of new hypotheses. Indeed, data collecting should focus on looking for new perspectives that would alter and develop theories.

As Länisalmi, Peiró and Kivimäki (2004: 242) summarized the grounded theory approach it does not aim to present a 'perfect description' of the research area. Instead, its goal is to develop a theory that accounts for much of the relevant behaviour influencing the subject matter. However, data should be from as wide a variety of sources as possible to guarantee that the most significant factors have been sorted out. Typically, interviews and participative observation are used as data sources. For the purpose of investigating 'real problems', i.e. from the 'real world', both are highly valuable sources (Länisalmi, Peiró and Kivimäki, 2004: 242).

The process of data collection and coding should have gathered a variety of perspectives on the research topic. After cohesion between the various concepts is drawn, the selected data must become more specific. Then, this data has to be based on the hypotheses (in my work how the data contributes to the research question) to test their validity (Strübing, 2008: 31). This process is called 'selective coding'. It aims at closing gaps in already generated hypotheses as well as testing them (Strübing, 2008: 31). Although new cases are compared, it should be primarily old data that is reanalysed by drawing from newly developed findings (Strübing, 2008: 31).

The process of sampling is highly interconnected with the process of 'saturating' the theory. For comparative analysis in its early research stage, fairly homogenous cases are to be selected. At the point where apparently no further characteristics of concepts and categories can be added, differing cases have to be selected to prove the saturation of concepts and categories (Glaser and Strauss, 2008: 68-9; Strübing, 2008: 32).

However, it cannot be overemphasized that the process of comparison and saturation is not oriented towards falsification or new formulation of the generated theory. Instead, the grounded theory approach holds the premise that different concepts and categories do not necessarily exclude each other; rather, they are coherent. Consequently, *all* findings have to be integrated into theory (Strübing, 2008: 32-3). Thus, the principal focus of grounded theory is on generating and not testing theories (Strübing, 2008: 32).

This definition of sampling and saturating a theory had a huge impact on the claim of representativeness or validity of theories. It is noteworthy that in regard to the claim of representativeness, grounded theory distinguished itself from other disciplines of humanities such as statistics. For example, the latter claims their random sample is representative for the population. In contrast, grounded theory is concerned with 'conceptual representativeness' – not with some sort of detailed predictability (Strübing, 2008: 32). Therefore, for comparison, cases are actually not selected for their persons or organizations, but for specific situations and the context of their emergence (Strübing, 2008: 32).

From that it follows that Glaser and Strauss (2008: 51) understood the term 'verification' in its rather extreme sense, namely as being the final theoretical explanation. They instead wanted to assert that all research is an ongoing, open process which is not final, even after the publication of a work (Glaser and Strauss, 2008: 50). This radical understanding of 'verification' was influenced by the origins of grounded theory to challenge the former hegemony of positivism and other established social theories (see above). Hence, testing and verifying theories rank rather low in grounded theory. Indeed, it was Glaser's and Strauss' main interest to highlight that social reality and social sciences are open and non-teleological processes. In consequence, methodology and methods to study the social world have to be adaptable to changing 'reality', which was taken by that time often enough to be more or less static. Glaser's and Strauss's motivations regarding this change in social sciences can be traced back to their desire to be interested foremost in reality and not in the refinement of theories in and for themselves.

The pioneering spirit of Glaser and Strauss is further revealed by their demand to be (critically) selective when 'saturating' categories. Only the most relevant behaviour should be in the focus of research, so only those types of behaviour have to be categorized. Equally, the saturation process has to follow this prioritizing principle by saturating the key categories the most thoroughly (Glaser and Strauss, 2008: 77-8).In this context, deep saturation meant that it was not sufficient to compare one single event. Instead, ideally, dozens of situations in different cases had to be compared to saturate a theory (Glaser and Strauss, 2008: 69-70).

In grounded theory, concepts remained relatively constant, even if the underlying data and facts might change. The essence of grounded theory is to reveal new perspectives and causalities, so the focus is on the categories and dimensions newly developed, not on the - or rather all the - specific data collected. For this reason, for Glaser and Strauss it was not a major challenge when it happened that some data was not proper and did not 'fit' the categories. As already mentioned several times, they were interested in the development of categories and dimensions, not in an exact or numeric validation of existing theories (Lamnek, 2005: 104).

Moreover, verification of theories was not Glaser's and Strauss' primary aim, because this would have needed a solid database and extensive data collecting. Instead, Glaser and Strauss (2008: 47) concentrated their data collection on the data relevant to the categories, to keep the focus on theory development. Thus, they limited verification for grounded theory to relatively few, but the most significant, regularities and variations in their cases which are allocated on the same conceptual level (Glaser and Strauss, 2008: 47).

In short, theoretical sampling (and saturation) has to be open, and not have the goal of testing and modifying the findings already made; it has to innovatively find out 'what the "real" is really like' (Glaser and Strauss, 2008: 47). This does not suggest that theoretical sampling cannot be evaluated according to its value; on the contrary, theoretical sampling is measured by looking at the cases the researcher selected; how far they differed and on what different grounds they were selected.

Those selections of compared cases are the criteria on which the range of the generalization of the theory can be based (Glaser and Strauss, 2008: 64-5). To put it another way, according to Glaser and Strauss (2008: 64) maximum difference defines the range of the theories' validity. Ideally, the process of comparison is only concluded after the research is finished. In contrast to conventional verification of theories, researchers of grounded theory cannot plan the number or kind of cases or groups beforehand (Glaser and Strauss, 2008: 58).

Range of grounded theory

Later, Strauss revised his work by according verification a greater role in the research process. Thus, this process encompassed a three-stage cycle: induction, deduction and verification. Nevertheless, by verification he simply meant plausibility of the theory as well as practical functional capability. He also diverted from the former view of a rather radical simultaneousness of the three phases. Later, for him, those research stages are separated. However, it is a process of chronologically increasing phases, with some switching allowed (Strübing, 2008: 73-4). In contrast, for Glaser verification remained not even a necessary part of the research process. Indeed, he believed that verification as a research goal would hamper the objectiveness of the researcher for a new cohesion and coherency of categories, i.e. new theories. In addition, he was rather reluctant towards extensive description of phenomena. In fact, he feared that this would negatively impact on finding relevant indicators. Indeed, researchers would be highly tempted to 'fit' their data to established theories and thus undermine the main principles of good scientific research (Strübing, 2008: 75). In contrast to Strauss, Glaser constantly refused to systematically test his hypotheses, as he interpreted this as being not in line with the spirit of grounded theory (Strübing, 2008: 75).

In summary, grounded theory has four main goals: modifiability of theory, fit, relevance and workability. Modifiability means that the theory has to be able to integrate all possible varieties of action. All varieties were used to enrich and refine the theory, not to falsify it. Thus 'modifiability' replaced the traditional validity. 'Fit' refers to how closely concepts fit the behaviour they described. 'Relevance' signifies that the generated theory has to serve major practical and not academic concerns. 'Workability' of the theory is measured by how much variation the theory could explain (Strübing, 2008: 74).

As demonstrated above, the pioneers of grounded theory were in the early stages of theory development rather cautious about integrating knowledge *a priori* into research, as they feared that this would hamper the creativity of generating new theories. Later however, Strauss acknowledged the positive contribution of *a priori* knowledge, whereas Glaser remained reserved towards it (Strübing, 2008: 59).

However, it has to be noted that is a rather difficult, if not impossible, task not to integrate or be influenced by knowledge the researcher possessed before the conduct of the study (Strobl and Böttger, 1996: 23-47; Kelle, 1996). Indeed, both Glaser and Strauss (2008) essentially acknowledged this fact and Strauss revised his former radical viewpoint on this issue. As already indicated above, the most appropriate solution for this issue in research (that in fact was and continues to be an issue) is that researchers must be highly aware and critical of their *a priori* knowledge, including any possible bias (Glaser und Strauss, 2008: 44).According to Glaser and Strauss (2008: 44-5), an inter- and trans-disciplinary approach promotes critical thinking, as new explanations and combinations of concepts are made accessible and possible. At the time grounded theory was developed, social theories in their current variety and interdisciplinary borrowing did not yet exist. Hence, in the past researchers might have felt more tempted to 'fit' their data to the existing body of established theories – a situation Glaser and Strauss (2008: 44) objected to.

In this study, I have followed the spirit of grounded theory by drawing from different social disciplines and approaches. My combination of post-positivism with grounded theory and psychological approaches is one example. Furthermore, to understand and explain the motivations and behaviour of the actors involved in risk reporting I have applied concepts from sociology as well as from economics, political science and cultural studies to analyse why distortion or manipulation in corporate risk reporting not infrequently occurred even though reporting regulations seemed to be sufficient in number.

2.3. Conducting the interviews

With respect to the influence of my prior extensive knowledge on my objectivity as a researcher I followed Strauss, who later recognized the positive contribution of *a priori* knowledge. Especially with regard to my research topic, I emphasize the validity of this view, as researchers until recently did not focus or touch upon many significant problems of risk reporting in the public sector that I experienced. For my *a priori* knowledge it is also noteworthy that Strauss did not discriminate between academic and everyday knowledge. The attribution of equal value to both forms of knowledge results from his goal of studying 'real' and practically relevant issues as well as from his concept of knowledge as being one of continuity (Strübing, 2008: 59).

A priori knowledge

My long-term work experience (eighteen years in the banking sector plus ten years in public firms, for six years of which I was a CEO) greatly informed the hypotheses I started with. Until recently, the vast majority of scholarly works neglected or even disregarded some issues of risk reporting in the public sector as I experienced them. Therefore, I give a brief account of my experiences to provide a better understanding of the subject's main issues and my *a priori* knowledge.

In risk reporting processes, risk reports are in general compiled once or twice a year. At that time, risk managers feed the data into the IT-system and assess risks quantitatively. This information is aggregated in one place and then discussed with the management. Only after the management has approved the data is the risk report sent to the board and shareholder.

I found that, generally, risk reporting is a task which is additional to the general workload. Therefore, risk assessments are often completed rather fast and not much effort is invested in them. Most of the time risk managers do not confer with other employees, superiors or auditors about risk assessments even though this might be useful, as risk reports from the various departments are reported at different times, but have to be set in relation to each other.

In my experience, risk managers in general concern themselves only with risks specifically requested by the IT-system, not new risk items. Most software also does not allow new risk items to be added. In my experience, making IT-systems more adaptive is not the foremost concern of many firms. Furthermore, to simplify risk reporting, the software is often programmed simply to approve the previous year's risk assessment. I found that this could tempt risk managers just to confirm quickly the previous risk estimations. As my interviews also revealed, employees are generally reluctant to report risks or assess them cautiously because this would point to own failures and they would have to justify themselves.

If risk assessment is perceived as an additional and unpleasant task, one main demand of best practice in risk assessment, i.e. long-term strategic thinking, is highly likely to be missing. This type of thinking is all the more important as risk assessment is complex and it is difficult to reach accurate prognoses. Risk assessment is also highly subjective because parameters are defined by risk managers and this is highly flexible. Therefore it is relatively easy to embellish prognoses (see Chapter 6 for the companies studied).

I observed frequent underestimation of risks; this is also due to business constraints to maintain a positive image of the firms and accounting law that does not allow to set too many accruals for risks aside so not to face over-indebtedness. Keeping a positive outlook on the firm's prospects is a dominant trait in the business world (see Chapter 5). In general, scepticism about business strategies or projects is suppressed, so even when risk managers do not underestimate risks, cautious risk assessment is often discouraged by the management. I experienced several cases where risks reported by risk managers were not included in the final risk report. In one of these cases the risk manager responsible was even suspended from work and fired.

One main problem then remains: that the management has considerable influence on the way risk reporting is conducted. They can easily implement their specific risk culture as part of the company culture because they have sole access to the most current company data. This behaviour is supported by the legal flexibility in the assessment of provisions for risks and cumulative adjustments (Balaciu, Bogdan and Vladu, 2009).

The special problem in public firms as opposed to private ones is that the owner does not lose his own money. My interviews, the literature as well as my own experiences point to lower risk consciousness on the part of the public shareholder. Even in crises, public firms may be restructured, but not dissolved. This has led to the widespread perception that risks cannot really endanger public firms as the state will provide the necessary financial aid. What will be lost is only state money, not one's own money.

From my experiences I can say that risk assessment is often done with lower-effort input as well as a tendency to underestimate risks. This attitude is also supported by many managers and in the case of public companies also by many public shareholders. It seems there are already many regulations in place; however, risk assessment, the basis of risk reporting, remains highly subjective and prone to manipulation so that best practice in risk reporting is not guaranteed.

Although my extensive knowledge about risk reporting informed the research questions I started with, I made sure that they did not influence and direct my field search by asking my interview participants open questions. However, I used semi-open interviews to ensure that interviewees would indeed talk about important topics. As it turned out this was helpful because most of them were reluctant to talk critically about their own actions and motivations in the risk reporting process or the control of it. I also validated not only the respondents' statements but also my own assumptions through the firms' annual, management, and risk reports as well as literature and press articles.

Selection of interview participants

As risk reporting processes consist of interdependent interaction between mainly three parties (management, boards, and auditors), I focused on the structure of these interactions and how they influence each other to depict the dynamic of this process. The most appropriate way to find out about the stated research goals was to conduct personal in-depth interviews with representatives of these actors. To model these relationships I used the principal-agent model which is frequently applied to analyse contractual relationships between the owner and management of firms. I decided on this model because of its ability to analyse conflicts of interest and conflicts between the different actors involved in risk reporting, and its control as well as violation of their contracts were in the focus of my analysis.

At the beginning of the planning of my research project the former minister of finance of the state of Berlin, Thilo Sarrazin (2002-2009) agreed to support my research by providing internal risk reports and complete board minutes of public firms. He also promised to make sure that interview participants of public firms and the senate administration were available. On the basis of these specific and detailed documents I intended to follow up main issues with the appropriate people in charge. In 2009, this minister of finance resigned from his position. Unfortunately, his successor cancelled the agreement, arguing that internal risk reports and complete board minutes contain information which is too sensitive. It should be noted that the former minister of finance is an exceptionally controversial figure who likes to provoke public discussions even about taboo subjects. My research topic certainly started to cause some discussions in the public in the course of some larger risk reporting scandals. However, it was still a taboo, and most politicians were more than reluctant to talk about this subject so as not to implicate themselves.

After the refusal of the new finance minister I approached public firms by myself. Some agreed to hand out risk reporting guidelines, risk matrices (unfilled), and occasionally excerpts of board minutes. It turned out that all these sources were of a highly general content. Obviously, even public managers did not want to give out material on their risk reporting practices. Given the limits of the available primary written sources I changed my intention to scrutinize the specific process of risk reporting practices to the viewpoint of the different groups participating in risk reporting or its control (managers, shareholders, boards, and auditors), connected issues and the interaction of these groups. The only valuable written primary source on firms' risk reporting remained the annual report containing management and risk reports, because it has to be published by law. Although this report might be in general of low information value because all the data is already matched, it turned out that its analysis produced some useful insights.

To ensure homogeneous conditions I chose public firms belonging to the same industry and the same shareholder. So, all the public real estate firms studied belonged 100% to the public shareholder in Berlin. Six such firms exist. Eventually, four of them agreed to an interview. The fifth firm withdrew its consent just a couple of days before the appointment. The sixth firm declined from the beginning. One of the firms participating denied an interview with the manager for "reasons of time" even though I offered any flexible date. Nevertheless, it was only possible to schedule an interview with the responsible risk manager.

Another participating firm gave an appointment only a couple of months after my request and then postponed it for another two months. Before the interview started the manager told me that he and his co-manager had discussed at length whether they should give an interview or not and that was why it took so long until they fixed an appointment. They finally only agreed to an interview because they knew me personally. However, the manager stipulated that he would not talk about company-specific affairs. This company had suffered from serious mismanagement in the past – although under a different management – and this explained their restrictions on discussion topics. Fortunately, I was still able to discuss with this manager conflicting issues of risk reporting using external examples in a very open atmosphere, and could then also gain valuable insights into the firm.

Similar to the reluctance of managers to give interviews, board members were also not always interested. One reason was that due to elections the state government of Berlin changed and many board members left or were about to leave their position. Another major reason obviously was the fear that statements would become public, stirring up discussions that might impede their career. This also held true for managers as well as auditors and shareholder representatives. Finally, two board members who were simple board members as well as board chairs agreed to an interview. Both belonged to the leftist party "Die Linke" that is known for their criticism of current political affairs. Both of them were critical of public shareholders' management of their firms and one of them was even very self-critical of his own role as a board member, revealing highly interesting points on boards' control practices as well as public shareholders' risk attitudes towards his firms.

In contrast to the open willingness of these board members to give an interview, the representative of the public shareholder was much more reluctant, even more so than the managers in general. I requested an interview with the head of division of the public shareholder management. He very hesitatingly accepted a date only several months after the request and under the condition that it could be postponed or cancelled "if he was too busy". At our appointment he was very surprised when I entered his office; obviously, he had forgotten the appointment. He then said that he had no time. Only when I urged him that I really needed to conduct the interview and would keep it short did he reluctantly accept. The interview was then interrupted by a phone call. I assume that this shareholder representative would have cancelled the interview if he had not forgotten about it. He was also very cautious about talking critically about risk reporting processes in public firms. Based on my findings from the previous interviews (eight out of ten) his hesitation seemed to originate from some unwillingness of the official stance of the public shareholder to criticise risk reporting systems in his firms or to elaborate on improvements. Public shareholders are also agents, namely of the original principal, the citizens. If substantial criticism of public risk management policies became public, representatives of the public shareholder would have to justify their actions. It seems that many public shareholders want to avoid these kinds of conflicts.

Only large firms have the capacity and knowledge to audit public companies. In Germany, four large firms belong to this group. Of these two agreed to an interview. Both auditors were heads of department of public firm audits with long working experience.

All in all, I interviewed five managers responsible for risk management and reporting. Of these four were chief executives and one a risk manager. The interview with the risk manager served as a contrasting example to those with managers. Four of these managers worked in public real estate firms in Berlin. As grounded theory always demands contrasting examples I chose for this purpose the manager of the state investment bank that is also part of the public real estate industry (through its loans and housing loan programs).

I also interviewed two board members, one shareholder representative and two auditors. In sum, I conducted ten in-depth interviews. As there are six public real estate companies in Berlin and I interviewed four of them, I covered two-third of this group. There are four audit firms which audit public companies; I interviewed two of them, thus covering half of this group.

Nr.	Function	Mark	Notes
1	Board	HW	Former minister, open and self-critical
2	Risk manager	KJ	Company A, become RM “accidentally”, self-confident, embellishing
3	Board	JH	Very open and self-critical, many critical points discussed
4	CEO	CB	Company C, quite, not open, embellishing, not self-critical
5	Auditor	WW	Self-confident, not self-critical

6	CEO	JM	Company B, silent, down-to-earth
7	Auditor	TK	Motivated, open, critical
8	CEO	UK	Bank, critical, self-confident
9	Shareholder	DS	Not open, embellishing, politic-related
10	CEO	US	Company D, very caution, (interview to proof former concepts and categories)

Although the number of interviews could have been increased, in the later course of the interviews it turned out no new subjects or perspectives were being brought up, and therefore the concepts and categories were saturated. Moreover, literature on public shareholder's risk management and reporting as well as my own experiences did not add any further aspects, but largely confirmed the results. As no new findings were to be expected this number of interviews seemed to be sufficient, especially because it is not the purpose of grounded theory to collect data in an encyclopaedic way, but to focus on the most relevant issues.

All in all, as I demonstrate in the following chapters, my findings support the main results of scholarly research on this matter. Additionally, some issues of risk reporting processes are explored further. This is not to say that new research in different settings will not add aspects, even though the main issues of the subject matter seem to be saturated.

The following section describes how I conducted the interviews.

2.4. Field research procedure

As already indicated, my research subject was so sensitive that primary internal written sources of the firms in my case study that could have delivered detailed information about the actual implementation of their risk reporting practices were not made available. The relatively high reluctance of most managerial participants to agree to an interview suggested that they would not talk about their practices in detail or speak critically about their own problems or issues, although they did so about problems of the other agents. The same turned out to be true for most of the other participants, especially the public shareholder representative and auditors, as the latter in particular has a delicate relationship with managers in the risk reporting process.

Anticipating this, I chose not to conduct open interviews as a grounded theory approach might have suggested, but semi-open interviews. This was useful because problem-centred interviews with guidelines (see Lamnek, 2005: 363-68, table 383) are sufficiently open for the interviewees' input and at the same time ensure that interview participants do not avoid talking about relevant issues.

As an in-depth investigation of actual reporting practices was impossible, I focused the research questions for the field research part of my work on how my interviewees represented the risk reporting process and its control, which problems they encountered and what their attitude was towards both. Fortunately, the analysis of the firms' annual reports gave some clues on actual risk reporting practices and validated some of the interviewees' statements (see Chapter 6).Due to the lack of sources, the part of my research on impacts of psychological factors on corporate disclosure was conducted through critical analysis of secondary sources.

In view of the interview participants' reluctance and possible bias when talking frankly about their own motivations and behaviour, the question arises of how to validate their statements. In respect to this aspect I resorted to guidelines set by Scheuch (1973).Scheuch (1973: 134) defined the 'reliability' of interviewees' statements as follows: “Reliability means the consistency of an event after repeated ratings or the independence of a result from a single rating or reproducibility of a value according to the chosen conditions of the experiment." Based on this premise he defined validity as follows: "Validity is therefore the capacity of a result to reflect what is being assumed when interpreting it." (Scheuch 1973: 134).

Scheuch distinguished external from internal validity. The former concerned representativeness. We are concerned with the latter, internal validity, i.e. the reliability of personal statements, for example in interviews. Scheuch's (1973: 143) rules for establishing internal validity were highly useful in validating the statements made in the interviews and are therefore listed below.

a) The weaker the relation of questions is to *observable* behaviour, the lower is the validity of allegations.

b) The less it can be assumed that an interviewee has already reflected about a question, the lower is the validity.

c) The less aware the interviewee is of the subject of the question, the lower is the validity.

d) If the interviewee sees a threat in the question, the validity of the answer is lowered.

e) Questions have to be distinguished between: 1. Questions of actuality, 2. Questions of opinion (i. e. those questions for which the interviewee needs to give a subjective answer), 3. Questions of attitude, 4. Questions of belief. This order reflects decreasing validity.

f) The more marginal an interviewee's position is in relation to the subject and even the object of a question, the lower is the validity.

g) Invalidity of answers from single interviewees is mainly punctiform; there is only low probability that an interviewee who gave wrong answers to one subject will do so for another subject as well. Only a small percentage of interviewees give consistently invalid answers.

h) In general, questions about current situations have higher validity than questions about the past or the future.

The main important points of these guidelines are that statements about non-observable behaviour have lower validity. However, the analysis of the annual reports of the firms' made some of their risk reporting practices visible. As to this aspect, I had to pay attention not to formulate my questions as a threat. Thus, I addressed topics by referring to other examples, general issues or behaviour of the other parties.

With respect to invalid statements it also turned out that these were not consistently invalid. Often, contradictions turned up in the same interview or in subsequent ones and could then be properly interpreted. In other cases they could be validated through literature.

In the following section I describe how I developed my interviews, i.e. how I developed concepts and categories from the generated data.

Development of concepts and categories

As already mentioned, even though my own experiences informed the research questions I started with, I made sure that they did not shape my field research. According to grounded theory, I did not strictly outline questions *a priori.* First of all, questions were semi-open. Second, after every interview I analysed the results, validated them with literature, press articles as well as my own experiences and revised and adapted my questions to elaborate important issues further.

In the first interviews I set the context by broad questions about changes experienced after the introduction of the Corporate Governance Code. All the interviewees stated that minor changes had occurred in recent years – mainly the professionalization of boards and a slight increase in risk awareness among public shareholders, although more on an individual level.

The first interview with a board member brought up important issues, namely the public shareholder being "the biggest risk" to his companies and collusion between managers and auditors in embellishing or manipulating disclosure. These two topics turned out to be so important that I followed them up until the eighth interview, when both categories were saturated (see below).

Unsurprisingly, answers to questions about concrete risk reporting practices were mostly biased, stating that everything was perfect. It was impossible to ask direct questions about these subjects because these kinds of questions would have been perceived as a threat by the interviewees, especially because they currently held relevant positions. Giving too much detail about internal affairs, implicating answers or confessing mistakes could have caused them to lose their job. Instead, I used questions about the organization of risk management and reporting systems to approach the matter. By enquiring further about risk analysis methods, I could detect some contradictions in statements about the high performance of risk reporting systems. The analysis of the firms' annual reports of 2010 further proved that risk management systems, the basis for risk reporting, were not always as comprehensive as is the norm. Besides, it turned out that some firms embellished their reports.

Despite the often general content of answers, it proved that the public firms' risk reporting systems were highly individual even though they belonged to the same branch and the same shareholder. Interestingly, one board member remarked that the public shareholder did not yet show any attempt to standardise these systems although it would have been very useful to compare the information reported and thus make it easy to detect peculiarities or omissions.

From all this information I developed the topic: 'the public shareholder's risk attitude towards his companies' as part of the category 'the public shareholder as risk'. This matter turned out to be important for all interview groups, and became one of the main categories, so that I elaborated it further until it was saturated at the end of the interviews.

This topic is specific to public firms, characterises their working conditions and can have a large impact on risk-reporting practices. Surprisingly, even the political board members agreed that public shareholders might often impede the operation of their firms as business strategies are changing - sometimes suddenly and to the opposite. Managers and board members reported that they had experienced that boards' decisions even violated the company contract which, in theory, they have to observe.

By following up on this subject some interesting details were brought up: not only that political board members often behave as if bound by party instructions which could cause conflict if they collide with company interests, but further internal conflicts on part of the public shareholder seemed to be far-reaching and deep, sometimes even breaking out during board meetings.

In other words, surprisingly, all the interviewees agreed that business decisions are often taken which have no major support and therefore their implementation remains conflictual. According to the auditors, often decision-making structures are not clearly defined or deliberately not observed, leading to conflicting orders. They also maintained that political stakeholders do not seem to try to greatly improve the coordination of decision-making power. This weakness of the public sector was also confirmed by the literature, but has not yet been studied in depth (Ganske, 2005; Scholz et al., 2009).

All in all, all the interviewees agreed that most of the time the public shareholder is not able to reach a consensus among his representatives on business goals, especially not for the long-term.

Clearly defined business goals and long-term objectives, however, are the basis of effective risk management and, indirectly, for reporting. Instability on the part of the public shareholder's policy towards his firms is unfavourable for effective risk management. This is also a sign of low risk consciousness of public shareholders, as one board member and managers emphasised. The main difference to private firms then is the risk attitude of the respective shareholder. Given the power of shareholders this cannot be neglected. Not only managers, but also political board members revealed that the public shareholder might quite often push for projects that are financially not viable or even violate the company contract. The interviewees talked about many illustrative examples of this type of behaviour.

Unstable business conditions and decisions taken to the disadvantage of firms might lead more easily to crises. Particularly in crises managers (and boards) might be more tempted to withhold discomforting information, as proved by the huge risk reporting scandals and argued by psychological theories on risk reporting (Langevoort, 2000).

Another topic derived from questions about risk reporting systems: communication between managers and boards. On the one hand it turned out that managers might not always care to inform boards about the results of their business operations and business risks. Interestingly, reporting practices could be very poor and managers are rather autonomous, as one board member remarked.

In my first interview with another board member he brought up the topic of the quality of managers' risk reporting, saying that boards always have to be very careful that managers “do not make a deal” with auditors that the boards do not want, i.e. manipulate the presentation of the financial situation - with the help of auditors. This subject was prevalent in most of my interviews, which is why I followed it up until it was saturated in the eighth interview. Although, unsurprisingly, both managers and auditors denied any collusion, some of their statements contradicted this interpretation and revealed some interesting details about their sort of collaboration in the compilation of annual reports where risks are reported.

These were such interesting aspects that I investigated them further. So, from the first interview on it became clear that controlling managers' risk reporting is a demanding job which ideally needs some institutionalisation, such as special control offices. Due to the advice managers get from auditors, manipulation is hard to detect as both board members asserted. Interestingly, one of them described how he used personal talks with auditors, where he questioned the annual reports, as an effective means of control. However, as this is very time-consuming, it is rarely practised and low effort input in controlling is a very common practice among boards, as he asserted; this statement is confirmed by research (Lentfer, 2005). Indeed, lack of control by boards was and is one of the main topics of Corporate Governance reforms.

In summary, the main topics I generated from my interviews were on the one hand the characteristics of the firms' risk reporting systems and risk analysis, and risk attitudes of political boards and the public shareholder; and on the other hand, communication between managers and boards, control by boards, and collusion between managers and auditors.

I analysed all the concepts and categories developed from my interviews from the perspective of conflicts and conflicts of interest, because my research focuses on failures of risk reporting systems and their reasons. This included perspectives, motivations and actions of the groups involved (managers, boards, auditors and public shareholders). After each interview I analysed the results, drawing on literature, press articles and my own experiences. Where new aspects were brought up I conducted a new literature search. Based on analysis of every interview I adapted my questions, reformulating, cancelling or adding questions according to the most relevant matters brought up. I stopped asking about matters if it proved that concepts or categories would not be developed further, i.e. neither interviewees nor literature added new points or aspects.

In the following section I describe my personal experiences during the conduct of the interviews to provide the reader with more insight into the research process.

2.5. Personal reflections on the field research process

My experiences from the interviewing process were manifold. First of all, although I did not expect to find interviewees easily, I did not anticipate the high degree of reluctance to my request exhibited by some people – for example cancelling fixed appointments at short notice.

It was also obvious from the beginning that many interviewees - although probably not all of them - would try to avoid talking frankly and/or critically about their own actions and motivations in risk reporting processes. Some participants were astonishingly open or self-critical.

As to the low validity of answers, Scheuch's (1973) guidelines for validating interviewees' statements proved to be true. Some answers might be invalid, but not consistently all of them. So I was able to validate and correct invalid answers on the basis of contradictory statements by interviewees. Furthermore, additional data (firms' annual reports, literature and press articles) as well as my own experiences helped to evaluate interviewees' propositions. For example, unsurprisingly, all the managers claimed their risk management systems were efficient, i.e. the basis for accurate reporting. However, when I asked specifically about risk analysis and its methods, it turned out that the methods did not seem to be refined and risk analysis seemed not to be a high-ranking workload task.

This impression was confirmed by the analysis of the firms' annual report containing the management and risk report (see Chapter 6). Mostly, risk management systems were not as comprehensive as they ideally should be.

The analysis of these reports also provided much insight into the firms' reporting practices. Reporting is done for a list of 'risk categories' according to the DRS 5 (German Accounting Standard for Risk Reporting[3]). Surprisingly, no firms gave comprehensive information on the vast majority of risk categories. In some categories low or even no information was given. Furthermore, no company observed the guideline to quantify risks so that concrete information is provided for the reader. All in all, all the firms' reports were neither transparent nor accurate nor complete. Most crucially, some reports were embellished, and one company even had to revise its report for 2010 because previously they did not report a risk that turned out to be existential a year later. It was especially this firm that tried to create the impression in the interview that their risk management and reporting practices were excellent. However, as became obvious during the interview, they focused their risk management on technical, real estate risks. The existential risk in the amount of € 250 million, however, was a legal financial risk obviously neglected in the original report.

In contrast to invalid answers about their own performance of risk reporting, most managers were more open to talk about their interaction and communication with boards related to discussions about business strategies and risks. Somewhat surprisingly to me, it became apparent that managers do

[3]See: http://www.drsc.de/service/drs/standards/index.php?ixstds_do=show_details&entry_id=8 [14.11.2011].

not always discuss risks with boards, but just present them. Discussing risks and explaining them to boards makes their possible impacts more transparent; then underestimation of risks is less likely.

It also came as a surprise to me how free managers seemed to be to involve boards or not, and how they report risks as my interviews with the board members revealed. Astonishingly, the public shareholder knows about many differences in the quality of reporting, but does not take steps to solve this problem, for example by standardisation of risk reporting systems.

Many interesting details – also about boards and public shareholders - came out of the interviews with the board members who talked very openly about their experiences with risk reporting and control, bringing up many interesting details. Especially one of them was highly self-critical. Both of them also immediately agreed to an interview, in contrast to the other interviewees. As mentioned, their frankness might be explained by their belonging to „Die Linke", a party on the far left that is traditionally in opposition and educated a habit of criticizing the political establishment and their affairs.[4]

In contrast, the shareholder's representative was highly reluctant to agree to an interview – it seemed that I was only able to conduct one because he simply forgot to cancel it. Other shareholder representatives were not even willing to be interviewed and declined right away. This can be taken as a hint that many public shareholder representatives might prefer to avoid discussions of this topic in public, possibly because improving transparency of risk reporting is not a priority of the official political agenda, as my interviews indicate and the literature confirmed (Scholz et al., 2009; Ganske, 2005; see Chapter 7).

[4] Among some other few states, die Linke was for about ten years part of the federal state government in Berlin (2001-2011).

Although the inefficiency of auditors is broadly discussed it was rather interesting what my interviewees contributed to this topic. Unsurprisingly, both managers and auditors denied any inefficiency of audits or bias of auditors towards managers. However, both groups' elaborations on their relationship revealed highly interesting aspects. It not only turned out that managers and auditors usually have a close relationship, but also a sort of collaboration when compiling annual reports seems to be widespread. This diminishes the value of audits.

In the spirit of grounded theory to enrich and validate current research with new generated primary data I took up the most relevant topics from my interviews as a rough guideline for my research on risk reporting and its control in public firms in Chapters 3 to 7. Chapter 7 is devoted to a more detailed discussion of the interview results as a sort of a kaleidoscope to look at these issues.

The part of my work on the impacts of psychological factors on corporate disclosure was not based on grounded theory because this kind research needs the willingness of participants, which is difficult to find in the business world where the secrecy of internal affairs is highly guarded.

In the following chapter, I describe as an introduction to my subject the background of risk reporting and control in Germany.

3. Public Corporate Governance in Germany

Increasing distorted corporate disclosure led to the introduction of the German Corporate Governance Code in 2002. As a background to corporate risk reporting I give in this chapter an overview of the role of boards, managers, auditors and shareholders in the risk reporting and control process against the background of changes in regulations. For the significance of the public shareholder's behaviour towards his firms I then highlight which obstacles to best practice risk reporting might result from his side.

Role of the board

Board members are assigned by the shareholder to their post to supervise (and secondarily to consult) the management. As a rule, the management informs the board on a quarterly basis about the financial and economic conditions of the firm during meetings between the board and the management. During these board meetings, those operations are also discussed that were assigned to the competencies of the board in company law. Additionally, the board decides on single business operations as defined by company law. Boards have to take responsibility to the shareholder for the success or failure of these decisions. However, the board is not entitled to in fact direct the management. In this regard, its competencies are restricted. So, it is only entitled to decide on business operations already approved by the management. Moreover, the board has no right to collect the most current data by itself to support its decisions. The only source of information for the board to control the management as well as to decide on single business operations is the management itself (or the various departments). Hence, it is solely the management who gathers and compiles this data. The latter is rather free in selecting which data to disclose and how to present it: in their balance managers can group data under different categories (e.g. accruals or not) so that, for example, final profit and loss or future expenditures might at the end differ quite a lot for the same numbers (see e.g. Müller, 2004). Simply because of the sheer amount of data, that disclosure will be selective.

So, accounting law offers many opportunities for managers to select, embellish or manipulate data while still being in compliance with the law (Jäckel and Leker, 1995: 294).[5] In short, it is the subject of control who provides the controller with the information necessary to control its performance. For this lack of control the management has at least the possibility to manipulate data selection and preparation in terms of quality, scope and validity.

The power of managers is based on the premise that it is not restricted in the conduct of business. Therefore, the power of the shareholder and his representative, the board, is limited to pre-set general corporate objectives and fundamental tasks of the holdings and to monitor them. This power sharing originates in the need to ensure the company's efficiency (Ganske, 2005).

Reforms

New legal changes were intended to put more checks and balances on the power of the management. According to § 91 cl. 2 of the KonTraG (Gesetz zur Kontrolle und Transparenz im Unternehmensbereich - Law on Control and Transparency in Corporations, 1998) the management is now obligated to establish an internal control system and report risks to the board.

On the part of the board, further changes should increase their efficiency and effort. Thus, more experts of the respective business should be appointed, a change to the former policy, in particular in public firms, of appointing 'political friends' who, however, displayed little if any interest in their task, as my interviewees observed (Lentfer, 2005). To push back the political influence in public firms, it is now also advised not to appoint a politician as board chair. For my case studies this held true, but not for other public companies in Germany. However, even where in my case studies the board chairs was not a politician,

[5] The reason for possible wide legal interpretations is the alleged need for corporate flexibility to ensure the survival of firms (du Plessis 2007).

the majority of board members were politicians or had a close relationship to politics. Thus, the reform process seems to be slower than conventionally assumed.

Additionally, board mandates are now limited to ten per person to ensure that board members are able to invest sufficient time and effort in their duties. However, compared with international standards ten mandates are still a rather high number (Lentfer, 2005). Moreover, increased liability of boards is intended to ensure their effort out of fear of disciplinary action (Lentfer, 2005).

3.1. Risk reporting regulations in Germany

The main risk reporting structure is consolidated accounts. In addition, public companies report risks in the annual shareholders' report as well as through quarterly reports addressed to the board. All these reports do not differ in their risk reporting regulations. Therefore, I discuss only the most important one, the consolidated accounts. Consolidated accounts contain the annual statement, the management as well as the risk report.

The management report

In addition to compulsory financial statements, a management or position report is also mandatory.[6] This report typifies a legally and functionally independent financial instrument and has to supplement and explain the annual financial statements (§ 289 HGB, Handelsgesetzbuch - German Commercial Law). It has to give general information relating to the financial performance of the business and the position of the company. More precisely, it must contain a balanced and

[6] For the following see http://wirtschaftslexikon.gabler.de/Archiv/58187/lagebericht-v8.html (09.03.2013).

comprehensive analysis of the scale and complexity of business operations. This report is important for holding the management accountable.

Management reports are distinguished above all by their prognostic orientation. Reports also have to assess and explain expected developments of corporate risks and chances.

The BilMoG (Law of Accounting Reform, 2009) added further components to the management report. In relation to the financial reporting process, corporations have now to describe the main features of the internal control and risk management systems (§ 289HGB, KonTraG, III, 1). The systems' objectives and policies, including its policy for hedging each major risk, have to be mentioned (§ 264d). Risks refer to price, credit and liquidity risk, as well as risks from fluctuations in cash flow. Consequently, for the shareholder the management report is the most relevant corporate disclosure source because he is mainly interested in the future of the corporation and its prospective risks.

Further new legal changes were passed to increase the value of business disclosure. For example, the newly introduced§ 289a HGB stipulated the inclusion of a separate statement on corporate governance compliance in the management report. The Code is still voluntary, so non-compliance is possible: only reasons for it have to be given. However, their validity is not checked (Konnertz-Häußler, 2011;Fatemi and Glaum, 2000).

Another change, induced by the KonTraG, refers to a stronger emphasis on risks defined as danger, not as a chance to make sure that shareholders are informed from the start about dangerous developments (Gulden, 2003: 20). However, there are no clear or fixed guidelines how to define them. The same holds true for the definition of essential or existential risks, the main content of risk reporting (§ 289 HGB). The prognosis horizon is also undefined. This is an important indicator for the accuracy of prognoses which decreases with increasing horizons (Gulden, 2003: 22). To increase comprehensibility the prognosis time frame should always be made explicit, so that the reader is able to estimate the certainty of the prognosis more adequately (Gulden, 2003: 22). None of the companies in my case study made the forecast horizon explicit to the reader, and some of them used five, ten or even twenty years as a forecast horizon for their risk management, which is rather long and thus imprecise.

The form in which data has to be presented, the scope of information, outline, and time frame also remain undefined (Gulden, 2003: 24). All this non-specificity increases a lack of transparency. However, establishing transparency was one of the main goals of the Corporate Governance reforms. The reader should now quickly be able to get a comprehensive overview of future risk developments of firms. Therefore, it should now be made clear in which section of the reports (annual, management and risk reports) risks are mentioned to avoid double or missing information (§ 252 clause 1 No. 4 HGB; § 249 HGB). Ideally, forecast models and methods are indicated, deviations explained and numbers to compare them given, e.g. comparison of target and actual figures of the previous forecast and risk report. Furthermore, important general information and statistics should be provided to increase comprehensibility.

Risks should also be quantified, but only if methods are approved, reliable and economically justifiable as outlined in the voluntary guidelines for proper risk reporting in the German Accounting Standard 5 (DRS 5) by the German Accounting Standard Committee (DRSK), as qualitative statements about risks are less comprehensible and clear, and thus more prone to embellishment than numbers.[7]

[7] Deutscher Rechnungslegungs Standard für Risikoberichterstattung (DRS 5). Available at: http://www.drsc.de/service/drs/standards/index.php?ixstds_do=show_details&entry_id=8 [14.11.2011].

As I will show in Chapter 6, none of the firms studied quantified risks. Other studies confirm these findings and reveal that, in general, management reports still lack transparency.[8]

Indeterminate regulations

Despite new legal changes, risk reporting rules are still rather indeterminate, non-standardized and mostly voluntary (Hamann, 2003). Thus, risk reporting is still mainly guided by the voluntary and equally vague principles of proper management (GOL) for risk reporting published in the DRS 5 (German Accounting Standard 5) by the German Accounting Standard Committee (DRSK). These are the principles of completeness, accuracy, objectivity, lack of arbitrariness, clarity, comparability, materiality, information gradation and caution, but also the freedom of choice. Although these principles cannot be enforced by law, in the case of court proceedings their non-observance increases the actual liability of the accused persons.

Firms are therefore still very flexible in practicing risk reporting. Even though the new KonTraG required the establishment of risk managements and internal control systems, these systems are also controlled only through plausibility checks on the management and board level (Langenbucher, 2003: 64). If the top management is involved in distortion or fraud, these systems fail (Langenbucher, 2003).

Disciplining

Most interesting for the practice of distorting disclosure of risks are the many legal categories for the corpus delicti fraud. These are: incomplete, incorrect, misleading, and forged information. Only outright false disclosure is forbidden. Alone the sheer number of legal categories for manipulating financial data

[8] For a study on management reporting practices in Germany see http://www.boeckler.de/pdf/mbf_lageberichterstattung_2004.pdf [09.11.2012].

suggests that both legal control and practice might be often rather weak. This assumption is supported by the late detection of risk reporting scandals as well as the results of studies on reporting practices.[9] By looking at the various types of possible convictions it is obvious that making a distinction between the different matters of fact is not easy, and many grey areas are possible. It is noteworthy that even by law, a so-called optimistic presentation of business performance and prospects is legal. The background of this official legal interpretation is to protect corporations against so-called self-fulfilling prophecies when statements about negative corporate development are made too early and therefore would take course. Based on this premise legally there are many accounting choices available to managers to present firms' financial positions and risks in an optimistic way. The borders between reasonable optimism and distortion are not always easy to draw. In contrast, in the public mind, disclosure often means *full* information guided by the worst-case scenario and, in cases of failed management disclosure, prison terms. Public as well as often scholarly debates most often do not take into account this gap between public expectation and legitimate claims. This makes solutions harder to reach..

Interestingly, capital investors such as banking institutions do not consider the information of managements' balancing sufficient information to grant loans or make investments (Mandler, 1997: 100). Indeed, additional background data and information from third parties is required. This hints at the fact that managers are not so much trusted to give a fair and true picture of the position of their firm.

3.2. Audits as control of the management

The board has to contract auditors to check if the annual statement and the management report give a true and fair view of the state of the company, describe risks of prospective developments accurately and observe all legal requirements (§ 316, 317 HGB).Auditors examine the bookkeeping of firms by taking random samples. Based on these random examples auditors include the following points in their inspection report: net asset, financial and profit position, risks of the prospective company development, forecast of the firm's development, presentation of the early warning systems for risks and serious legal offences where present.

The results must be reported to the board in inspection reports (§ 321 HGB). If the firm passes these checks the auditor issues to the public an unrestricted audit certificate. Otherwise he has to restrict his certificate (§ 322 IV HGB). As I found out in my interviews, this restriction is almost never or only very rarely issued. The auditors interviewed asserted that only in very severe cases might auditors threaten to restrict the audit certificate, and in general then managers adapt their reporting so that an unrestricted certificate is finally issued.

It is important to note that the legal mandate of auditors is limited to checking for implausibility of the data presented (Hamann, 2003). An examination of fraud or manipulation is not part of the audit because of the limited scope of checks. Thus, an unrestricted audit certificate does not testify that no fraud or manipulation has occurred. In my interviews the auditors stressed once again that, contrary to common public opinion, it is not their job to police managers (see Chapter 7).

Studies revealed that often the scope of data examined in audits is at a rather low level, often between 20% and 30% of the available data (Hamann, 2003). When little data is verified, plausibility checks as a monitoring tool are rather inaccurate. For the detection of misconduct of fraud or distortion auditors seem to play in general only a minor role (e.g. about 15% of detected cases in 2003 in the US, see Langevoort, 2006; for an overview with similar general results see Hamann, 2003). The reason is not so much insufficient qualification (auditors are required to pass a state-regulated high-level examination), but rather a lack of effort input and motivation.

The dependence of auditors on managers, resulting in low effort input in audits, is one major subject of corporate governance reforms. In general, it is the management who propose an audit company to the board. Even though the board has the final say, most often the management's proposal is accepted, as was also confirmed by my interviews. Thus, auditors mostly perceive the management and not the board as their principal. This perception including some "loyalty" is exacerbated by the fact that auditors often receive in addition to audits lucrative consultancies from the same managements they audit. This income can be two to five times higher than from audits (Kitschler, 2005). Obviously, it can be difficult to criticize the reporting of the manager you hope to get some more lucrative contracts from, as the auditors interviewed acknowledged (Müller, 2004: 3-4; and Chapter 7 below). Astonishingly, these auditors did not mention the interest of their principal, the board, to invest high effort in their contract.

In practice we observe that e.g. inspection reports, the means of monitoring for boards, are first sent to the management before they are handed to the board. The problem is that the initial gatekeeper reports first to the subject he is supposed to monitor (Coffee, 2006: 227). In turn, this severely diminishes the value of his inspection.

I also found out during my interviews that usually managers contact auditors well in advance of the actual audit for advice on how best to balance 'complicated matters'. So managers already get some professional help from auditors about how to use accounting choices favourably. The board members I interviewed called this collaboration between managers and auditors in balancing "making a deal" (see Chapter 7). It becomes clear that the purpose of this "deal" is not necessarily to give a true and fair view of the position of the company when they also remarked that these kinds of deals are hard to detect.

To put a check on auditors' dependence on managers it is forbidden to audit transactions the audit company itself conducted, and for public firms auditors have to rotate every five years (Kitschler, 2005). Further restrictions such as prohibiting audits and consultancies being conducted by the same firm are objected to by strong auditor and management lobbies – including my interviewees from these groups. Mainly it is argued that it saves a company a lot of money if they contract their auditor for consultancies, as because of his considerable knowledge about the firms he could offer lower consultancy prices (Bormann, 2002: 192; Chapter 7 below). I argue instead that possible additional costs for consultancies have to be accepted because consultancy restrictions better ensure auditors' independence and thus improve the value of audits.

Thus, there are many incentives for auditors not to put a lot of effort into their control of the management so not to lose their favour. This argument is in line with Doll (2000: 8), who states that the auditor's effort input is determined by which of the involved interests is most compatible with his own.

3.3. Conflicting interests of the public shareholder

The public shareholder has seats reserved for his representatives in every board of his firms. The board is part of the company. Therefore, all board members, including the ones who are representatives of the public shareholder, are obligated to solely pursue the welfare of the company, not the interests of individual shareholders (or employees) (Baumbach and Hopt: 2006). However, if board members do always clearly prioritize the well-being of the company, this might cause conflicts with the public shareholder if the latter pursues other interests, e.g. political ones. In practice, many times it is not clear whether the single board members act in their role in the name of the public shareholder or in the name of the company. It is important not to confuse the interests of public companies with those of the (current) public shareholder who is a current representative of the people – they do not have to be identical.

Conflicts of interest between public company and shareholder in fact often play out in the board. So, for board members who are on the one hand representatives of the public shareholder and on the other hand part of the public company, conflict arises when the instructions, reports and information they receive from the shareholder overlap or collide with their company mandate. More often than acknowledged this might be the case, and one main demand of good public corporate governance is to push back the influence of the public shareholder (Ganske, 2005; Scholz et al., 2009).

Public shareholders might sometimes prioritize goals that are contrary to the firm's welfare and interfere in business operations. All my interviewees confirmed this, even regarding the public shareholder as the main risk for his own companies (see Chapter 7).

Public firms are legitimated on the basis of their public mandate, i.e. to offer public services. With the reform of the public sector they have to be competitive now. In contrast to private firms, public ones have to balance these two goals. However, the public shareholder as politician is exposed to further interests such as other economic, social or political targets including elections or interests of the people employed by the state and public enterprises (Lenk, Rottmann and Woitek, 2009: 212). Thus, many and sometimes diverging objectives might influence his behaviour towards his firms. In many cases these constitute incentives for politicians to act against the welfare of their firms (Scholz et al., 2009: 6-13;Ganske, 2005).

For example, often one main goal is the consolidation of the state budget. The following example illustrates how this might impact on public companies. The public shareholder in Berlin ordered one of my case study companies to buy another public firm so as to book a surplus in the annual state budget (see Chapter 7). However, this purchase, which was made possible with loans, turned out to damage the buying firm later and contributed to its over-indebtedness. In this case, for the public shareholder his goal - to artificially consolidate his state budget–took priority over the interests of the firm. Short-term thinking and exploitation of public firms is one of the main reasons for the demand to restrict the influence of the public shareholder on his firms (Scholz et al., 2009;Ganske, 2005). My interviewees and the literature both named election periods as further incentives for short-term thinking (Ganske, 2005). One board member interviewed maintained that in the last one or one-and-a half years of election periods political board members were no longer very interested in the welfare of their firms (see Chapter 7).

This kind of behaviour is hard to discipline, and thus to eliminate because after elections the decision-makers often no longer hold their position. Moreover, because of strong party loyalty, party members are hardly ever disciplined. Additionally, it is widespread that public shareholders (and managers) regard the state as the 'lender of last resort' (Schütz, 2009: 123). This means that the state would always provide money to finally save public companies. Consequently, risks are often not considered a real danger to public firms. These circumstances strongly foster low levels of risk-conscious behaviour on the part of public shareholders, as all of my interviewees including politicians attested (Chapter 7).

Moreover, governments often believe they can eliminate risks by legislative fiat so as to push otherwise unprofitable businesses. One example in our case studies is the failed urban development policy of social housing in Berlin in the 1990s. Here, the primary goal of the public shareholder was to boost social housing and therefore considerable government aid in the form of expenditure loans was provided for this project. These loans would have over-indebted the public real estate firms. In this case the public shareholder would have had to provide the firms' financial aid from the state budget. To save state expenditure, the public shareholder passed a new special legal regulation that these loans do not have to be included in the balance sheet so that no over-indebtedness is indicated there. In short, the public shareholder controlled risks politically by passing laws favourable to otherwise non-viable projects, a feature that is not uncommon. In 2012, however, the public shareholder was forced by the courts to nullify the special treatment of these debts. From now on, firms had to book these liabilities in their balance. This caused one of the firms in my case studies to become over-indebted. Thus, the policies of public shareholders contributed to severe financial difficulties.

Other factors complicating political behaviour are conflicts of decision-making power among politicians. Most often, competencies are not clearly designated, in particular on the horizontal level. As good corporate governance depends to a great degree on clarity and transparency, one of the auditors interviewed commented that conflicting orders by different politicians were a major problem. The interviews confirmed as well that the problem of lack of cross-government coordination arising from a factionalized government is very present in their firms (see also Ganske, 2005). Thus, the urban development and finance department often carried out their conflicts about business goals even in board meetings.

Clearly defined business strategies and objectives, however, are the prerequisite for effective and transparent risk management and reporting. Many of my interviewees emphasized that because of changing and diverging interests of the public shareholder a clear and sustainable business strategy is often hard to establish, which makes it difficult for them to adhere to best practice in corporate governance.

In conclusion, the implementation of best practice in risk reporting to guard the welfare of public firms faces problems because of many flaws in regulations, which offer managers many opportunities to distort disclosure. Also, the effectiveness of the monitoring of risk reporting by auditors depends to a large extent on their effort input, which might be decreased because their interests might converge more with the managers than their principal, the board. In the case of public firms, however, we are also dealing with interests of the public shareholder impacting on the welfare of his firms. The various interests of the different agents involved in risk reporting and its control and how they are theorized in principal agent theory are the subject of the next chapter.

4. Principal-agent theory, public firms and risk reporting

After having given the background and the main issues of risk reporting and its monitoring in public firms I outline in this chapter the theoretical approach I took to analyse conflicts inherent in contractual relationships between managers and public shareholders, namely the principal-agent theory. Below I detail why the principal-agent theory is particularly useful in analysing conflicts of interest of agents leading to non-compliance with contracts while also referring to some deficiencies of current applications of this model. Then I depict the specific features of public firms, namely multiple agent relations. I conclude this chapter with a short discussion of current solutions to agency problems, i.e. non-compliance of agent with contracts, in firms.

4.1. Principal-agent theory

As its name indicates, the principal-agent theory offers a model for agency relationships in terms of their contractual relationships. The founders of the principal-agent model, Jensen and Meckling (1976: 305), defined a principal-agent relation "... as a contract, under which one or more persons, the principal(s), engage another person, the agent, to perform some service on their behalf, which involves delegating some decision-making authority to the agent."

As a response to the former conventional model of the firm, Jensen and Meckling (1976) developed the principal-agent model as a model of individual actors' contractual relationships to better explain economic and company development. Based on their observation of frequent shirking[9] of managers (Jensen and Meckling, 1976: 306), they denounced the assumption that firms are homogenous units free of internal conflicts, calling this a "legal fiction" (Jensen and Meckling, 1976: 310). Instead, Jensen and Meckling (1976) made the firm itself the nucleus of analysis focusing on internal conflicts between the

[9] (draw aside, sidestep)

participating individuals, particularly in the case of separation of ownership and management. They highlighted the fact that managers might concentrate more on short-term profit-making as they benefit from profit-sharing bonuses awarded. However, concentration on short-term goals might easily mean long-term goals were disregarded, and thus might result in disadvantages for the firm's welfare in the long run. These observations as well as the risk reporting scandals proved that profit-making by firms is not only constrained by *technical* feasibility because firms are not single actors making straightforward decisions, but also suffer from internal resource allocation and conflicts (Klein, 1999: 464-465).

To better explain the complexity of phenomena leading to the disadvantages of firms (in some cases maybe even insolvencies), principal-agent theory, instead, is based on the model of the *homo economicus*, the rationally acting human being who first and foremost pursues his own interests. Thus, central to the principal-agent model is the question of conflicts of interests and how to mitigate them to keep transaction costs low (costs borne by the principal, see below).

The role of the *homo economicus* in this model is rather important because it is assumed that to a certain degree people will *always* try to increase their own benefits. For contracts this means the agent (here the manager, but also the public shareholder as an agent of the state) wants to invest the least possible effort and gain the maximum potential output. The principal, in turn, wants to gain as much output (performance) from the manager as possible and wants to invest the least possible effort (e.g. money). In other words, on the basis of the premise of the *homo economicus* (i.e. the profit-maximizing individual), both parties are interested in low effort input and high output. Consequently, conflicts are inherent in the contractual relationship. This means that the agent will fulfil the delegated tasks without having exclusively the principal's benefits in mind; he might pursue his own interests, thus reducing the benefits of the principal. Furthermore, to a certain degree control is never absolute because tasks are delegated. Moreover, control is cost-intensive and therefore decreases the gain of the principal. As a consequence contracting agents will always cause the principal a certain 'residual loss', i.e. the difference between the achievements of the agent and the optimal achievements possible (Jensen and Meckling, 1976: 308). Furthermore, agents might pursue interests that might even be outright disadvantageous to the principal (Wenger and Terberger, 1988: 506). Therefore, contracting involves several costs (losses) for the principal: a) bargaining costs (the time and effort put in ex ante), b) enforcement costs (the time and effort put in ex post), c) the "residual loss" (Lane, 2005: 251). In consequence, there is the problem of ex ante and ex post contract, i.e. the anticipated and the actual gain for the principal. In other words, by delegating tasks the principal will always bear some loss.

For public contracts this problem of loss for the principal increases because of multiple agents being involved. The public shareholder representative is also an agent and therefore prone to shirking. Furthermore, he engages an auditor, another agent, to enforce the management contract for risk reporting which involves additional costs (losses). What exacerbates these inherent losses caused by transaction costs (monitoring and enforcing the contract) is that the actual owner, the citizens of the state, is not directly involved in the contract. Thus the influence of the actual owner on his firms is rather small compared to the influence of the various agents contracted (managers, public shareholders, boards, and auditors).

The aspect of principal agent theory most relevant to my subject matter -risk reporting failures – is the fact that it takes a different perspective than conventional theory to analyse the development of firms by focusing on harm caused by internal conflicts and not by external threats. The significance of this change of perspectives cannot be overestimated. The shift to an analysis of internal conflicts and how they might impede firms' developments is particularly crucial for the study of the complicated principal-agent relations in public enterprises involving multiple powerful agents while the actual owner is in a rather weak position.

Thus, acknowledging that the development of firms depends largely on good relationships *within* the firm is a good reason to scrutinize these relationships and their contractual arrangements. Equally, there is good reason to focus on the management contract as it is widely agreed that the firm is mainly characterized by management structure, especially since the introduction of the New Public Management reforms that increased the power of managers, including in public companies (McAuley, Duberley and Johnson, 2007: 89; Koch and Dixon, 2008; Klein, 1999: 464-5). There is little dispute that at the very top of the firm are the relationships between the firm's shareholders, its directors and its senior managers (Klein, 1999: 464-5). Moreover, my research topic concerns the management who have to report risks.

Hence, a useful way to study these relationships and their impact on economic development, in our case in particular risk reporting, is the application of the principal-agent model as developed by Jensen (1976) to stress the significant role of managers in the development of firms. Moreover, the principal-agent model allows the complex role of the public shareholder to be investigated. He is acting as the principal, but being an agent he is likely to pursue his own interests, which may not be fully compatible with the interests of the owner of the company (the citizens), thus reducing the latter's benefits.

More precisely, looking at conflicting interests *within* firms to explain their welfare development adds a different dimension to the neo-classical approach because of its focus on internal decision-making processes and transaction costs. On the basis of the principal agent model we are able to assess the ways in which all the agents do not (always) solely pursue the primary goal of the company contract, namely the welfare of the firm.

Since the introduction of NPM economic viability has become the bottom line for business operations of public firms, as the board members interviewed as well as managers agreed. The managers interviewed in particular pointed to problems negotiating boards' and public shareholders' business objectives, balancing profit-making and provision of public services (in our case the provision of affordable housing for the broad society) (for this problem see Scholz et al., 2009; Ganske, 2005).

The focus on internal decision-making processes in companies integrates agency theory and property rights and finance theory, thus suggesting another crucial influence, the factor 'uncertainty' in business decision-making, should be considered (Williamson, 2010). Particularly the managers interviewed, but also shareholder representatives, stressed the problem of uncertainty for public business operations because the individual public shareholder representative might change due to elections, or might change his plans for the company for other political goals. Boards, managers and auditors all agreed that, "the public shareholder is the biggest risk for his companies" (see Chapter 7). Mostly, the interviewees explained by a lack of business expertise, because they are politicians. However, I show that on the one hand one of the primary foci of corporate governance reforms, the professionalization of company boards, has been quite successful and thus diminished this issue. On the other hand I argue below that conflicting interests such as political goals other than the company-specific public mandate or personal career benefits of politicians might be the main cause of this behaviour. To be clear: this kind of behaviour of public shareholders violates the company contract, which demands that only the welfare of the firm should be pursued.

The present study clearly benefits from this behavioural management approach as the impact of uncertainty of risks on managerial behaviour is an essential point of investigation (see Chapter 5).

In summary, principal-agency theory assumes that the agent always wants to shirk because this is how he increases his benefits. Because this decreases the gain of the principal, monitoring the agent to enforce the contract is a central issue. Therefore, control or how to motivate the agent to comply with the contract is the subject we turn to in the following section.

If all contracts include losses for the principal, we have to answer the basic question: why not do without contracts? Services are contracted because the principal lacks the expertise or time, or both, to accomplish the task himself. Hence, the principal needs to contract an agent to get the job done. The need for business managers as experts to lead public corporations too increased during NPM. However, as I argue with Scholz et al. (2009) and Ganske (2005), the need for external managers in public firms resulted more from the need to restrict the public shareholder's influence on his firms because he often endangered their wellbeing. This view was also supported by all of the interviewees (managers and auditors, but to a lesser degree by the boards).

Therefore, the main problem of contracts is the asymmetry of information between principal and agent, i.e. the information deficit on the part of the principal (Grossmann and Hart, 1983: 7). This holds particularly true for public firms because the public shareholder is not closely involved in the daily business operations and in general lacks expertise (Ganske, 2005; Scholz et al., 2009).

The principal-agent model theorizes four main categories of information asymmetries roughly corresponding to different phases of contracts which are introduced below:[10]

1. Hidden characteristics
2. Hidden action
3. Hidden information
4. Hidden intention

[10] In the following I refer to Picot, Dietl, and Franck 1997: 85-7 as well as Lane 2005: 64, if not indicated otherwise.

1. Hidden characteristics designate hidden shortcomings in the professional and personal skills of the agent (e.g. performance level) which he hides at the conclusion of the contract. This means that the principal might not know about possible shortcomings of the agents (i.e. risks) when concluding the contract. In general, for the principal these shortcomings are hard to detect beforehand. Consequently, the principal always chooses the agent with a certain amount of uncertainty about his actual qualifications. In other words, there is always a certain risk that the "wrong" agent has been selected.

2. Hidden action refers to the agent's actions during the provision of services that the principal cannot or can only imperfectly observe. This refers to the so-called incompleteness of contracts. It implies that the tasks contracted for will always include actions that are not specifically defined in contracts. Therefore there will always be some scope for flexibility of action, leaving it up to the agent to choose the level of effort by himself, while presenting his effort input as being the best possible. Thus, for every contract there will be some actions - often a considerable number- where the principal is unable to assess *exactly* the effort input because not all actions are observable. So he will not always know in detail which *specific* actions the agent took to meet the ends and if they were the most economic ones (Palli, 2004: 67). Hidden action then refers to the possibility for the agent to use these kinds of margins to deceive the principal by investing lower effort and gaining more output. This opportunity to deceive the principal is called "moral hazard".

3. Hidden information refers to information at the disposal of the agent that the principal does not possess or is unable to understand because of lack of expertise. The agent might then capitalise on this informational edge for his own ends, i.e. will deceive the principal. Again, this situation constitutes a moral hazard for the agent. (It is important to

note here again that the principal cannot effectively handle moral hazard situations for hidden information or action, at least not without additional costs.)

4. Hidden intention alludes to the phenomenon that even for the observable actions of the agent the principal might not know all the agent's objectives. The lack of this type of knowledge might be especially crucial in situations where the agent confronts the principal, for example, with large or even irreversible (risky) investments which have been made. In these cases, the principal might have too much to lose to still discipline the agent and/or withdraw from the decision. This case constitutes a so-called "hold up" situation where the principal is to some extent at the mercy of the agent (Picot, Dietl and Franck, 1997: 86).

These four possible situations could undermine the main objective of the contract, i.e. increasing the benefits of the principal (Schreyögg, 2003: 4). Instead, these conditions imply possible losses. (Here we have to remember that the public shareholder is also an agent. The actual principal, the owner, is the public. For this specific problematic see below).

The main types of asymmetric knowledge discussed in the literature for principal-agent relations are "moral hazard" and "adverse selection" (Lane, 2005: 40). In this study I will focus on the problem of "moral hazard" because we are dealing with a problem, risk reporting, occurring after the conclusion of contracts. Thus, this problem is inherent in every contract. Furthermore, I take the position that "moral hazard" concerns everyone because certain situations, for example times of stress, might lead to shirking behaviour and this is to a certain extent independent of the personality, as I argue with Langevoort (2000). Rather it can be traced back to cognitive biases that are *not* pathologies (see Chapter 5). According to these arguments I take a situational approach because non-disclosure of company information during times of stress might make even "good people" find themselves responsible for bad behaviour, as Langevoort (2000) convincingly outlined (see Chapter 5).

By highlighting the "normality" of these cognitive structures, instead of quoting the often-cited argument of CEO hubris, I aim to correct the image of top managers as being specifically "bad people", following Langvoort (2000, 2006). This is an aspect that has so far been very neglected in management and business literature.

For our subject matter it is crucial that one of the main problems of management contracts is the non-observability of the agent's effort, so that not all management actions are easily verifiable to third parties and most importantly in court (Lane, 2005: 39-40). It is also significant that even boards' and shareholders' behaviour might harm the welfare of the company.

In short, the primary variables for moral hazard actions are effort variables (Laffont and Martimort, 2002: 145). For every moral hazard situation the agent faces a dilemma as more effort increases his productivity, while decreasing his own utility of the transaction, i.e. minimal effort input (Laffont and Martimort, 2002:145).[11]

What complicates the problem of "moral hazard" is the above-mentioned difficulty of *exactly* measuring the performance of the agent (Laffont and Martimort, 2002:146). With regard to the measurement of the outcome, the agency problem resembles the signal-extraction problem popularized in macroeconomics by Lucas in the early 1970s. The signal-extraction problem

[11] An exception to this rule is the risk-neutral agent. Despite the non-observability of his effort, moral hazard is not an issue as he will still implement the first-best level of effort (Laffont and Martimort 2002:154). Yet, if the agent is not risk-neutral, inefficiency in effort provision will arise due to moral hazard (Laffont and Martimort 2002:155).

refers to "noisy data" that cannot be easily observed and filtered – not even at high cost (Bidarkota and McCulloch, 2002: 3). With respect to the result of the agent's action, i.e. his output, there is always some ambiguity as to how much of the agent's output is due to his effort and how much is due to factors beyond his control, i.e. luck, e.g. the market or other factors (Klein, 1999: 465). Regarding problems of measuring managers' (as well as boards') performance, *normal* cognitive biases such as overstating one's own contributions and understating external influences is a significant problem, as I show in Chapter 5 (see also Langevoort, 2000).

This argument corresponds well to Laffont and Martimort's (2002:146) classification of uncertainty to correctly assess the effectiveness and efficiency of the agent's actions as an endogenous, not an exogenous, uncertainty. By this, they mean that whereas the output depends explicitly on the agent's effort, his "productivity level is only a noisy signal of his actions" (Laffont and Martimort 2002:146).

To put it differently, because the relationship between effort and performance is not deterministic, the principal cannot precisely verify the effort on the base of the output. Thus, as Laffont and Martimort (2002:146) persuasively argue, this type of endogenous uncertainty is key to understanding the contractual problem under moral hazard because non-observable effort (action) remains non-verifiable. Hence, it also cannot be contracted indirectly as accurate examination of output is impossible, since it derives from the agent's effort and pure luck (Lane 2005: 64).

Many of my interviewees acknowledged this fundamental dilemma to different degrees, stating that management shirking and collusion with auditors cannot be eliminated - only minimized. So, effort in risk reporting cannot be exactly known through the output and the agent is always likely to overstate his own effort. This dilemma increases when the agent faces moral hazard situations. Again, the agency problem cannot be completely solved, as it is impossible to design complete contracts. To put it differently, the principal cannot absolutely condition the agent (Lane 2005: 64). This holds particularly true for management contracts in the business world as managers need to be flexible, and not bound too much by contracts. Nevertheless, I point out that public firms, especially our real estate firms in Berlin, do not need to be very flexible as the market is manageable, and they are neither expected to open new markets nor to return high dividends (see Chapter 7). One risk manager even maintained that during his almost two decades working for the company they had returned dividends only twice see (KJ).

The inherent uncertainty about the actual effort input and the optimal performance level poses a crucial problem - especially for business corporations. Firms are strongly interested in saving costs and human capital is one resource where large savings can be made. The uncertainty of transaction costs thus makes it difficult for companies to install effective incentive systems for their agents (Laffont and Martimort, 2002: 146). As to this aspect it is crucial to be aware that human agency is never absolutely determinable and therefore cannot be definitely conditioned. This unpredictability of agents' practices remains the major problem of control and incentive systems. Multiple agents' relations are the special problem of control and monitoring systems in the public sector. In public corporations agents representing the owner, i.e. politicians representing the citizens, contract and control other agents, namely managers. Furthermore, the public shareholder contracts another agent, the auditor, to control the managers, which contributes to the already complex agency relations impacting on issues of shirking, control, and effort input. Most crucially, the actual owner, the citizens, is far removed from firms' business operations and in a rather weak position to exercise control over all his agents. The effectiveness of public pressure for stricter control of public firms' management and risk reporting is more or less confined to times of huge crises such as during the huge risk reporting scandals (Lenk, Rottmann and Woitek, 2009). Because of the large impact of these scandals public discontent reached a level of sufficient pressure to fast-track Corporate Governance reforms. However, management and auditors' lobbies were still powerful enough to ensure that most regulations remained voluntary. Thus, the ability of the public to exercise control on public firms seemed to be more short-lived.

The complex multiple agent relationships reveal a more complicated agency problem in public enterprises than in private ones. The agents' relationships are characterized by likely tacit alliances which are constantly newly negotiated. In particular in times of crisis this might lead to circumstances where shirking of agents might be a problem more prevalent in public than in private firms. Therefore, I present in the following section the main features and issues of public firms.

4.2. The agency problem in public firms

For public firms, efficiency and competitiveness have been new challenges. Because public enterprises are legitimated only on the ground of providing services to the public (*Ingerenzpflicht*), they are not allowed to abandon them at all.[12] Consequently, in theory public firms are not allowed to pursue purely economic profit (Scholz et al., 2009). Therefore, 'the' public mandate might (or is often likely to) limit public enterprises' efficiency and profit-making opportunities. As we shall see later, the term 'public mandate' is very broad. It is highly context-dependent and contested as our interviewees confirmed. It might even "disappear" as the comparison of the annual reports of 2003 and 2010 of the companies studied revealed (see Chapter 7). In short, public mandates

[12]Another specific characteristic of public firms is 'accountability', acting as a role model as the state is the law maker (Lane 2005). In the literature, this feature is highlighted as being rather relevant. In contrast, my interviews revealed that accountability plays only a minor role for public firms (see also Scholz et al 2009). Mostly, accountability as a norm is re-enacted during investigations. However, in these cases, accountability becomes a rather strong feature for the orientation of the public shareholders' behaviour (the politician). Interestingly, in the vast majority of cases investigation or charges against managers (and increasingly boards) are launched only by the respective opposition. (For further details on this aspect see Chapter 7. Compare also Scholz et al., 2009 who slightly understate this phenomenon.

structurally restrict the profit-making of public companies so that an inherent conflict in public firms exists (Scholz et al 2009; Ganske 2005).

Yet, public firms have to fulfil only public mandates specific to their operations. For example, the public mandate of our real estate companies is "to provide broad levels of the population with affordable housing".[13] However, who are "broad levels of the population" and what is "affordable" are highly context-dependent and remain more or less contested (Krätke and Borst, 2000: for the specific development of this issue for our firms see Chapter 6).

On a macro-level, public shareholders' representatives always pursue other political goals and might give them higher priority than the business goals of their firms. In some cases other political objectives might violate the company contract and endanger the firm's welfare. It has also happened that it led to financial losses, sometimes to the extent that firms would have gone bankrupt if the public shareholder had not provided financial aid (e.g. the public real estate firm WBM in 2006, the LBB federal state bank in 2001: see Krätke and Borst (2000) for the early developments of these and other cases).Public shareholder actions impeding business operations or even resulting in losses were an issue frequently raised by all interviewees including board members, although to different degrees.

To illustrate possible violations of company contracts by the public shareholder, the representative of the principal, I give the following examples. Public shareholders might want to pursue primarily political goals, e.g. consolidation or restoration of public finances or improvement of the job market or the general economic situation (Krätke and Borst, 2000).Some of my interviewees shared this view, mainly managers (see Chapter 7). The goals pursued being in conflict with their contract might also concern prestigious but uneconomical projects.

[13]See Bach and Keßler (2010) for a short discussion of the change of the public housing mandate since the 1950s.

After the introduction of the reform of the public sector a broad new consensus was established: as a guideline, public firms should not conduct unprofitable business.

However, especially with regard to prestigious projects, this does not seem to be always the case. One illustrative recent example is the Berlin-Brandenburg Airport where huge risks to maintain its opening date were reported very late. So far the opening date has had to be postponed for two years (see Introduction).[14]Critics of this large project maintained from the beginning that costs would explode and that the airport's profitability was highly questionable (Welskop, 2009).

Another good example of the public shareholder's actions impeding the welfare of his companies is the Berlin senate's failed urban policy from the 1990s until the early 2000s, resulting in losses for public real estate firms (Krätke and Borst, 2000). This policy was based on excessive construction of office space, shopping malls and the like in Berlin to attract companies expected to create many jobs and improve the local job market which was (and is) in a rather bad state (Krätke and Borst, 2000). For one of our firms these projects led to severe losses which contributed to its near bankruptcy in 2006.[15]

Actions by public shareholders to the disadvantage of their companies are not single cases (Ganske, 2005; Scholz et al., 2009). Because public shareholders are not only obligated to pursue the welfare of their company but also other political goals, conflicts might arise. As politicians are measured more on the

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[14] Handelsblatt, Anon., 2013. Flughafen Berlin Brandenburg. Der Geisterflughafen. (23.03.2013). Available at: http://www.handelsblatt.com/politik/deutschland/flughafen-berlin-brandenburg-der-geisterflughafen/7958010.html. [28.03.2013].

[15]Die Zeit online. Rose, M. D., 2009. Das ist der Berliner Filz, Filz, Filz., 15.10.2009. Available at: http://www.zeit.de/2009/43/WBM. [12.12.2011].

basis of their political achievements than on their firms' management, political goals can easily take precedence over the welfare of the company (for more details see Chapter 7). Sometimes, especially when discomforting information on firms has to be published, the personal interests of the responsible politicians to withhold it might dominate (Ganske, 2005; Scholz et al., 2009). This is one of the main reasons for reform attempts to minimize the public shareholder's influence on his firms.

In summary, public enterprises face a structural problem of being exploited by the public shareholder which might lead to huge financial losses. The motivation of the public shareholder might be political, personal or both (Scholz et al., 2009; Ganske 2005). This type of misuse of public firms by public shareholders is difficult to resolve because most of the time the state balances losses and prevents insolvencies through financial subsidies, i.e. it uses tax money to save the firms. This constitutes not only a considerable loss for the actual owner, the citizens, but also violates market laws as it unlawfully gives these firms an advantage. It has to be remarked that states also might save private firms or banks as happened in the recent financial crises when they are considered vital for the economy.

For public firms, misconduct by the "owner", the public shareholder, is more prevalent than in private firms. The public shareholder is on the one hand bound by the company contract and on the other hand by public law specifying his duties as a Member of Parliament or government. These two laws are often in conflict when they have to be realized. Therefore, politicians potentially face more moral hazard situations than private owners. In this type of situation politicians might decide in favour of the political goal. As Ganske (2005) and Scholz et al. (2009) as well as one of the board members interviewed pointed out, this behaviour is very much driven by election periods. The last mentioned board member, who was surprisingly reflective and self-critical, said that it is common practice for politicians to care less about their companies during the last one or one-and-a-half years of the election term (JH). The possibility of frequent change of the public shareholder thus promotes short-term objectives or even negligence of the firm's welfare, because politicians often cannot be held responsible for their actions as they are not in office any longer (Ganske, 2005; Scholz et al., 2009).

Shirking problems for risk reporting

In the following section I introduce the repertoire of shirking patterns available to agents as identified by Lane (2005) highlighting the patterns that are most likely to be relevant for risk reporting. Lane identified several strategies and tactics in the form of hidden knowledge or hidden action available to the agent to increase asymmetric information and pinpointed their relevance for public firms (Lane, 2005: 58-60).

- **Risk of arbitrariness**: refers to the abuse of power and is one form of hidden action. To uphold the law is vitally important for public firms because of the special demand for credibility and accountability of the state, the law maker. With respect to risk reporting this concerns compliance with the Corporate Governance Code as well as non-manipulative application of accounting law. Here, we have to take into account that corporate governance is a rather new process that has yet to be implemented. However, change of practice is a long-term process, as some interview participants also remarked.

- **Risk of appropriation:** describes the use of resources other than instructed.

  Appropriation could be done in many forms and range from embezzlement to corruption. In cases of appropriation it will have a negative influence on risk reporting. However, unreliable risk reporting does not have to lead to appropriation. In a case of appropriation it might create an atmosphere of alliance between the parties involved in misusing government resources and encourage non-compliance to other tasks such as risk reporting. The development of appropriation is also likely to be determined by the practices and attitudes of the public shareholder and the state.

- **Lack of information on outputs and outcomes**: refers to the tendency of people to be detailed in what they need of resources, i.e. give a detailed account of their input, but to remain vague when talking about their outputs. In other words, people tend to avoid giving detailed and precise information on their output or the outcome data. This holds particularly true for measuring outcomes; consequently, this applies to risk reporting as this communicates managers' overall performance outcomes.

The tendency not to give precise information on one's own action outcomes is likely to be stronger during crises when output is more negative, because human beings tend to be reluctant to disclose errors made but usually euphemize their own performance (Langevoort, 2000).

- **Incremental behaviour**: according to Lane this type of action refers to the strategy of shielding oneself by focusing on the increments, i.e. the small changes, making them look more important or large and so distort the overall picture. This could apply well to the task of risk reporting as the agent might disproportionately focus on minor risks instead of discussing major ones (see Chapters 6 and 7).

- **Misrepresentation of costs:** refers to the strategy of tactically using cost estimation. This means that start-up costs will be underestimated and later follow-up costs overestimated. By this means the principal will be forced to continue the project. This strategy can also be used for risk reporting, namely underestimating risks in the beginning and then successively disclosing the actual costs (a rather common practice as the scandals indicated).

- **Increasing discretion or autonomy:** refers to the agent emphasizing the significance of discretion or decentralization for being efficient. However this increases the information gap between him and the principal. Until now managers have been rather autonomous in conducting risk reporting. Moreover, it is often argued that detailed control of risk reporting is a problematic issue as much of the necessary information is sensitive. It is also argued that the management has to stay autonomous to remain flexible and be able to react immediately. I argue instead that flexibility is less important for public managers than for private ones because public firms do not need to expand and open new markets. Furthermore, the actual owner, the citizens, is rather risk-averse and afraid of financial losses.

- **Blaming unforeseen events or factors:** describes the strategy of shifting responsibility for one's own actions to allegedly unforeseeable factors which caused the crisis. In this sense, an often-repeated argument of managers charged with fraud, manipulation or distortion is that risks occurred very suddenly and could not have been predicted. As not all agents' actions are observable, his exact effort and failures are not always easy to determine.

- **Collusion:** refers to monitoring the agent by hiring another agent (in our case, the auditor). This may have an adverse effect, i.e. lead to a search for even more discretion and autonomy or even to collusion between the agents to shirk. For risk reporting and its control by auditors collusion between managers and auditors is a major issue (see Chapter 3).

For all possible practices and strategies, Lane makes an important point, often neglected in the literature: the agent also bears transaction costs for these practices to hide information.

As the risk reporting scandals showed, if these costs get too high the agent starts reporting losses more truthfully. Most of the time, the full amount of losses was reported only bit by bit, indicating managers' potential reluctance for full, immediate and transparent disclosure in times of stress. In the vast majority of cases when huge losses are involved this point is likely to occur when the system breaks down. To be sure, this cannot be taken as a rule. Nonetheless, the reported risk reporting scandals all followed these patterns. Most often it was either the managers themselves who finally reported risks when they could not withhold the information any longer or insiders provided the media with some information which triggered more truthful reporting (Langevoort, 2006).

Most interestingly, control institutions in charge of detecting business fraud or manipulation cannot pride themselves on delivering the biggest share in their detection. According to statistics, detections by control institutions in general never reach high percentages. In the US for example, in 2003 the state control institution detected less than 15% of all detected cases (Langevoort, 2006). Langevoort explained this low output by the rent-seeking interests (benefits) of control institution officers who also want to maintain their jobs. He added that control of risk reporting is often not only ineffective but also costly. Principals however are not interested in decreasing their gain by high transaction costs, i.e. cost-intensive control, particularly if this is supposed to be rather inefficient.

In the next section I summarize and pinpoint the main shortcomings of the principal agent model, especially in the public sector, and then comment on current solutions.

4.3. Short-comings of the principal-agent model

As indicated above, agency theory struggles with the exact estimation of agency costs. A precise assessment of performance (output) is impossible (Lane, 2005). Many studies developed highly elaborate mathematical formula to calculate these costs by defining effort and output level. (see e.g. Laffont and Martimort, 2002). However, these formulas are difficult to apply in the "real world", i.e. to accurately measure agents' performance. These models are based on the assumption that human agency can be absolutely determined. Another set of problems of the model is closely related to this issue: the rationality of action (Wenger and Terberger, 1988: 506). Although some authors of agency theory of new institutional economics include non-rational behaviour in their approach, the majority of works on principal-agent relations adhere to the concept of the *homo economicus*, i.e. the rational actor. However, it has to be considered that action is not always deterministic and, most of the time, the information available to actors is limited (Wenger and Terberger, 1988: 506). Another problematic premise is that people systematically resort to a uniform menu of behavioural pattern. Thus, in the principal agent model the specific context is rather neglected (Sunstein, 2000).

For these reasons, formulas can only roughly assess actual benefits resulting from improved monitoring of the agent as there remains inaccuracy regarding the numbers of gains and losses because of a certain indeterminacy of human action. However, agency theory can provide valuable insights into an agent's compliance on the qualitative level. Furthermore, through qualitative approach as yet under-researched factors such as for example psychological impacts can be usefully integrated and analysed. Thus, the focus on qualitative aspects of agency problems sharpens perspectives on essentially challenging issues of contractual relationships.

Furthermore, principal agency theory allows us to scrutinize the role of the public shareholder who is also an agent and has, as mainly a politician, potentially more incentives to act against the welfare of his firm if he has to choose between this or political goals.

Based on my research findings about impeding behaviour by the acting principal in public firms, public shareholders, I focus on the interaction between the multiple agents and how these dynamics might cause conflicts for 'true and fair' risk reporting and its control. Because the principal-agent model focuses on shirking behaviour it is very useful to provide insights to the main challenges for contracts, contract violations and the management of conflicts. For this analysis it is significant to consider the complexity of each agent's interests as well as their interdependence.

As I started my research with the hypothesis that psychological factors play a significant role when managers withhold information especially during crises, I also highlight the main important psychological underpinnings of these contractual relationships (see Chapter 5). Integrating these aspects in the principal-agent model allows us to better grasp the challenges inherent in contracting. It may also help to find more practicable solutions for these problems even though absolutely effective control will remain impossible. Moreover, too much control of managers is undesirable as this could hamper the conduct of business as well as being a negative motivation (Alparslan,2006: 4; Wenger and Terberger, 1988: 507). Despite these normative restrictions on solutions of agency problems for risk reporting, some solution approaches exist which I describe in the following section.

4.4. Solutions to principal-agent problems in firms

Having highlighted a repertoire of main counter strategies of agents, this still leaves the question of how to minimize their use. In this section I will give only a brief overview of the main solutions to agents' shirking and will discuss proposals specifically for risk reporting in public firms in Chapter 8.

To reduce the risk inherent in delegating tasks, i.e. the possible loss of utility for the principal, several solutions are proposed. Schreyögg (2003) lists the main ones: an optimized selection of agents, an elaborate information system, additional control, sanctions implying loss of reputation for the agent or - the main proposition of agency theory - incentives for the agent promoting a balance of interests and inducing the agent to pursue first and foremost the principal's objectives.

Nevertheless, all these measures are quite cost-intensive and more ineffective than often assumed in the business world as well as in academia (see above). Also, it cannot be disregarded that the principal tries to keep transaction costs low according to the premises of the *homo economicus* model. Hence, for all possible improvement of the contract through increased control, this has to be traded off against minimizing agency costs (Laffont and Martimont, 2002).

With respect to incentive schemes, their properties have to satisfy incentive as well as participation constraints of the agent (Laffont and Martimort, 2002:147).

The optimal incentive contract balances the principal's desire to give the agent incentives to increase effort (often through compensation based on the outcome) with the agent's desire to be insured against fluctuations in compensation that are caused by factors beyond his control (Klein, 1999: 466).However, the past scandals proved that the problem of management shirking is not solved yet. To date mainly pecuniary incentives for managers have been established which have, however, proved to be rather ineffective.

Solutions of principal-agent problems in business management

Currently, the main focus in solving management shirking problems, mainly caused by the information imbalance between the principal and the agent, concentrates on money- and profit-orientated aspects, such as for example shareholder values or performance management systems (e.g. balanced scorecard, performance pyramid, or quantum performance measurement system).However, the implementation of these measures has revealed some of their pitfalls. Below, I summarize their main shortcomings.

- Effective information- and control systems need sufficient up-to-date data. In many businesses, and especially for risk management, this data is (and will always be) to some degree outdated because risk analysis of prospective risks is based on current data but makes predictions about the future. However, data about the future remains to a considerable degree uncertain.

- Non-feasibility of tight control (too cost-intensive) and undesirability of tight management control so as not to impair business.

- The implemented monetary incentives work only in a "positive" direction, i.e. payment for positive business results. Monetary disciplining for management failure (e.g. for inefficient reaction to markets) does not exist. The only disciplining mean for errors is that bonuses for positive business results are not paid. Payment for errors is not included in control systems.

Thus, the state of affairs leaves plenty of opportunity for the agent to shirk and to protect his own interests by hiding information from the principal.

Another crucial pitfall of these measures relates to the assumption that the management will be replaced should it be unable to optimize shareholder value because stock companies mark such companies as take-over candidates. However, these mechanisms do not come into effect or if they do, only too late, with organizations that are not registered in the stock market - like the public companies we are looking at here. Therefore the risk of capital loss or damage through incorrect management, wrong decisions taken or delayed information is there rather ignored.

It is generally assumed that companies with 'strong' (knowledgeable) shareholders are more likely to replace their management (having a strong motivation to keep control) (Wirtz, 2006: 207, 223). However, this seems to apply only in a limited form to public companies because usually there is a great gap of knowledge between shareholder and CEO – therefore the shareholder is specifically in a rather weak position.

Indeed, the work of Fama (1980) gives evidence that managers are rarely substituted because of misconduct. Fama (1980) analysed mechanisms of job markets regarding the role of reputation for managers, meaning that managers would abstain from shirking out of fear to lose reputation and job. He showed that although market mechanisms could discipline managerial behaviour to some degree this was limited, as for managers reputation was sufficiently valuable to predominantly invest in.

Further discussion of effective means to ensure managers' compliance addresses "dynamic agency" (Rubinstein, 1979; Radner, 1981). Both authors refer to risk sharing by the agent. The optimal solution would be full risk sharing. However, this is not feasible due to the prevailing unwillingness among managers to bear the risks of such dimensions. (For similar objections to increased liability by boards see Introduction and Chapter 7.).Therefore, Rubinstein (1979) and Radner (1981) developed a series of contracts which would hold the agent more accountable if he considerably missed business objectives. Furthermore they designed control systems that would provide more precise information for more accurate evaluation of the agent's performance. Besides the remaining questions of costly control and restricting business development by restricting managers, a solution for deliberately dishonest or delayed reporting in times of crises was not touched upon (Foss, 2000: 26).

It follows from the above that the conventional approaches described above offer some useful insights into agent compliance to contracts. However, these approaches are to some degree limited in their explanation of non-compliance. These approaches tend to disregard important influences that "make the system work". As I argue, psychological impacts on risk reporting are crucial aspects for compliance or non-compliance to rules; this is an aspect which is rather neglected in the literature and which I treat in more detail in the next chapter.

5. Cognitive psychology and risk behaviour

My argument to consider the psychological dimension of compliance to contracts is based on the findings of research on motivation and work. Effort input in tasks is mainly determined by intrinsic motivation and voluntary commitment (see e.g. Frey and Jegen, 2001; Dickinson and Villeval, 2004; Harvey, 2005). The power of intrinsic motivation - driven also by self-interest - makes it apparent that control of humans is not an easy task. Human agency is not absolutely controllable and behaviour not definitely predictable.

'Bounded' rationality is a more dominant theme in situations with uncertain and risky outcomes. This highlights the fact that situations and not the individual himself largely determine how people behave. Especially when risky situations develop into threats to the self-interest of agents they might resort to breaching their contracts to preserve what they possess. For the importance of the context, I concentrate my analysis on risk reporting in times of stress and how this is impacted by cognitive mechanisms affecting risk assessments.

Theories of Cognition, risk behaviour and bounded rationality

From the 1950s on, cognitive psychologists developed descriptive theories of how people make decisions under conditions of risk and uncertainty. Herbert A. Simon's work "Models of Man. Social and Rational" (1957) can be regarded as the beginning of a new field of academic research on economic behaviour.[16] This new research area had its origin in a critique of the formerly prevailing model of the *homo economicus* in economics. With time, an increasing number of scholars became dissatisfied with inaccuracies of this behavioural model.

[16] Another ground-breaking article is "Prospect theory: An Analysis of Decision Under Risk", Econometrica, 263-288 (Kahneman and Tversky, 1979). A good compendium is "Judgement Under Uncertainty: Heuristics and Biases (Kahneman, Slovic and Tversky, eds. 1982).

They criticized an apparent gap between theory and reality. Instead, this group of academics assumed that humans do not always act rationally, but exhibit strong traits of "bounded rationality" in their chosen action (Noll and Krier, 2000). This group of academics argued that human preferences and values are *constructed* rather than elicited by social situations (Sunstein, 2000). They maintained that people do not walk around with menus in their heads from which they then choose according the situation (Sunstein, 2000). Most importantly, these scholars pinpointed the many differences in choices that can be observed in the real world which are inconsistent with the *homo economicus* model (Thaler, 1996). Their main claim (which is even acknowledged by the majority of the defendants of the *homo economicus* model) is that the *homo economicus* model is too ideally typical. In contrast, adherents of the "bounded rationality" concept try to explain differences in choices, namely inconsistencies observed (even) in economic behaviour. They thus follow a situational approach to study human behaviour to revise the standard norms of economics (see e.g. Noll and Krier, 2000).

For our subject, one dominant theme in cognitive theory is particularly interesting: the assumption that most people do not evaluate risky circumstances in the manner assumed by conventional decision theory. From the 1950s on, cognitive theorists began to claim that people's actions often do *not* result in the maximization of the expected value of some situation when selecting among actions with uncertain outcomes. In this work, I will look at how cognitive theorists describe the way people perceive and make decisions concerning hazards to their own interests and then transfer the main findings to likely behaviour of managers and shareholders in risk reporting processes during times of stress.

Before doing this, one of the major problems of cognitive psychology must be mentioned. Its new insights are mainly derived from experiments and surveys. There is a general tendency in academia to question the validity and representativeness of behavioural experiments (in and outside the laboratory: see Frey and Stutzer, 2007 for this subject). Moreover, empirical studies conducted by cognitive psychologists are also criticized for their specific design having influenced participants' behaviour and research results (Noll and Krier, 2000: 326). However, despite this criticism a large number of insights from cognitive theory are consistent with conventional decision analysis. In this work I do not use controversial research results, but mainly well-established theoretical assumptions, for example on human biases (Noll and Krier, 2000, see below).

There are two main claims of cognitive decision theory. First, people *systematically* mis-estimate probabilities. Second, people do *not always act* on the estimates they make. These principles considerably revise conventional decision theory (Noll and Krier, 2000; Sunstein, 2000; Langevoort, 2006).At the origin of systematic non-rational behaviour are biases which are inherent in cognitive structure. These biases have to be distinguished from cognitive pathologies. Cognitive pathologies are defined as systematic, repeated decision methods (not random errors) that are *simply irrational* and mistaken (Noll and Krier, 2000). They consist of presuppositions and calculation methods that incorrectly consider information and do not preserve decision costs. They can be *expected* to result in losses for decision makers.

Biases and heuristics, instead, refer to so-called cognitive shortcuts people use to solve complex problems. These shortcuts cause “mistakes” in the sense that they lead to decisions *inferior* to decisions that would have been chosen had the shortcuts not been used. Thus, these types of decisions increase costs for decision makers. Nevertheless, the use of shortcuts is not necessarily irrational, because in general it saves information-processing and decision-analysis costs. People use shortcuts to save time by selecting from the information available, often by rule of thumb, i.e. heuristic means. Heuristic means are also used when taking business decisions (see below). On many occasions this works out well, but it may also lead to systematic errors. If errors induced by heuristics and biases are on average sufficiently small and if information and decision costs are sufficiently large, then the use of shortcuts can yield net benefits to decision makers, i.e. their use is rational.

To deal with these behavioural traits that are assumed to be more dominant in real life than conventional analysts recognized, cognitive theorists developed a set of hypotheses about how individuals evaluate risky outcomes. In doing this they wanted to offer alternatives to mathematical formulas used in conventional decision theory. This set of hypotheses based on assumptions about human biases and heuristics is called prospect theory.

For my present work on risk reporting, I am only interested in the essentials of cognitive theory, so I will not discuss all aspects of cognitive and decision theory, but only the most important implications of cognitive theory for agency behaviour in times of stress and crises and how this may affect the risk behaviour of the various agents involved (managers and shareholders). To highlight these possible cognitive mechanisms, in section 5.2 I will look more closely at the process of calibration of data assessment when it means disclosing negative information about the company and thus one's own performance (here I refer foremost to managers, but secondarily also to boards, as bad news about firms implies also the latter's failure as the responsible controller).

5.1. Heuristics and biases

As mentioned above, it is well established that people suffer from various biases and aversions that can lead to inaccurate perceptions. In the following section I give a brief description of a selection of biases and heuristics that are of particular relevance for our topic: moral hazard in risk reporting, i.e. the choice to breach the manager contract (for the following see Langevoort, 2000 and Sunstein, 2000).

Status Quo Bias: People tend to prefer the *status quo*. Deliberate change of the *status quo* demands a great deal of effort for them, and it also demands much effort to justify departures from it to others. So, one central finding of prospect theory is that people evaluate situations from a reference point; mainly this is the *status quo*.

Extremeness Aversion: People tend to avoid extreme outcomes. Whether an option is extreme depends on the stated alternatives. By trend, this gives rise to compromising effects. However, people appear to approach risk-taking differently depending on the framing of choices. When evaluating potential gain, people exhibit a strong degree of risk aversion. But if faced with the choice of trying to avoid loss what they currently possess, people tend to be more risk-seeking. For our topic, assumptions about loss aversion are most important as in crises managers fear losing their job and are highly likely to preserve it. Thus manipulating data in these situations is likely to occur as, for example, the risk reporting scandals proved.

Optimistic Bias: Human beings tend to be optimistic. This characteristic taken alone seems to be beneficial; but it can lead to making more or less big mistakes. Even accurately informed people tend to think that risks are less likely to materialize for themselves than for others. Thus, there is systematic overconfidence in risk judgments and people tend to reflect illusions about themselves.

Hindsight Bias: People tend to think *after* the event that things were inevitable. Hence, even their judgment *after* an event based on inferior choices is incorrect in its assumptions. In some sense this bias refers to the limits of learning, indicating that some cognitive non-rational mechanisms cannot be washed out.

For human behaviour towards risks and risk assessment, behavioural economists and cognitive psychologists have uncovered a wide array of heuristic devices which people use to simplify their tasks and which I introduce briefly in the following section.

Availability: People tend to think that risks are more serious when an incident is readily called to mind or "available". Depending on its pervasive power, the availability heuristic will produce systematic errors. Assessments of risks will be pervasively biased, in the sense that people will *think* that some risks are high, whereas others are relatively low. This bias may lead to over- or under-estimation of risks, or over- or under-reaction to them.

Anchoring: People often make probability judgments on the basis of an initial value, or "anchor". Crucially, they tend to be reluctant to adjust this focal point of information to new information. Further, the initial value may have an arbitrary or even irrational source. This may lead to a high level of arbitrariness. In the worst case, the probability assessment may go badly wrong. However, cognitive conservatism, i.e. an aversion to revising one's choices, is a widespread phenomenon. For our risk reporting cases, it could be observed that not only the involved managers tried to maintain a good image of the company until it inevitably broke down. Interestingly, investors also kept believing in this image even though it was a long time before the collapse became sufficiently transparent for the ordinary market investor to recognize the severity of the firm's problems (Langevoort, 2006).

Case-based Decisions: Because it is often difficult to calculate the expected costs and benefits of alternatives, people often simplify their burdens by reasoning from past cases, mostly the best available ones. In combination with the optimistic bias, we may assume for our cases that many managers may tend to assess risks on the basis of past successes (also of other companies), not failures and interpret the data accordingly. For example, one of the board members interviewed said that they had just revised their risk assessment and introduced as its guideline the worst-case scenario principle. This implies that this was not done before. At the other companies studied, worst-case scenarios were not guidelines for risk assessment (see Chapter 6).

Organizational Behaviour

Starting with the path-breaking article of Jensen (1976) on the internal structure of firms, there was an increasing tendency among scholars to transfer the concept of individual behaviour to the macro level, i.e. here the organizational level.

Recently, scholars have drawn more attention to the role of culture in business and in firms (Langevoort, 2000) as a powerful concept to explain the working of firms as it is constituted by various agents.[17] It is also now established that culture is important in promoting business productivity, as it is the basis for creating cooperation and trust in firms. In the end, this makes firms more efficient and also makes their external commitments more credible.

One important and well-established assumption is that culture (also) depends (much) on myth. Or more precisely, culture can have strong elements of myths. Culture does not depend on reality and too strong a dose of reality might be even seen as counterproductive. As to this aspect in business organizations during crises, it is highly important that myths reduce the fear and stress that uncertainty often generates.

Consequently, for this role of culture in organizations, there are strong arguments in the literature on organizational theory that biases operate within corporate belief systems that are inherent in human cognitive structure and that cannot be eradicated. Thus, these biases are *predictable.* Most crucially, they cause managers to *misperceive* events and risks. These biases allow them 'in good faith' to perpetuate an unrealistic belief system even - or particularly - when facing external stress. Especially during crises companies need strong cultures, i.e. a shared set of values, to function well and efficiently to overcome them. As Shrivastava et al. (1987) have demonstrated particularly in times of external threats managers tend not to see reality, because they fear losses.

[17] For the following see Langevoort (2000) if not indicated otherwise.

This fear could more often than not lead to “utterly fantastic” things published by managers during severe crises (e.g. Citibank, International Harvester: see Shrivastava et al., 1987: 90)

If cognitive biases play a crucial role in the actions of managers (and shareholders/boards), then we have another reasonable explanation for misleading corporate disclosure practices. Thus, we can assume that often corporate disclosure will (not always) reflect what an objective observer would see, but what someone embedded in the corporate culture would perceive (for embellishment practices in accounting in the firms of my case study see Chapter 6).

We have to add that there are no predetermined rules inevitably blinding corporate managers. In regard to this aspect, I take up the main arguments of Langevoort (2000, 2006) pointing to a loose connection between beliefs and productivity and disclaiming the widespread assumption among conventional theorists that both are completely separated (for conventional theorists see e.g. Häußler-Konnertz, 2011; Hamann, 2003; Scholz et al., 2009; for a subtle critique of conventional analysts see Ganske, 2005)

We also have to stress that decision-making is highly contextual depending on the information, the situation and the individual. For example, some information is hardly ambiguous and thus difficult to distort, e.g. sales data or cash-flow. Distorting reporting behaviour has been little studied to date, so that we cannot make any precise predictions about its development. Moreover, I do not want to overemphasize the phenomenon of distortion in corporate reporting. However, against the background of recent increase in delayed reporting, distortion or fraud, it is significant to look more closely at possible developments from a behavioural and cognitive perspective as the above mentioned biases are sufficiently well accepted both in the theoretical and empirical literature to be taken seriously.

As we can assume that the above-mentioned biases are typical features of processes of communication (Langevoort, 2000: 148) it is worthwhile to take a closer look at the ones that are the most relevant for the corporate disclosure process.

Cognitive conservatism and decision simplification

Cognitive conservatism: People build schemes to provide them with "best available" interpretations. Only when they are given enough motivation will they revise these schemes to reflect new information. Further, processing capacity limits lead to a bias against revision. Thus, the general cognitive strategy is to construe information and events in such a way as to confirm prior attitudes, beliefs, and impressions. Like all biases, this "cognitive conservatism" occurs unconsciously.

So, people are likely to unconsciously tend to resist the significance of information which calls into question the viability of a course of action because it is something particularly worrying and humans tend to resist revision of perspectives to the worse. We could observe this type of behaviour at least for one company studied that did not include pending legal changes negatively affecting its financial situation in their risk assessment (see Chapter 6).In addition, as Argyris (1993) argues in his research on organizational learning, many corporate cultures discourage (mostly in an informal manner) open expressions of doubt and scepticism. This tendency of corporate attitude skews information flows, especially when it comes to risk reporting.

So, potentially troubling information is frequently subject to dismissal or rationalization. However, as long as it can be processed to be consistent with the original belief (i.e. project objectives), this is done without much conscious deliberation. The tendency to ignore evidence that bring changes to one's environment is likely to be especially strong when the bits of information come sequentially in small doses rather than aggregated in some salient event. However, as the risk reporting scandals proved, even during crises, in general, managements show huge reluctance to publish immediately a full assessment of all expected losses.

Although this behavioural tendency can be simply explained in terms of 'bounded rationality', in addition, it fulfils the motivational role of reducing stress. Revising a schema is anxiety-provoking, especially if it opens up a host of worrying possibilities. Subconsciously, busy managers do not want to be bothered with discomforting information, and so are likely to seek to minimize the threat. Like most people they are likely to tend to ignore risks that appear to have little probability of occurring. The preferred action will be to keep the dismissal or explanation of risks in conformity with the existing schema. As to reaching business decisions, many studies confirmed a tendency among many managers toward circumscribed information searches guided by seeking bolstering information to support their status quo decisions while ignoring contradictory data (e.g. Messick and Bazerman, 1996). This implies that it takes a fairly visible or significant threat to prompt revision. In short, we can assume that in general most managers will systematically underestimate external threats or risks as opposed to overestimating success. In our case studies this behaviour is exemplified by the risk reporting behaviour of one company indicated above. The public shareholder passed a new law to record expenditure loans as liabilities, which amounted to a considerable sum for this firm. As other firms appealed on this new law, the company ignored it until finally the law was approved by court. This amounted to such a significant incident that the firm revised its previous risk report indicating near bankruptcy. Thus, new information was resisted for a long time – until it could not be ignored any longer.

Generally, people are optimistic about the results of their actions as indicated above. In the following section I highlight the aspects of the previously mentioned biases that are crucial for the interplay of these traits and how this may lead to the distortion of corporate disclosure by managers when assessing risks in times of problems (and maybe with the tacit agreement of the public shareholder and board).

Over-optimism and the Illusion of Control

The over-optimism bias belongs more to the motivational sphere than the *status quo* bias. People are not merely optimistic about the success of their actions, but tend to over-rate their own skills. This is indicated by the way people tend to identify causes for negative and positive events. The first one is generally attributed to external causes, the second to internal ones, i.e. personal skills. This bias is called the egocentric bias. Largely unconsciously, people filter self-referential information with the same asymmetry to bolster or maintain self-esteem (on the need for self-esteem see Greenberg et al., 1992).

While especially in corporate settings some external expressions of optimism and confidence are deliberate forms of impression management, psychologists believe that most often the person *truly* accepts the excessively positive self-schema (Langvoort, 2000). More precisely, by publishing optimistic statements about the company managers start believing them in fact, if they have not done so before. Thus, we have to say they *truly* believe in their (over-) optimistic statements and do believe they are complying with their contract until their risk assessments are shaken by *overwhelming* counter-information.

It is further noteworthy that over-optimism is likely to produce more positive results than less optimism. Therefore, over-optimistic behaviour is often rewarded and thus re-enforced. This holds especially true for the business world where risk-taking and high output are highly important, particularly for corporate leaders.

As to the demand of the corporate environment to maintain a positive image of the firm's development - including future risk developments - even or especially in times of stress, another cognitive mechanism comes into play: self-deception. Sustaining an illusion (i.e. a positive account of the firm's situation in times of crisis) is important to diminish the anxiety caused by stress and crises to keep the company's action focused and thus increase the chances of successfully managing the risks faced. This is most effectively accomplished by self-deception that decreases self-doubt (Langevoort, 2000).

The risk reporting cases mentioned earlier revealed that the responsible managers tried hard to maintain the illusion about the wellbeing of the company as long as possible. The managers interviewed also all strongly emphasized that they were in full control of risks, both present and prospective, and that they operated highly elaborate risk managements in an almost perfect manner (for further details see Chapter 7).[18] Accordingly, most interviewees, being boards, shareholders or auditors, claimed to always fulfil their tasks to the highest standards (see Chapter 7). In short, all the interviewees exhibited overconfidence in their skills, one of the major highly valued business principles.

This suggests that overconfidence and some sort of self-deception in business and in politics is a predictable and frequently observed bias. In public companies this bias is also shared by political boards. It becomes particularly crucial when public shareholders decide on prestigious but unprofitable projects or policies, such as the promotion of constructing office space or shopping malls at a huge and much overestimated level, as happened in Berlin in the 1990s and at the turn of the 21st century. Another example is the Berlin-Brandenburg Airport that was severely miscalculated from its beginning in the late 1990s but was pushed through, until very suddenly in April 2012 the opening was

[18] Managers eagerly maintained this image of perfection, even though they somehow contradicted themselves by saying that risks can never be assessed absolutely accurately. Thus, in this case they valued their own performance as high while naming external factors (risks) as the cause for (possible prospective) mistakes. For more details on this aspect see Chapter 7.

cancelled three weeks before the planned date (see Chapter 4). These are just a few of the many examples of failed business strategies forced by public shareholders, driven by overconfidence and commitment as well as by the perceived availability of the state as the 'lender of last resort' (for the last point see Chapter 3).

The crucial point, then, is that overconfidence results in over-commitment and thus underestimation of risks. This behavioural tendency is supported by the existence of a “can-do-culture” that prizes the dismissal of risks. This behaviour might well lead to failures and these behavioural traits do not tend to be eroded by learning and experience (Langevoort, 2000; 2006).

Commitment and cognitive conservatism largely determine the attitude of decision makers towards projects and their risk assessment. For projects with high commitment the decision maker has a strong motivation to resist evidence that he was badly chosen. He would most likely be afraid to revise his previous decisions because he expects that this would be taken as a sign of inconsistency, a feature not appreciated in general, especially not in corporate settings. Thus a person will fear a negative impact on his self-esteem if he departs from a previous decision. This will be even more true if he had to announce it in public. For corporate leaders this action is all the more difficult as they function as role models (see McAuley and Duberly, 2007 on this point).

This tendency to self-inference or self-deception is explained in cognitive dissonance theory by the human need to maintain a positive self-image (Harmon-Jones and Mills, 1999). This premise is supported by management literature that suggests that once managers have committed to a project or action they are biased to information on this commitment. This means they filter the information disclosed, but to some extent also the information gathered. This is especially so when their choice is public and they can be held accountable for their decisions (compare, for example, the delay in disclosing crises in the risk reporting cases).

Management research has not only found out that managers might have a strong drive to distort information for these types of projects, but also that they might well *start action* to secure them (Langevoort, 2000). It is hold that they might actively seek bolstering evidence while resisting discomforting information. Most researchers maintain that this is done more subconsciously, although we can see a possible rational basis for this behaviour originating in the "last-period problem", where every effort is invested to prevent essential or existential losses (Langevoort, 2000; 2006).

Self-serving Beliefs

The notion of self-serving inference is another fundamental construct in social cognition. Self-inference processes - the way individuals make judgments about themselves - have been studied in social psychology and sociology for many years. However, a distinct literature on this topic has not emerged due to the diversity of relevant issues. For our subject the most significant are the impacts of self-inferences on conditions motivating 'escape from the self' – in our case embellishing or manipulating corporate disclosure (Langevoort, 2000: 158).

The bottom line of this concept is that when there is enough ambiguity to permit it, people "see what they want to see" (Langevoort, 2000: 158), and what people tend to want to see is what most benefits their self-interests. Threats to their self-esteem or career prospects are in general ignored. Threat is stressful and is therefore resisted. Moreover, particularly for small groups (e.g. boards) threats to self-interests upset group cohesion (for this aspect see below).

To be sure, this is not to say that management control groups live in settings of joyful ignorance. Much information is just too unambiguous to manipulate or deflect. For example, companies do have regular feedback in the form of sales data, cash flow and the like. It should also be added that self-serving inference is not an anxiety eliminator, but only a buffer. However, a self-image of efficacy and control is of high value to managers (and also to boards) to justify their positions and their status to themselves and others because they are corporate leaders acting as role models for their employees. Furthermore, as company leaders they are expected to be successful.

Here, the Janus face of optimistic corporate culture becomes visible. On the one hand optimistic culture is very much needed as a motivator (for the manager and for his employees who first and foremost are, and have to be, motivated by him). On the other hand, this type of culture is likely to promote self-deception. Additionally, this cultural characteristic can lead to justifying the preservation of the *status quo* – and then rising risks are likely to be ignored.

Moreover, it is likely that enacted optimism mechanisms lead on average to an even more optimistic attitude than before. As optimism is also needed to stay focused and succeed, this suggests that highly optimistic forms of belief may well strengthen even in the face of increasing discomforting information as it starts to threaten the personal interests or needs of the manager.

Most importantly, self-serving inferences are pervasive and hard to disentangle from business justifications. For the presentation of business projects or strategies, factual numbers and developments are hard to separate from the personal performance of managers. This means that the predicted profitability of projects might be structurally distorted by an over-optimistic presentation of the manager's actions and performance. This indicates an interesting connection between social psychology and conventional economics. Self-serving inferences might lead people to mis-estimate risks "in good faith". They do not perceive themselves as breaching their contract (Langevoort, 2000).

It is essential to emphasize that these cognitive mechanisms are *not* pathological. Instead, cognitive mechanisms are the reason why otherwise 'good' people may find themselves responsible for 'bad' behaviour (Langevoort, 2000). The development of this behaviour is due to the so-called "whipsaw" effect of over-optimism and over-commitment (Darley, 1996: 13). Increasingly, ethicists recognize that antisocial behaviour in business settings may be less the product of base moral corruption than of the ability of normal people to distort and rationalize in stressful situations (Langevoort, 2000). Consequently, considering self-serving inferences is particularly useful in better understanding the nature and persistence of agency costs and moral hazards in organizational economics,.

5.2. Business settings, risk reporting and crises

Having described the impact of cognitive mechanisms on reporting on projects, project results and risk developments, we have to look at how these apply to corporate disclosure. For this, we first have to recall the main features of the general conditions of corporations and demands for reporting risks.

Since the introduction of the various corporate governance regulations, all larger firms have to establish risk management and internal control systems designed to prevent information gross distortion. Accounting control systems are well suited to monitor the use and disposition of corporate assets, but on a basis that emphasizes *current* and *historic* reporting, not future trends (Albers, 2007). Thus the major problem in budgetary or financial control systems is a certain out-datedness of information relating to product and technology, so that prospective risks show up only very late.

Structural delay of risk information inherent in risk management systems is exacerbated by legal control regulations. As mentioned in Chapter 3, even after reforms it is still the management alone who has direct access to information about relevant corporate matters. The other agents, even more importantly the controllers, lack direct access to risk information (Langevoort, 2000: 161). Given the over-optimism and self-inferences biases, these cannot be neglected when looking at manipulation of corporate disclosure. This is not to say that managers would always make use of their power to embellish or manipulate data because they are the only ones who have direct access to it; however, in times of stress, it is likely that they will increasingly do so. Furthermore, as I indicated above, managers do not always distort the information *in bad faith*. This implies that it is difficult to regulate the above-mentioned cognitive mechanisms and/or create incentives for managers to report in the sense of a risk-averse shareholder (the taxpayer, the actual owner, is particularly risk-averse).

It is also relevant how the shareholder and his representatives communicate their risk reporting goals to the management. As the shareholder is the employer of the management it is significant which value he accords to timely risk reporting, as this affects how the manager values it. Conflicts in corporate disclosure arise when this collides with the public shareholder's self-interests, e.g. disclosing discomforting news during election periods or concerning prestigious projects with high commitment (Ganske, 2005). In these cases, low interest on the part of the principal - here the representative of the actual principal, the politician and an agent – in timely reporting on risks can be assumed, which might negatively affect the effort of the second agent, the manager.

In conclusion, the combination of dominant straits of corporate culture to discourage open expressions of doubt and scepticism and some structural reluctance of political boards and public shareholders in some situations to report in a timely fashion on large risks might skew the information flow. These circumstances make distortion of discomforting information more likely to be a feature of reporting practices, the more so in public business because of the complexity of multiple agent relations. Moreover, market mechanisms to eliminate these practices do not function well in public firms because in general the state will be resorted to as the final creditor in order to save endangered firms.

These decision-making processes in relation to risk reporting inhibit another important aspect. Groups can increase (over-)optimistic biases (c.f. examples not only from business, but also from sports; see Langevoort, 2000). In fact, overconfidence in business organizations is well researched (Argyris. 1993; Shrivastava et al.,1987).

"We are building this airport because *we want it*!" was the answer of the former Berlin mayor Eberhard Diepgen facing criticism of the unprofitability of this project in 1999 (Welskop, 2009: 73). "Some people do not want you to have success" replied the present mayor and board chair of the airport, Klaus Wowereit in 2012 when confronted with the risk reporting failure of the airport managers leading to the sudden delay of the opening of more than two years and yet not fully disclosed damages in the millions.19

These statements are clear evidence that in public firms not only managers but also political boards might distort risk reporting when it is in their self-interest. These quotations are good examples of how the above-mentioned biases (cognitive conservatism, over-optimism) can readily lead to ignoring some kinds of risks. Especially when people are highly committed to ideas or projects (the Berlin-Brandenburg Airport is such an example) it is likely that information on deviance is easily explained away. Instead, management and board are likely to interpret incoming risk information as a minimal, containable danger.

Generally, commitment to projects makes the responsible person want to manage the information flow so that no negative and endangering news reach

[19]Handelsblatt, Anon., 2013. **Flughafen Berlin Brandenburg.** Der Geisterflughafen. (23.03.2013). Available at: http://www.handelsblatt.com/politik/deutschland/flughafen-berlin-brandenburg-der-geisterflughafen/7958010.html. [28.03.2013].

the shareholder and/or the public. Persons with immediate access to project information will be very aware that any risk information will provoke stress and potential loss (Langevoort, 2000).After all, we have to be aware that at the early stages information about risks surfacing at a conscious level is often still speculative and temporarily remote. Hence, they are still very susceptible to rationalization. It is still easy to explain them away and preserve the aura of optimism. As a result, risks are either not reported at all or they are communicated upward (in our case to the shareholder and the public) in a form that dulls them. However, even if there is conscious shading of reports, it is not necessarily done in bad faith but is a result of the optimism schema.

Omission of certain information

As a means of avoiding more fully detailed disclosure, omission of certain information can be readily justified by the argument that the people to whom the information is addressed might take it out of context, overreact to it, or otherwise misunderstand it. In my interviews it became apparent that managers very often claimed that political boards were not knowledgeable enough to make sense of annual audits or other business and risk reports; it was said that they lacked the necessary expert knowledge and therefore could not fulfil their duty properly. Similarly, one board member remarked that some managers do not dare to discuss business developments and risks with boards in much detail because they think they will not understand it.[20]

Apart from the argument that political board members need too much explanation if they are to understand reports, there is a general tendency to simplify agendas for group discussions in order to make decisions tractable, because groups can concentrate on less information than individuals (Miller,

[20]This view is mirrored in the literature (e.g. Lentfer, 2005). Less emphasised is the fact that effectivity of control may depend more on the will of the controller to invest high effort, be investigative and expect manipulation than his expertise (also, according to the CGC managers should report in plain language.) This view on control was confirmed in my interviews. The board members explained that through very tight control of both managers and auditors they could detect manipulation even though they are non-business experts (see Chapter 7 and Hamann, 2003).

2003).Information processing in groups is therefore frequently done by focusing the group's attention only on immediate, first-level effects. However, the effect of this focus is to minimize or even put out of mind the more complicated and unpredictable second-level and systematic consequences – even though they are potentially important. Furthermore, because of the complication of holding discussions in groups, ambiguous information tends to be dismissed as unmanageable. Therefore, a tendency may well be exacerbated in groups, namely that information that cannot be demonstrated is not passed, as my interviews also indicated. It seemed that discussions in board meetings are very much tainted by how managers select the information. This selection is likely to be determined by their self-interests and biased information searches (Messick and Bazerman, 1996).Interestingly, Langevoort (2000) also found that in groups it is more likely that risk information is held back because of existing collective pressure to save projects and the interests of the group as a whole and its individual members. This holds true especially in times of stress.

There is also a kind of circularity to these behavioural mechanisms of "herding behaviour", meaning that if no one reports this encourages the belief that it must be right to do so and wrong to do otherwise. Herding behaviour is much more prevalent than often assumed because acting in a manner which does not conform to the group standard will cause discomfort for oneself and for the group. People have to strongly justify their group-deviant behaviour; therefore this kind of action demands strong commitment. In some risk reporting scandals it became apparent that some members raised internal criticism before the crises deepened, but were silenced (e.g. Enron, LBB).[21]

[21]For Enron see Cruver (2002), for the federal state bank of Berlin, the former LBB see Zimmermann (2006).

Business decisions and rationality

As to expertise and business decisions, new research emphasizes that failures are not so much a problem of expertise and knowledge, but have their origins in the limits of human rationality and behaviour (Langevoort, 2000; 2006; for a good critique of the so-called competency trap see Levinthal and **March,** 1981).

Langevoort (2000; 2006) and Noll and Krier (2000) hold that most business decisions, especially expansion into new fields and high-risk taking operations as undertaken in the risk reporting scandals, are ambiguous, and particularly so in the early stages.

Due to often uncertain signals from the business environment, most of these business decisions are not taken on very rational grounds but, rather, high commitment is put somewhat blindly into projects where most of the time it is not certain that they are going to be a success. In this light, it is crucial that nearly all failures can be assigned to intervention and unforeseen situational factors rather than to flawed decisions.

Such environments frustrate organizational learning and rational decision making. In this kind of setting, rational choice readily gives in to superstitious explanations. Therefore, especially in times of crises, decisions and processes that are more symbolic than real may develop. This is not so much because firms are not motivated to act rationally, but rather because environmental signals frequently leave a void that has to be filled quickly to stay focused.

So, generally, the social role of senior executives prizes decisiveness and action to prevent organizational paralysis. Often choices have to be made fast and therefore probably by using heuristic means. Typically, these kinds of business decisions would be made with a special commitment to monitor a project in its early stages closely so that it can be abandoned should risks surface. However, as we have seen in the risk reporting scandals this is not always done.

As mentioned, the use of heuristic means in decision making might be to all intents and purposes rational. Selective information processing in corporations might well be rational because routines, and hence stable perceptions of situations, might be necessary to be able to maintain consistency and focus, even though it might result in tunnel vision and ignoring risks. Also, more optimistic, potentially distorting, companies are competitively superior to more "realistic" companies. This premise finds a great deal of support in the social-psychology research on individual and group behaviour relating success to optimism (Noll and Krier, 2000).Furthermore, it is suggested that optimism is crucial to build trust. Especially corporate leaders need to be overly optimistic to build the trust of their employees in their business strategies, which is even more important in times of crises.

It should be noted that the findings on bounded rationality in making business decisions resulted from studies including highly successful international corporations including investment companies (Langevoort, 2000). Langevoort's assumptions, belonging to the social sciences, are in contrast to orthodox economic theories on the rationality of agents and the efficiency of markets. Orthodox economist's claim that the market will wipeout those firms that act in a less than rational, and hence inefficient, fashion. According to orthodox economists, firms with management myopia, excessive optimism and executive hubris will not survive. Accordingly, these subjects will not be crucial issues in business. In contradicting this view, Langevoort (2000) refers to the limits of learning and experience proved by recurring failures of the same structure. These features will remain to some degree persistent because even if market forces finally wipe out firms with those types of managers, given the strength of cognitive biases there will always be some companies entering the market with overconfidence. So, the market will never be fast enough to wipe out all firms forever.

With these arguments Langevoort (2000) criticized the basic model of orthodox economists, the *homo economicus* who acts rationally. Thus, bounded rationality of economic actors is not confined to public business where non-experts might influence the course of action.

In summary, the conditions of risk reporting in business organizations are under strong internal and external pressure both to grow the business and increase profitability and prove success. These demands are the principle environmental factors that drive management's (and to a lesser extent shareholder's) actions in relation to business decisions and risk disclosure. In our cases we also found that prestige, subsidies or tax cuts might drive public shareholders and managers to commit to uneconomical projects where distortion of corporate disclosure is more likely because of their probable failure (US: 17).

Risk behaviour: cognition of action

We have seen that the desire to keep the *status quo* is one of the main reasons why people tend to avoid reconsidering their risk assessment once it is made, even if risks have developed. People also tend to exhibit loss aversion, a negative change from the *status quo*. Generally, people tend to invest more effort into preventing losses than receiving gains. This is especially so when it comes to essential or existential losses. So, when managers are faced with losses they are more likely to preserve it. This could lead to distorting corporate disclosure.

These assumptions of cognitive psychology contradict accounts given in the literature as well as by my interviewees of continuous and systematic monitoring, evaluation and adaption of risk management systems. At least, we can assume that continuous monitoring, reassessing and possibly changing previous risk disclosure for the worse would be a great challenge to human cognition.

It is important to emphasize that this behaviour is not pathological or necessarily of bad faith. Managers might distort information on risks while still believing they are doing the right thing for the company. In the beginning, most of the time risk information is still vague enough to be easily ignored or at least not be reported (Langevoort, 2000; 2006).Yet, when the situation arises that less ambiguous risk information reaches the persons who have the most direct access to the information, biases are likely to shift even more from the cognitive to the motivational sphere. At this point, post-decision commitment becomes stronger. Now initiators have not only an emotional but also an economic investment in the survival of the project. Its failure is likely to have very troublesome career implications for those who find themselves in this particular "probational crucible" (Langevoort, 2006: 155). At that point responsible officials may well perceive themselves as being in something of a personal "last period" (Langevoort, 2006). In "last period" situations generally psychological resistance of the concerned persons hardens and the temptation to distort discomforting information increases. Yet, as Langevoort (2000) argues, managers might still not necessarily distort information in bad faith, even though at this point some background awareness of trouble may surface.

In the process when risk information increases in scope and value, the responsible person faces competition between conscience and motivated rationalization. This competition continues until the information becomes so clear-cut that its implications are unavoidable. Thus, as we have witnessed in all the numerous risk reporting scandals: Managers only reliably reported on risks when it became inevitable, i.e. when the system broke down.

I still maintain checks and balances can improve corporate risk reporting and its control (see the interviews in Chapters 7 and 8). However, regulations promise to be more efficient if bounded rationality of organizations and individuals is kept in mind. As my interviewees emphasized, it is important to also focus on the establishment of new norms, as rules will be followed only when corporations and managers believe they are to their best.

Current management practices of risk reporting of the firms of my case study as well as the risk attitudes of managers, public shareholders, and boards are the subject of the following two chapters.

6. Case study: Management reports of public real estate firms in Berlin

In the previous chapters I discussed principal conditions and issues of risk reporting and its control in public firms. Against this background, I analyse in this chapter the annual, management, and risk reports of the companies studied to extract their disclosure practices as mirrored in these reports. As already mentioned, a detailed analysis of risk reporting practices was not possible, due to the lack of internal sources and the unwillingness of my interviewees to reveal too much about their internal affairs. After the analysis of the reports of each of the four companies I compare them and then highlight the role the public shareholder has in this process.

For the analysis of the companies' risk reporting practices I analysed all of the four real estate corporations' latest available annual reports (2010) with a focus on the management and risk report, and then compared the most important issues with the reports of 2003. I chose 2003 as the year to compare to the most recent reports because in this year a different shareholder was in place conducting a different policy than the current one.

I concentrated on the analysis of the management report as the disclosure of existential and essential prospective risks are located here (Gulden, 2003). It has to be repeated that only these types of risks are reported. Risks below this level do not have to be mentioned to maintain clarity and focus. Mentioning minor risks would distort the information and distract the reader's attention or divert it from the major problems (Hamann, 2003).

For the technical Case Study please see the chapter 10. Appendix

Results from the Case Study:

In summary, it is most revealing that for the vast majority of risk categories all the firms provided no information at all. This ranged from 11 to 13, and even 15 from a total of 20 categories. This supports my argument that all reports are of rather low information value and implementation of reporting norms is weak.

For all annual reports, the main part is devoted to further detailed presentation of the actual figures, but not the target ones. In contrast, risk reports of all firms are rather short. Reports are rather optimistic - sometimes too optimistic - and reporting concentrates mostly on citing many examples of business successes and social projects (including interviews and pictures). Reporting business successes seems to have priority. Thus, little space is made available for critical matters as well as risks.

Compared with the scope of recommendations by the DRS 5, all risk reports of the management report show many significant gaps. Moreover, contrary to the recommendations of the DRS 5, a lot of information is not included in the risk report of the management report but mentioned in other parts of the management report, namely the economic and forecast report. This makes it more difficult for the reader to get a quick and comprehensive overview of the main risks, because he first has to gather the information. Also, quite a high number of risk categories are not even mentioned. This is contrary to one of the main guiding principles set by the DRS 5, the principle of completeness. For example, it is noticeable that one firm does not report on 15 risk categories of 20 although it is well known, even in the press, that this firm is still suffering from severe financial difficulties. The other companies do not perform much better (see table above). Furthermore, all the firms cite risks only as examples but avoid presenting a full overview. Moreover, no firm quantified any risks. This makes it hard or even impossible for the reports' addressees to assess the actual impact of risks on corporate development. Additionally, the firms report on all risks in very general terms, so that it is impossible for the reader to trace facts and comprehend the prospective risk development.

All the firms only partially adhere to the principles of proper management reporting such as accuracy, lack of arbitrariness, completeness, clarity, comparability, materiality, information gradation and caution. For example, property assets were only indicated as book values. An additional indication of fair value, the actual market value, was not provided. Thus, there is a lack of the required transparency, because hidden reserves or charges which may exist are not disclosed. In contrast to IFRS (International Financial Reporting Standard), the German Commercial Law (HGB) does not demand the disclosure of hidden reserves. Book value is always lower than actual market value because permanent impairment of value has to be written off and increase in value is allowed only to a very limited extent (only in the context of previous special depreciation due to "extraordinary" transactions). So, all the requirements of the § 289 HGB were formally fulfilled by all the firms. Nevertheless, even though the content of their reports in fact also stands up to this, completeness cannot be checked.

Risk reports also have to indicate risks for which no accounting measures were taken, e.g. through provisions (DRS 5). However it is up to the management how to define risks, so it can decide which ones to mention and which not. Thus the list does not have to be complete.

The principle of lack of arbitrariness demands a consistent derivation of risks including the description of underlying assumptions as well as the forecast horizon. Here, all the reports show that forecasts on the future corporate development were very general without giving explanations or necessary details. Recommended gradation of information with a focus on materiality was also not given. For all the firms, risks were mentioned without making differences or specifics apparent.

Lack of quantification comes into play here. This made it impossible for the reader to know the specific prospective impacts of the various risks. Prioritizing risks is thus impossible. Setting priorities, however, is one main purpose of the report to effectively guide action if it becomes necessary. For this purpose risk probability has to be placed in relation to damages. For example, a risk with 5% probability can be essential if in the worst-case scenario damages amount to several million €. On the other hand, a risk with a probability of 25% and worst-case damage of € 50k is not essential.

Comparison of the risk reporting of the various firms is, moreover, difficult because the structure of the reports is not uniform. Managers are free to choose the structure of their report and the presentation of data. This applies even within the same industry. In addition, a comparison of reporting practices of single firms with previous years is also difficult because even within firms most of the time no uniform reporting structure is followed either. So, in general only current risks are indicated, and this information is not related to data from previous years.

In summary, the low level of reporting practices of all the firms is also made possible because of their autonomy in risk reporting. Therefore, public real estate companies should be required to adhere to the DRS 5. Possibly, this could be also checked by the auditor. Most importantly, the structure of reports should be standardized – in particular for firms of the same sector and the same shareholder – because uniformity is an important prerequisite for an insightful comparison of data and the detection of differences or contrariness. Thus, these measures would increase the information value of the risk reports.

The Case Study outcomes gave the opportunity to analyse and check as part of the triangulation data generated by the interviews – as the following examples show:

All reports are more or less embellishing and no quantification of risks is included. This does not fit with the interview outcome of the company representatives, that all risk reporting are fine and well done.

One company representative sees risk reporting more as a fulfilling of legal requirements. "When it´s done, it's ok". And normally "nothing changed" is reported. The annual report of this company shows despite an improved real estate market, rental income, and the main revenue source, decreased. Moreover, a risk existed because not all operating expenses of real estates were cleared yet. This amounted to about 30% of the total facility management costs. This illustrates, that this company does not report properly and does work with this risk systems.

All companies were awarded an unrestricted audit approval (as we can see in the case study). But one company had to revise the annual statement and was facing an over-depth because of occurred legal risks. This shows, that neither the company has a good risk reporting – as the interviewed representative claimed – nor the auditor has checked the legal risks (here an existential risk) sufficiently.

After having analysed the companies' annual, management and risk reports for 2010, I will now briefly compare them with the firms' reports for 2003 by focusing on the business goals to highlight how these are influenced by the public shareholder and how this affects their business operations and might indirectly also impact risk reporting.

6.1. Comparison of the annual and management reports 2010 with 2003

A comparison of the 2010 management reports with those of 2003 shows a different priority in the firms' business goals. This was due to a change of the public shareholder after elections. In contrast to 2010, in the reports of 2003 the business goals focus on reductions in personnel, restructuring and increase of efficiency, i.e. maximizing of return (shareholding report 2003 of the state of Berlin: 306 for Company A). Furthermore, successful rent rises and selling objects en bloc are very much emphasized as objectives (shareholding report 2003 of the state of Berlin: 316, 321). In contrast, even though the recording of expenditure loans as liabilities is presented in length, their risks are not mentioned at all (shareholding report 2003 of the state of Berlin: 325). Interestingly, the public mandate, i.e. providing broad sections of society with affordable housing, is also not mentioned at all.

Regarding Company C, a successful rent rise is also emphasized as one of their main objectives (shareholding report 2003 of the state of Berlin: 224). Similar to Company A, allegedly necessary organizational streamlining as well as changing the payment system to the cheaper wage agreement for housing companies (formerly the German civil service pay scale) are highlighted (shareholding report 2003 of the state of Berlin: 227).

As with Company A, sale of housing objects en bloc to third parties is planned to maximize revenues (shareholding report 2003 of the state of Berlin: 229). The advantages of these sales are supposedly "market-driven apartments at competitive prices"; again, the principle of affordable housing for broad segments of society is not mentioned (shareholding report 2003 of the state of Berlin: 229)

Company B pinpoints the tension between public mandate and profitability, but then proceeds to emphasize the importance of rent increases to improve the corporate financial situation (shareholding report 2003 of the state of Berlin: 420). Debt write-off and improvements in the results of property management are the two main goals for the following years (shareholding report 2003 of the state of Berlin: 432).

It is difficult to compare Company D with the other firms because of its considerable economic difficulties.[22] From 2003 on, a restoration program was implemented that concentrated solely on profit-maximizing.

The most striking aspect is that in 2003 none of the companies analysed focused on the public mandate – however this is defined. Instead, all the companies concentrated solely on increasing their return. In contrast, in 2010 the public mandate was part of the business goals. This inclusion impacted negatively on profit from business operations. When business is more difficult, crises might arise, and having financial difficulties might promote withholding discomforting information, as I argued with Langevoort in Chapter 5. This is not to say that this definitely has to be the case; however, it is obvious that in good

[22] For the difficulties of company D see http://www.zeit.de/2009/43/WBM/seite-1) (06.11.2011).

times it is more likely to report more truthfully, i.e. not overestimate the situation, than in bad times.

To be able to assess the political influence of the public shareholder on the business of his companies, I now turn to investigate his political stance towards public mandate and firms' profit-making.

6.2. Politics, public real estate companies, and obstacles

As demonstrated in the analysis of the companies' reports for 2003, the state finance minister from 2002-2009, Thilo Sarrazin, set as a single priority the profitability of public real estate firms, i.e. increase in revenues. The main goals of his policy were to decrease subsidies, permanently reduce firms' debt and to create positive annual surplus.

The numbers prove the success of this policy. Profit of all firms increased from € 758 million in 2005 to € 1,024 million in 2006.[23] This amounts to an increase of 35%. Accordingly, losses decreased from € 37 million to € 7.2 million. Sarrazin's successful policy continued during his entire term of office. From

€ 1.16 billion losses in 2002, these decreased significantly and, indeed, a surplus of € 1.02 billion could be generated. Further, state subsidies for public firms decreased to € 541 million.

Interestingly, the public mandate of public real estate firms was not part of this policy. The single goal of these companies was to increase their revenue. In this period the goals of the finance ministry to consolidate the state budget and thus

[23]Senate of Berlin, Press release No. 07-029, 2007. Beteiligungsunternehmen: Eine Milliarde plus. (20.04.2007). Available at: *www.berlin.de/sen/finanzen/presse/archiv/20070420.1340.76501.htm*. [13.12.2011].

also its firms dominated over the public goals mostly pursued by the urban development department.

After 2009, the state government coalition changed. The new finance minister, Ulrich Nußbaum, moved the policy for public real estate companies back to the public mandate as a business goal. In this context of change, a so-called "Mietenbündnis" (rent alliance) was formed.[24] Its representative was the minister of the urban development department. The agreement between the federal state and the public real estate companies consisted of lower increases in rent to be able to provide affordable housing for wide segments of the population. Thus, we witness a change in policies and a re-emphasis on the public mandate as opposed to profit-making. Nevertheless, a passage was included in this agreement stating that if these stipulations caused the public real estate companies financial difficulties they were allowed to opt out. Here, we observe that one of the main goals of NPM now prevailed. The limit for public services was now to ensure public firms' profitability.

The potential conflict of the two goals, profit-making and public services, is clearly visible here. Public mandates are only to be fulfilled if it is economic. Yet, pursuing the goal of public services remains not free of conflict for public managers. According to their contract they are not allowed to abstain from possible profit-making. They might even be charged with breach of trust in this case. Thus, under company law, public mandates reducing revenues can be implemented only in a limited form.

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[24]Paul, U., 2012. Finanzsenator stellt Mietenbündnis in Frage. *Berliner Zeitung.* 04.09.2012. Available at: http://www.berliner-zeitung.de/berlin/wohnen-in-berlin-finanzsenator-stellt-mietenbuendnis-in-frage,10809148,17045766.html. [09.02.11.2013].

Conclusion

In summary, we have seen great instability on the part of the public shareholder. This potential conflict is further intensified by internal conflict on the part of the public shareholder. This concerns mainly opposition of technical departments, i.e. the finance and urban development ministry (see above and following chapter). Often they pursue opposing goals, namely profitability by the former and public services by the latter. Moreover, actions by the public shareholder are highly influenced by the political goals of politicians. More importantly, they often behave as if constrained by party instructions even though this violates their contract with the public firm. All these characteristics produce a highly unstable and conflictive environment for business and thus for managers.

Furthermore, the public shareholder often initiates projects which are prestigious, but which are clearly unprofitable from the beginning (see Chapter 3). In these cases, political representatives of the public shareholder might not always be interested in immediate and full transparency, i.e. disclosure, due to political reasons and other self-interests. This reasoning is supported by the fact that the public shareholder has not yet standardized risk report requirements for his companies in the same sector. Also, adherence to the DRS 5 is not pushed. Against this background, it comes as no big surprise that managers also seem not always to be very motivated to disclose risk positions immediately and completely. One reason for this attitude might be that managers might assume that political representatives will not always want to be informed immediately and fully, e.g. during election periods.

This argument is supported by the fact that the investigation of risk reporting scandals in public firms always concentrates a great deal on the question of when the public shareholder in fact found out about the damages. Many times, political representatives try hard not to disclose this, and often it was revealed later that they knew more in advance than stated.

Also, I myself experienced that in general the public shareholder is willing to discuss business problems face-to-face, whereas discussing problems via email is most often strictly avoided. The reason for this reluctance is that emails always indicate the date they were sent and confirmation of delivery, and could thus serve as strong evidence in case of later problems and clarifications.

Having given an overview of the general state of risk management and reporting practices in Germany and a detailed investigation of reporting practices of four public real estate companies in Berlin, I turn now in the following chapter to the most important topics raised by managers, shareholders, boards and auditors during my interviews.

7. Risk reporting in the German public sector: Public real estate companies in Berlin

In this chapter I deal with the main issues concerning risk reporting and its control in public companies as they were raised in my interviews, and guided the previous chapters of this study. I interviewed managers, board members, representatives of public shareholders and auditors, then compared their different views on special issues of risk reporting and control in public companies.

The main issues encompass the organization of risk management and reporting systems, problems of business operations in public companies, the complicated and sometimes conflicting role of public shareholders and issues of control by the board in the face of the relatively large autonomy of managers to handle risk reporting on their own. I also discuss the main problems of control by auditors, highlighting their complex relationships with managers and boards that might decrease their effort input in monitoring risk reporting by the management.

7.1. Efficiency of risk management systems and efforts of risk reporting

The main legal change introduced by CGC (including the Berlin Code of Corporate Governance - BCGC) is the obligation to establish risk management systems and risk reporting guidelines (besides reports in the annual balance sheet) and to do this in writing (see Chapter 3).

7.1.1 Communication between management and board

In addition to the annual statement, managers have to report on risks and prospective risk developments in quarterly reports. Both types of report have to be compiled according to accounting law (BCGC VI.1.) Annual statements have to be discussed with the board. In contrast, it is optional to discuss quarterly reports (BCGC VI.1.)

Personal discussions of risk reports allow immediate investigations by the controller. This is less possible when reports are just handed in. In my case studies, all the managers explained that they also discuss the quarterly reports with boards (KJ, JM, CB, US). If this is true the managers would have fulfilled the BCGC even for non-mandatory regulations which would be a sign of a relatively high standard. However, the same managers' statements were to a certain degree contradictory because they also said that reports are only presented and not discussed with board members (KJ, CB).

With respect to time intervals of control, all the interviewees stated that board and managers meet at least every three months (e.g. HW, KJ, JM). According to BCGC III.1., boards are free to choose how often they meet managers. An interval of three months for board meetings is recommended by the CGC and would be of a rather high standard.

Interestingly, one former board member said that he met the managers of the Berlin water company every month, but the managers of the state investment bank only every three months (HW). The Berlin water company does not face high risks. In contrast, the state bank faces higher risks. Furthermore, it has suffered from past mismanagement and had to be restructured.

Against this background tighter control of the management of the bank seemed to have been more urgent than of the water company. Control of the Berlin water company was also stricter because a special control office was established by the board collecting data independent from the top-management, namely from the second level management. As I demonstrated previously, collection of data independent from the top-management is an effective control instrument because it diminishes the large opportunities of managers to manipulate data.

The fact that the management of the low-risk water company was controlled rather tightly by the same board chair, as opposed to the more risky bank, raises questions about the reasons. The board chair declared that it was definitely necessary to keep a close eye on managers to ensure compliance with legal regulations and sustainable business. When I then investigated with one representative of the shareholder the topic of the special control office for the water company, he remarked that this was an unusual measure taken only by the board concerned, but that he himself disapproved of this kind of institution (DS). He furthermore asserted that the office would be dissolved soon as the board chair had just resigned from his position due to elections. This shareholder representative explained his objections to getting information from the second management tier, i.e. independent from the company's management, as follows:

> "The management has to know which information is given. I would always get information only from the management itself so that the information and communication flow is kept in order, and so that no one later says: 'Well, if you had asked me, I would have told you something completely different.' And when they [managers] disallow information - well, this does not help me in my work." (DS).

This statement is highly interesting. The public shareholder representative justifies his opinion not to get information from the second-level management because it might be contradicted by the top-management. However, it should be assumed that all management levels of one firm should provide (almost) the same information. Also, contradicting information can be proved right or wrong for each side. However, this public shareholder representative accords executives the most trust - or maybe rather the final say - in advance.

As Berlin also witnessed management distortion in corporate disclosure, this 'blind' trust in managers' honesty does not seem to be easily justified. In summary, his statement gives the impression that tight control of public managers might be a minority position among public shareholders.

This reasoning is confirmed by statements of board members and shareholders alike that so far there has been no attempt at implementation of the BCGC or standardizing risk management and risk reporting systems (DS, JH, HW). As already mentioned, standardization would considerably increase the value of the information in risk reports because comparison allows us to detect peculiarities or omissions more easily.

The main goal of corporate governance initiatives was to ensure timely provision of information on prospective risk development, because early reporting is the prerequisite for effective countermeasures and prevention of insolvency (Konnertz-Häußler, 2011). Therefore, now strategic risks have to be included in the risk reports to increase their information value for the addressee. According to one auditor, this change has considerably improved risk management in its foresight and detail (WW). However, he was quick to add that in the vast majority of cases risk management and reporting practice were of a high standard (WW). Asked about the increase of detected risk reporting scandals he classified them as isolated, very rare cases which are not at all representative of the state of reporting practices.

Studies revealed a rather poor record of risk reporting in Germany.[25] Interestingly, one of the managers interviewed (of the state bank) supported these findings, which also give a glimpse of the effort input of auditors. According to this manager the bank's auditor issued an unrestricted audit certificate for a certain annual report (UK).[26] Banks, however, have to observe

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[25] For a study on management reporting practices in Germany see http://www.boeckler.de/pdf/mbf_lageberichterstattung_2004.pdf [09.11.2012].

[26] We have to consider that this manager most probably was open to recall this incident because this annual report was compiled by his predecessor. Otherwise it is unlikely that he would have implicated himself.

stricter rules and control than firms. In addition to checks by auditors their annual statement is also controlled by the German Central Bank and the Federal Financial Supervisory Authority (FFSA). With respect to the already approved annual report, both institutions detected several serious transgressions in the report and ordered a revision. This is one hint that auditors do not always invest high effort in controlling managers. Indeed, dependency of auditors on managers is one of the main topics to ensure reliable risk reporting, as discussed earlier (see also below).

In summary, all the interviewees described the effectiveness of their risk managements as high. Recalling the organizational mode, the systems seemed to be of a high standard, sometimes even surpassing the mandatory regulations of the BCGC, for example, discussing quarterly reports. However, (tight) control of managers by the board does not seem to be so easily implemented as the difference in the level of control of the Berlin water company and the state bank showed. Here, strictness of control did not correspond to the respective business risk level.

The main pillar of risk management and reporting systems is risk analysis. This is the subject of the next section.

7.1.2 Psychological influences on risk analysis and reporting

Risk analysis and methods have experienced rapid development during recent years (Gärtner, 2003; Hamann, 2003). Particularly important was the development of more sophisticated models to quantify qualitative risks. Quantification of risks is important because it makes more accurate and transparent statements than mere verbal descriptions. Thus, the information value increases. As I showed in the previous chapter, none of my case study firms did quantify risks. Furthermore, in most risk categories no comprehensive information was given.

Unsurprisingly, all the managers asserted that the performance of their risk management including risk analysis was excellent (JM, KJ, UK, US, CB). They also claimed that their systems could be quickly adapted even to sudden changes. Yet at the same time they cautioned that risk analysis can never be absolutely precise or include all possible risks (JM, KJ, UK, US, CB). One of the managers stressed that except for e.g. loans and financing it is impossible to exactly calculate all prospective risks (though to various degrees) (JM). He maintained that, despite all elaboration of risk analysis methods, this will remain impossible because of the inherent uncertainty of risks, i.e. the unpredictable nature of the future. Also, analysis is based only on current data; future data remains to a certain extent imprecise. As examples of risks in real estate which are especially hard to assess, this manager named legal regulations such as rent and energy laws (JM).

His argument that the future is inherently unpredictable is indisputable. Nevertheless, the analysis of the firms' annual reports proved that even standard risk analysis methods were not used, e.g. quantification, explaining methods and their underlying assumptions. I also demonstrated that at least some firms embellished their financial position. One company even had to revise their annual report because they originally omitted an important legal risk which finally led to over-indebtedness.

Most importantly, all the firms showed a rather poor record of risk reporting. Most risk categories were not reported at all, in some only low information was given, and no risk category contained comprehensive information. In summary, all the reports lacked comprehensibility, transparency, accuracy and completeness. Therefore, the statements of the managers interviewed can be doubted. The over-optimistic evaluation of their risk reporting is seemingly due to one of the human biases, as explained in Chapter 5.

It is also noteworthy that the main problem of past failures of "true and fair" as well as timely risk reporting was not chiefly caused by the unpredictability of the future. As the risk reporting scandals proved, risks developed to a dangerous level (even an existential one) well before they were reported. Actually, risks were only reported when the system broke down and reporting could not be avoided any longer (e.g. Enron, SachsenLB, IKB).[27]

This characteristic of disclosure manipulation is due to the human bias towards over-optimism and overconfidence as well as high effort investment when faced with losses, as explained by behavioural economists (see Chapter 5). Thus, interestingly, the managers I interviewed advanced the same argument as the managers charged with manipulation. All of them maintained that risks develop suddenly and cannot be foreseen. It seems that this belief is widespread in the business world among corporate leaders. Finally, this assumption served, and probably will continue to serve, as a justification for late risk reporting. In contrast, research on all risk reporting cases found that risks were apparent for a long time before they were reported, so they did not develop as suddenly as argued by the charged managers.

Interestingly, Langevoort also corrected the conventional assumption that the market detects such failures (Langevoort, 2000). Instead, he proved the inefficiency of the market, for example in the Enron case where it was evident for a long time before the crisis was announced that the management reports gave inaccurate information. The problem with markets then was that most people kept seriously believing the management despite the availability of contradicting information; thus they acted irrationally.

[27] For the Enron Case see Utzig (2002). For the IKB see Der Focus, Anon., 2009. Anklage gegen Ex-IKB-Chef erhoben. 01.07.2009. Available at: http://www.focus.de/finanzen/news/ortseifen-anklage-gegen-ex-ikb-chef-erhoben_aid_413205.html. [12.11.2011]. For SachsenLB see Spiegel online. Anon., 2007. Schwere Vorwürfe. Anklage gegen Ex-Vorstände der Sachsen LB., 10.09.2011. Available at: http://www.spiegel.de/wirtschaft/unternehmen/schwere-vorwuerfe-anklage-gegen-ex-vorstaende-der-sachsen-lb-a-785556.html [12.12.2011].

Langevoort's assumptions about inherent biases promoting delay of risk reporting in specific situations are supported by the explanations of one risk manager interviewed. He mentioned that he has to strongly motivate his employees to report on risks because of a general great reluctance to do so. This manager tries to convince his employees to give full risk disclosure by stressing that risks are not their personal fault (KJ). Yet, this argument is only valid if risks originated from a time before the employee started his work.

Reluctance to report on risks and thus indirectly admit personal failure derives from the human bias of overstating one's own performance, as already mentioned. When even employees are reluctant to report on risks, this must be even more true of corporate leaders, because they are the principle responsible for the whole company and therefore have to fear more consequences.

Regarding tendencies of reluctance to report discomforting news, the following remark of one board member is interesting:

> "However, he [the manager] will think *twice how* to present this information. Thus, a manager of a large firm who had to give information on his company on a monthly basis, he [actually] would report relatively early, but he would mention them under item 27 B on page 173 of his report saying *maybe something* [risks] *might* develop. So, then he has said it and written it down. Then, just after that, he will also list all the numerous countermeasures he has taken and then he will wait. Will the board react or not? If it reacts this is a sign that he has reported early and in a solid manner. If it does not react, then he has still reported it [the risk] and so he is on the safe side. "(JH, emphasis original).

Thus, this ex-board member described management behaviour as often being a wait-and-see attitude. Managers ensure that risks were mentioned in some form – but they do not make them sufficiently transparent, as the expression "*maybe something* [risks] *might* develop" indicates. The word "something" is indeterminate, i.e. a vague verbal statement. This hints at the use of general phrases open to all kinds of interpretations. This seems to be the basis on which managers ensure they have sufficient opportunities to justify their rightful behaviour in case of problems (see the Enron and IKB scandals). The following comment quoted is a further hint that managers might often be reluctant to report risks: "He will also list all the numerous countermeasures he has taken..." creates the impression that this risk has already been well taken care of.

In summary, it was and is not so much the issue that managers omit reporting on essential risks; however, it is not unlikely that they make imprecise, non-comprehensive and non-transparent assessments.

Moreover, this account tells us that managers might be rather confident that such reporting practices are successful and accepted by the board. This in turn questions the effectiveness of control by the board (see below). How such rather low level of risk consciousness is mirrored in managers' risk analysis we will see in the following section.

As I explained in the previous chapter, another indicator of the level of risk reporting is the time span of the prognosis horizon. As mentioned, the literature sets as an ideal a two-year horizon for essential risks and a one-year horizon for existential ones. The firms I studied instead used a five, ten or even twenty year prognosis horizon (JM, CB). Because increasing years of prognosis decrease the accuracy of information, at least two of the firms are lagging far behind. Statements of other risk managers about how they conduct risk analysis are further revealing:

> "Certainly, you can only report what you *know*. [...] Of course, *you might also assume* certain things to be under way. [...] Well, but this is a sensitivity analysis that you can only conduct in theory." (KJ).

This statement modifies the value of risk analysis methods. The manager seems to express that you *may* assume things, but you do not have to and you can only report what you know (for sure). However, risk analysis is about making assumptions about the future. He also said that sensitivity analysis maybe conducted. All in all, he did not seem to be very interested in risk analysis and data accuracy. This interpretation is supported further in the interview. This risk manager talked only about technical risks such as construction defects etc. The firm's risk report proved that its risk management did not consider many risks. It focused more on technical risks and was therefore not all-encompassing as it should be ideally (see e.g. Müller and Brackschulze, 2011; Ganske, 2005; Langenbucher, 2003).

Furthermore, the risk manager remarked that risk management was assigned to him accidentally rather than deliberately (KJ). All this, including the above quote, supports the impression that the firm's risk management is not very highly developed. For example, the risk manager stated that assumptions of prospective risk development are not really at the centre of their risk analysis. Another of his statements supported the impression that little effort is invested in risk analysis:

> "That means I obtain from the numbers which *I may analyse theoretically every day*, as well as from all this information we have anyway about the objects ... well, there the things [risks] *pop up automatically*." (KJ).

The phrase "I may analyse (the numbers) every day" gives the impression that this is not a firm rule, but may also be omitted. The comment "risks pop up automatically" indicates that risk analysis is regarded as an easy task that does not need much effort input. In fact, in the mind of this risk manager it does not even seem to be a task in its own right, but a by-product of the management of the corporate data. In summary, these statements as well as the report of his firm prove a low level of risk management, thus also of risk reporting and risk consciousness. Crucially, it is exactly this firm that disregarded a legal risk that finally amounted to an existential level.

Unsurprisingly, many managers do not seem to be overly eager to invest much effort in reliable risk reporting, as it is unpleasant to report risks you might have caused yourself or reported them late, as I demonstrated in the previous chapter. Instead, many CEOs seem to expend more effort on how to present company risks most favourable in the annual statement (see below). Hints at low levels of risk consciousness among the managers in my case study can also be found in the following remark of one CEO:

> "Well, this is, - the risk level for [public] real estate companies is [in general] not very dramatic, well, ... there is nothing particular to it [risk management], but to [...] fulfil the duties of having a functioning risk management system, you have to report every quarter; most of the time reporting 'nothing has changed'. This is mainly the information we give every quarter to the board in our quarterly report." (CB).

Notwithstanding this statement, the firm's annual report of 2010 gives different information. Despite an improved real estate market, rental income, the main revenue source, decreased. Moreover, a risk existed because not all operating expenses of real estates were cleared yet. As this amounted to about 30% of the total facility management costs, these costs could develop to considerable levels if the statutory period were exceeded. Crucially, no accruals were set aside for this risk. As I analysed this annual report in the previous chapter, I will briefly summarize the results. This company indeed faced some risks in 2010 and it also embellished the report on its financial position. Thus, the report contradicts the above-mentioned statement by the firm's manager that in general there is nothing to report.

Testimonies by the two board members I interviewed provide further insights into the state of managers' reporting practices. Both declared that (risk) reporting practices are highly diverse and differed widely (JH, HW). Consequently, the state of knowledge of the public shareholder about his firms ranged from good to very poor (JH, HW). One of the board members described managers who gave poor records on their business operations and risks as follows:

> "As to the latter [who tend to disguise risks], I often had the impression they view reporting as an imposition. They think it is them, and only them, who will find the best solution." (JH).

In contrast, he described managers who report in detail about their business operations including risks as seeking regular consultation with board members (JH). He elaborated that this behaviour (seeking regular contact with the board) originated not so much in a drive for more control, but to discuss how to deal with and solve risks (JH).

Even though this is a rather broad division of managers which in fact might be much more nuanced, it reveals important factors for managers' motivations to reliably report risks. Individuals who perceive themselves as being the only ones who could find the best solution often regarded the board as insufficiently qualified. Consequently, they would not view reporting as a priority as the party to be informed is regarded as not being sufficiently skilled to participate meaningfully in handling the matter. The other group, on the other hand, regarded consultation with boards as useful.

This topic refers to the lack of business expertise among many board members, in particular among political ones (JH, CB). As already mentioned, corporate governance reforms also concentrated on professionalization of boards to enhance their capability to control managers (see e.g. Lentfer, 2005). Therefore, reforms stipulated that at least one financial expert of the respective industry has to be on the board. At the same time, the boards' consultancy role was also emphasized. Although in general experts are better equipped than lay people to find adequate solutions in their field, I argue that for effective control the most important thing is not understanding the subject but being willing to ask inquisitive questions. This reasoning is on the one hand supported by Langevoort's findings about the inefficiency of markets, where even the vast majority of experts did not draw attention to the crises (Langevoort, 2006), and on the other hand by the application of effective control instruments holding interrogations with experts by lay men (see section board control practices).

With a pinch of salt, it can be argued that if managers deliberately seek contact and consultation with the board, their reporting might tend to be more detailed. Therefore, I pursued this matter with further interviewees. The risk manager mentioned already several times replied to the question of common consultation between managers and boards about risks:

> "What does that mean, *collective* [decisions]? It is principally the management who propose solutions [on risks]. That is also what the company law tells him to do, to say, 'Ok, I have a problem, but I also have the solution'." (KJ).

He further elaborated on this subject:

> "All risks discussed in the meetings, *are already known*. And then, the management presents how to deal with it – and that's it. There is no actual participation [by the board]." (KJ)

This risk manager was very surprised at my questions about whether managers discuss risks with boards, even though corporate governance reforms are intended to strengthen the consultancy role of boards. It is expected that stronger involvement of the board will enhance their motivation to control management and business risks. The two quotes above, however, indicate that in this firm the board takes a rather passive role. Risks and their solutions, and hence also the definition of risk magnitude, are simply presented by the management and seem not to be questioned by the board in general. Indeed, according to the risk manager the board seems to play only a minor role.

In the case study I showed that this company has a permanent debt of about € 30 million. Most crucially, the firm recently faced an existential risk due to the new legislation to record expenditure loans as liabilities. This risk has been apparent for at least five years, and the other firms in my case study took the necessary steps early and started to record these loans in previous years. This firm, however, was less risk conscious, which resulted in serious problems and the need for large financial aid from the public shareholder to avoid bankruptcy. Obviously, there were essential if not existential risks to be discussed between management and board. We do not know if these matters were really not discussed with the board. However, they were not mentioned in the 2010 annual report so we would be justified in assuming that managers did not disclose the actual financial situation to the board. However, it could also be the case that the board was informed but that with the consent of the board this information was not made public. In any case, both assumptions support Langevoort's hypothesis that during crises managers tend to withhold discomforting information, at least from the public.

In summary, all the managers claimed that their risk management and reporting systems were high-performing. Notwithstanding these statements, the analysis of their risk reports proved otherwise (see Chapter 6). Indeed, the value of information given was rather poor, not indicating the majority of risk categories or quantifying risks. Some reports were also clearly embellished. The auditors interviewed also commented that corporate risk management and reporting systems were in general highly efficient. The board members, instead, recognized that risk reporting practices vary a great deal. Consequently, the public shareholder's knowledge about his firms' financial positions differs greatly. They concluded that some managers report very poorly. One of the board members even maintained that this might be a common problem (see the third section of this chapter). He then elaborated:

> "As a board member, I can demand it [reliable and detailed information] five times from the manager. If the manager does not want it to happen, it will not happen. As to that subject [reporting], they are definitely autonomous." (JH).

This comment shows some resignation regarding disciplining managers. Even though managers are the employees and not the employers of boards, in the end the former often seem to be more powerful. This indicates that the relationship between managers and boards might sometimes be turned upside down. How this impacts the effectiveness of the control by boards I discuss below.

As to managers who report poorly, the above-mentioned board member explained that one characteristic of them is reluctance to consult with the board. This type of reluctance was also expressed by the risk manager interviewed and his firm's reporting was rather poor (see above). Thus, we might conclude that close interaction between managers and board would improve risk reporting, as is also recommended by the Corporate Governance Code.

As already mentioned, thorough risk management is based on clear business goals. In contrast to private firms, public ones pursue not only profitability, but also public services. Thus, their business conditions are more difficult than those of private firms, as they have to balance both goals while staying viable. Moreover, as I have already indicated, the public shareholder in particular might further hamper business by pursuing other interests that might be to the disadvantage of his firms. Thus, we can assume that public firms face more problems than private ones, leading to slightly more vulnerability to crises. And it is especially in crisis situations when human beings might tend to avoid disclosing discomforting news, as I argue in common with Langevoort (2000). For all these factors, I investigate in the following section the influence the public shareholder has on his firms and their business operations, which was also one the main issues raised by all of my interviewees.

7.2. The public shareholder as risk

According to one former board member, it is the senate which sets the broad outline of business goals for his companies once a year (JH). In theory, these goals should be discussed with boards to reach a joint decision. In reality this was not the case as this ex-board member claimed. (JH). In fact, he first encountered the outlines of business plans defined by the public shareholder when the ministry sent it to him because his signature was obligatory as he was the secretary of state of the department of economic affairs, technology and women (JH). He critically concluded, because of obvious lack of time the senate did and could not expect him and his department to review the business plans in any serious manner.

He explicitly criticized the fact that business plans were decided on by the finance department alone (on behalf of the senate), but did not involve the boards of firms. He pinpointed that the company's board is closer to the firm than the finance department and therefore should be consulted (JH).

To better understand his objection to the dominance of the finance department we have to remember that he belonged to a technical department. As he elaborated, conflicts often existed between the two departments about the business goals of public firms. According to him, most of the time the different factions among the political board members tried to settle differences before board meetings to ensure smooth operation, but sometimes conflicts were so fierce that they broke out again even during the meetings. Thus, there seems to be structural internal conflict about business objectives on the part of the same public shareholder.

To various degrees this was confirmed by managers. Auditors even named this as one of the major problems for public firms. One of them elaborated on the impact of internal shareholder conflicts further (WW). He recalled an incident when a former minister of finance instructed his firms' managements to request any conflicting orders from other ministries in writing so that they were documented in case of possible future problems. However, the other ministries refused this order. This auditor remarked that this was only one example out of many where public shareholders lack coordination of decision-making structures causing conflicts and tension, in this case for public firms.

He asserted that the different representatives of the public shareholder are unable to define a common business strategy. One board member added that this holds especially true for longer periods (HW). All these points are confirmed by other research (Ganske, 2005; Scholz et al., 2009).

Some managers elaborated further how instability on the part of the public shareholder might impact on the ease of conducting business. So, one manager stated that it is difficult to identify business objectives accepted and adhered to by public shareholder representatives because of internal frictions on the part of the public shareholder (CB).Not surprisingly, one board member denied this, whereas as the other board member who was quite self-critical affirmed it (HW, JH). As one example he recalled an incident where political board members tried to pressure managers and other board members to ensure the local population had a say on the use of a market hall in their neighborhood (JH). Instead, the non-political board members and managers wanted to pursue the most profitable use and replied:

> "[Dear] friends, this [your goal] may well be so, but then you first have to reformulate the mandate of this company." (JH).

Obviously, political board members did not always care if their goals violated the company contract even though they had committed to it by law.

Another manager of the Berlin state investment bank also confirmed that the public shareholder might often cause problems for conducting business (UK). He explained that particular interests of the various public representatives play a dominant role in business decision-making processes (UK). Also he stressed that many times final decisions are not based on sufficient consensus among the politicians themselves as well as managers.

Interestingly, the manager mentioned above had similar experiences. He said that even after business plans were accepted by the public shareholder, he could never be really sure if the same shareholder would keep to them (CB). From all this it follows that the public shareholder is not always reliable and predictable. Consequently, he is a risk to his companies as the following remarks confirm:

> "The political risk caused by activities of the public shareholder is hard to compensate. And it [this risk] is very common. This is our core problem that has been keeping us up day and night for years. And this is my favourite phrase that I always like to quote, you can quote it too: 'The [public] shareholder is much more dangerous for his companies than the market.'" (KJ)

> "I have said this once. The biggest risk for public firms is the public shareholder. Many managers also think so." (HW).

One manager further criticized the fact that public shareholders often want to pursue business projects that are economically not feasible, but were guided by other interests and that it is not easy for managers to convince them otherwise. As to this aspect he elaborated:

> "And a lot of attention is paid to whether the business policy fits the political line. [Managers' performance] is measured first and foremost according to political goals. And, there is much political in-fighting. Administrative staff are forced to defend their political viewpoints, because they work in politics, and there, such structures prevail. For a chief executive, this [behaviour] is very difficult because he wants to concentrate on his business and not on political goals. [In the end], in public companies, a manager's achievements are less acknowledged than in private firms because his performance is first and foremost assessed on political grounds – if it suits current politics - even if he produced good [economic] results." (UK).

As one example of these kinds of projects he named the micro loan portfolio in his bank (UK). According to him, representatives of the public shareholder pushed this project that was not economic purely “because everybody knows someone who wants to become self-employed with a small shop.” (UK). Thus, in this case it seems to have been more important for shareholder representatives to accord their own relations favourable conditions than to do it for the welfare of the state bank. This is a sign of low risk consciousness on the part of public shareholder representatives. According to principal agent theory this can be explained by their not being the original owner of public banks or firms and therefore they do not lose their own money if business strategies fail. Indirectly, in these cases public money is used to pursue political goals.

It is also important to consider another of this manager's statements. He explained that for failed projects initiated by public shareholders against the advice of managers, in the vast majority of cases when these projects do indeed fail, public shareholders then try to blame managers alone.

This explanation indicates that at least some managers perceive the public shareholder as a rather unjust employer. Thus, sometimes the relationship between public shareholder and his managers is lacking in trust. This interpretation was shared by other managers with regard to business conduct (see examples above and below). They also maintained that especially in case of problems public employers were more unjust than private ones (JM, UK, CB).

They remarked that if managers made mistakes private owners in general would try to settle this conflict smoothly and would also consider any previous good performance of managers. Public shareholders, instead, would easily drop managers during crises even if they themselves were somehow involved in the causes. According to them, this behaviour is due to specific structures of the political realm that makes hard and allegedly unfair judgments in case of crises.

Several cases among the already mentioned scandals in public firms or bank support this interpretation (for example IKB, SachsenLB, WestLB). Many times managers are singled out as scapegoats to protect boards from liabilities and thus protect their interests. Mostly this works well, not least because top-managers are widely considered as being significantly overpaid, which makes them a favourite target of public criticism.

During my interviews other proofs of lack of trust between public managers and public shareholders were brought up. For example, one manager said that in general the public shareholder would inform executives about relevant changes to business plans, but mainly because only the firms have the most important information he needs for business revisions (UK). Yet in general managers do not get concrete information in advance. Instead, many times when essential decisions have been taken managers only learn about it from the press. As one example, this manager of the Berlin state investment bank named changes in property finance.

Thus, public shareholders do not always seem to integrate public managers in important decision-making processes. Instead, if chief executives receive news from the press instead of from their own shareholder, more often than not the latter's information policy towards public managers might be rather poor. As this behaviour displays a lack of communication and trust between both groups it seriously hampers business and suggests – at least sometimes - the existence of conflicts about business strategies. However, we cannot easily draw the conclusion that these circumstances will lead to poor risk reporting. Nevertheless, these conditions make the conduct of business more difficult and might more easily lead to crises than in the private sector where the employer loses his own money. As a possible consequence, during crises it is more likely that executives might resort to withholding discomforting news more easily than with employers they perceive as fair (see Minkler, 2008) Yet, certainly, this is not to say that this has to be the case.

For all these criticisms, managers and board members still saw some positive changes in the behaviour of the public shareholder towards his firms. Since the introduction of the public sector reform in the 1990s, a bottom line has been established that first of all public firms have to stay viable (JM, HW, CB, KJ). As to this one manager remarked

> "...we do not want to go back to the 1990s where these kinds of limits were not respected." (CB).

Yet, sometimes this new principle was still breached when other interests of the public shareholder dominated. All the interviewees explained this behaviour as resulting from a lack of business expertise on the part of the public shareholder as they are politicians (KJ, HW, CB). Instead, I argue, in common with Ganske (2005) and Scholz et al. (2009) that negligence of profitability by the public shareholder is not so much due to his being a non-expert, but to his prioritizing other of his interests. Crucially, if other interests of the public shareholder become dominant he often might pursue them even if this causes severe harm to his firms' welfare (see Ganske, 2005; Scholz et al., 2009. as well as examples above and below).

As one example of this type of behaviour of the public shareholder, the risk manager interviewed named the failed housing policy of the Berlin senate in the early 2000s. Based on the false assumption of a large population increase, many public housing programs were launched, especially in the social sector (KJ). Furthermore, the impacts of this incorrect supposition were exacerbated by the total cutting of follow-up subsidies for these programs (KJ). As a consequence this cost his firm,

> ".... I do not say hundreds of millions, but in any case this will cost us way more than € 100 million." (KJ).

In this case the predominant interest of the public shareholder was an urban policy that turned out to be uneconomic. Later he was first and foremost interested in balancing the state budget and cutting follow-up subsidies, although this severely impacted on his firms' welfare. These kinds of problems caused by public shareholders were a topic much discussed by the managers interviewed. The above-mentioned risk manager cited another illustrative example. With the consent of the board his company launched a larger investment program. Rent levels were already fixed. However, shortly after, new regulations on rent were passed which would have endangered the program. According to this risk manager the firm then said to board:

> “No. First of all, board decisions have primary authority. Second, all finances for this program already have been calculated and fixed. The bank [that gave the necessary loans] relied on these figures. So, no joking anymore!” (KJ).

The risk manager further explained that, even though political board members might often breach the company contract, public firms are not absolutely helpless. However, he also asserted that firms "constantly“ had to remind public shareholders and their representatives of the contract conditions, in particular of decision-making rules (KJ). That this was not free of conflict is exemplified by the following remark by him on disagreements between managers and public shareholders about business strategies:

> "Sometimes, [public shareholder representatives] said: 'Then [if managers still object] we will transform you into a limited company. Then we can give you orders.' [The firm replied]: 'Ok, then do it. But as long as we have laws, we, the management, have to adhere to, it is as it is!'“ (KJ).

As to the relationship between managers and public shareholders, all the managers complained that the public shareholder often impedes business and does not provide for stable business conditions (UK, CB). Therefore, they hold that it is best for public firms if political influence is limited, i.e. the public shareholder is underrepresented in the board (CB).This stipulation was also part of the reform of the public sector and constitutes structural change. New regulations demanded heterogeneity of the board and at least one financial expert of the respective sector should be included. In practice, these new regulations have been widely observed (UK, CB, HW, JM).

Yet, in public companies and also in the firms of our case study this was not always the case. Moreover, in our firms two to three board mandates were still reserved for public shareholder representatives. Furthermore, it turned out that in some cases the majority of non-political board members had close relations to politics. It is important to note that boards also have to adhere to the outlines of business plans defined by public shareholder representatives. So absolute independence from politics is not feasible.

From the above it follows that public firms might often face risks from the public shareholder; most often if he primarily pursues other political interests that might even harm the firms' welfare. To better understand the public shareholder's relationship with his firms with regard to risks and risk reporting we therefore have to look more closely at his attitude to risk.

The above examples show that public shareholders might not always be as risk-averse as conventional theory assumes and the risk-averse taxpayer, the original owner of public firms, demands.[28] Correcting this premise is indicated by further statements of one of the board members interviewed (JH).

[28]For research correcting this assumption proving that agents – in this case managers – are less risk averse than assumed see Fatemi and Glaum, 2000.

He was rather sceptical as to whether the Corporate Governance Code in fact increased the risk awareness of the public shareholder. Even though he attested to a rise in individual board members' risk awareness, exemplified through more intense discussion on risks in board meetings, he maintained that on the political level this consciousness was still underdeveloped. He declared that, compared to private owners, public shareholders are much less attentive to companies' risks (see also Ganske, 2005; Scholz et al., 2009).

This board member gave further evidence of his hypothesis. Even five years after the introduction of the Corporate Governance Code the public shareholder did not evaluate its implementation or show any sign to do so. However, it is obviously necessary to know about the state of reform and to adapt it if necessary. Furthermore, the public shareholder in Berlin did not unify and standardize risk management and reporting systems. As a consequence, risk reporting practices are still very diverse and of very different standards and therefore not at all transparent. However, it takes only few steps to standardize risk reports of companies from the same industry (see above).

Currently, the knowledge of the public shareholder in Berlin about his firms depends to a large extent on the willingness of managers to disclose company information. Both board members also acknowledged that sometimes this information is rather poor. Standardization of risk reporting, instead, makes it possible to compare data and therefore to detect peculiarities or lack of information.

In contrast to the above-mentioned criticism of the public shareholder by one board member, the other two representatives of the public shareholder interviewed argued against any (further) standardization of risk reporting systems. Both referred to the old argument that firms' conditions and needs are too specific to be standardized (DS, HW).Interestingly, both auditors even called for new deregulation of reporting regulations as, in their view, misuse was not common and thus no real danger. They concluded that more rules would not have much positive effect because misuse and circumvention of rules are only isolated cases, and these will always happen, they cannot be prevented by more regulations, so, there is no real need for more laws. It seems that auditors might not always have a strong interest in more rules because this might minimize the relevance of audits, their job. Fewer rules make audits more significant. Accordingly, more extensive audits can be expected, remunerated with higher fees.

Calls for deregulation are on the rise and have already entered the committee of the Corporate Governance Code.[29] These voices seem to have little awareness of the increase in risk reporting scandals with increasing financial damages (Hamann 2003).Regarding their main argument against standardization of regulations, the firms' need for flexibility, I argue that it is at least important to differentiate between the needs of private and public companies. Public firms do not need to open new markets and expand on a grand scale. Therefore, for them the alleged need for flexibility and individual application of corporate governance rules and regulations is less valid. Moreover, I emphasized in my interviews that my question about standardization of rules concerned specifically firms of the same sector and the same shareholder. These kinds of firms are not so individual that their risk reporting cannot be standardized. Moreover, as already mentioned, the taxpayer is rather risk-averse. All these factors justify stricter rules for public firms.

Yet, as I mentioned above, a rise in risk consciousness among public shareholder representatives did take place on an individual level and could impact public firms' risk management. For example, one of the board members declared that he had introduced a new risk management system in the state bank where he was board chair (HW). He replaced the old risk management system with a more advanced value-at-risk management that exceeded legal minimum requirements (HW). Value-at-risk managements are still uncommon in Germany. They originate from the Anglo-Saxon economy where "fair value"

[29]http://www.corporate-governance-code.de/ger/news/podiumsdiskussion.html [20.02.2013].

reporting is the principle of accounting law. “Fair value” refers to the actual market value of the product. Thus it gives more accurate information on firms' financial positions than the book value common in Germany, and therefore is also more transparent.

According to this board member the introduction of value-based risk bearing ability made the bank’s business operations more risk-averse (HW). He also asserted that when he was board chair, the goal of the bank’s risk policy was to “stay absolutely on the safe side” (HW). Risk assessment, then, was guided by worst-case scenarios (HW).

In summary, the relationship of public shareholders to their firms is very complex. **It is characterized by multiple agent relations** because public shareholders and their representatives are, like managers, only agents and not the actual owner of public firms. My interviews confirmed the premise of principal agent theory that agents will always pursue also their own interest, thus acting against the interest of the principal, namely the citizens.

Interestingly, all the groups interviewed (managers, boards, shareholders and auditors) agreed that public shareholder representatives (politicians) are often the biggest risks for their companies. Often business conditions are unstable and business objectives not clearly defined. Crucially, clear definitions of business goals are an important prerequisite for effective risk management and reporting. Moreover, the behaviour of public shareholder representatives' (politicians) might cause risks for public firms when they pursue other goals than the welfare of their firms. This might be policies, e.g. restoring the state budget, or prestigious but uneconomical projects. Most crucially, often this type of projects might harm firms, sometimes to a considerable or even existential level. Therefore, it is crucial to note that public shareholders might not be shy of exploiting their firms. This point is also acknowledged in the literature and led to the demand to repel the influence of the public shareholder on his firms (Ganske, 2005; Scholz et al., 2009).

However, it also appeared that risk attitudes of public shareholders towards their companies has changed to a certain degree, namely on an individual level among board members. Board members are responsible for the control of the management. Mainly they conduct control by contracting auditors to check firms' annual reports. However, they are also personally involved in management control through board meetings. For the importance of control to ensure managers' compliance with contracts, I first investigate boards' and then auditors' control practices in the following two sections.

7.3. Boards' control practices

As mentioned above, the board is the main body for the control of the management, including their risk management and reporting. I also demonstrated previously that Corporate Governance initiatives are intended to strengthen the role of the board so that managers are more strictly controlled. Steps taken to improve the control by boards lead us to the question of how the general state of control in public firms was in the past. The following quote from one auditor on board meetings gives us a glimpse.

> "Well, about ten years ago, when you sat in a board meeting, it was more or less drinking coffee some biscuits with it, if there were some sandwiches - wonderful, but it was mainly nodding through. [...] Most of the time board meetings in public companies were finished in one hour. Then they were done with the full programme, the agenda. Because they were all of the same opinion. Nobody asked further questions. Everything was clear. Whether they talked to each other on the phone before, I have no clue. But board meetings were more or less a matter of just passing management's decisions. " (TK).

This description of board meetings fits with the above-mentioned risk reporting scandal cases as well as with the research (see e.g. Lentfer, 2005), and was the reason why corporate governance reform also focused on re-establishing boards as control bodies mainly through boards trainings and increasing liabilities in case of failures (see below).

Reform initiatives have borne some fruits as the above-mentioned auditor observed in the following remark:

> "For eight or nine years board members have been increasingly interested in their job. Obviously, now they read the reports thoroughly, they stick post-it notes on the pages. They really examine the report. All this proves that now many board members take their mandate much more seriously and fulfil their duty." (TK).

A tendency towards increasing interest of boards in their mandate was testified to by all the interviewees, managers, board members and auditors. As already mentioned above, one board member also observed increasing attention to risks in board meetings. The other board member was very proud that he established a risk-averse risk management in the state bank.

One reason for this change is to be found in following remark of one board member:

> "The appointment of boards is now very different from back in the day. In the 1990s, one said: 'Oh, there is a politician who deserves to join' or 'Oh, I know a good friend of mine.'" (HW).

Obviously, one goal of Corporate Governance reforms, namely professionalization of boards, was widely implemented. Now board members are selected more carefully. Regarding this aspect, one auditor maintained that nowadays board members also have a better understanding of the work of auditors (who control managers' reporting) (WW). The establishment of various committees including an audit committee has furthermore improved collaboration between boards and auditors because discussions in small circles are more intense (WW). Both managers and board members agreed that in general boards now fulfil their mandate better than before.

Despite all the improved efforts, all the interviewees agreed that the state of affairs of boards' control is still fairly good and effort input still rather low (JH, WW, TK, UK, KJ, CB). Moreover, most of the time boards do not behave in a proactive manner. It has to be noted that effective control especially for reporting on prospective risks depends very much on the controller being proactive. According to the managers interviewed, political board members often pay most attention to formalities instead of content, although the latter is more important (UK, CB). This implies that managers might also focus more on correct formal criteria than on content. The analysis of the risk reports of my case study firms supports this assumption. Formally, all the reports were correct; however, not all their contents satisfied the standards of Corporate Governance norms. All in all, the reports were of limited information value and information on prospective risks was even rather meaningless.

Similarly, the managers responsible for risk reporting manipulation or fraud always complied with formalities, even when their firms already faced severe risks. Thus, correct formalities do not guarantee that information is undistorted.

All of the interviewees explained the low performance by the political board members as resulting from their lack of expertise. I argue instead that even though non-experts need more time and effort to understand matters that does not have to lead to their failure in exercising control. For example, managers are asked to provide information in plain language so that even lay people can understand it easily. Obviously, often this does not seem to be the case.

In addition, I argue that exercising control depends not so much on expertise as the will to ask inquisitive questions. The latter argument was supported in my interviews by the two board members. One of them stated that through personal interviews with auditors alone he could detect failures in reporting (JH; on auditors' role see below). He also admitted that this took a lot of time which he invested only when he was board chair, but not when he was a simple board member. He also confirmed that most of the time management reports were not thoroughly investigated because of lack of time. He asserted that this was common practice. The other board member indirectly agreed on this point, stating that it needs much time and effort to control managers, but if effort input by controllers is high even non-experts are able to exercise effective control (HW). Indeed, he said that:

> "One has to be very close to companies and be in permanent communication." (HW).

What makes boards' tasks much more complicated is that they also have to control auditors', the agent they contracted to control managers' reporting (for this topic see below).Thus, effective management controlling needs high effort. It seems that effectiveness depends more on the time available or devoted to it than on expertise. We might also assume that investigating firms' reporting might not be of the highest priority to political board members if it concerns uneconomic projects initiated by the public shareholder because it would implicate them and him.

Another reason for the low effort input of boards is their short-term position due to elections. So, one board member told me that in general in the last one or one-and-a-half years political board members have not been very interested in (the welfare of) their firms (JH). At that point in time, political and personal interests become more dominant. Thus, according to him, due to election times the vast majority of political board members try to avoid any incidents (for example detection of risk development) because this would impede their political and personal interests.

Lack of effort input by many boards is difficult to eliminate. Among other reasons this is caused by the fact that misconduct is not disciplined because, due to elections, political board members are often no longer in their position (Scholz et al., 2009). One of the goals of Corporate Governance initiatives, increasing boards' liability in case of failures, seems to remain difficult to implement for other reasons also, as the following quote from one auditor indicates:

> "Quite simply, they do this [holding political board members liable] if and only if things [ruling parties] have changed. Then, this happens. Otherwise never !" (TK)

This auditor makes an important point. As many examples proved, if it comes to party members most politicians do not pursue them in the event of failure or violation of their duties[30]. Only politicians from other parties or the opposition will do this, and then most often quite fiercely. Especially opposition parties often have insufficient power to implement this successfully. Disciplining failures by political board members and thus ensuring high effort input remains therefore difficult.

In summary, boards that are the main controlling body of managers did increase their effort input compared to the past when control in public firms was in a poor state. Although all the interviewees testified to this improvement they stated that efforts were still rather low. Interestingly, all the interviewees explained low

[30]See, for example, for cases in Berlin, *Berliner Morgenpost*, Anon., 2006. Opposition: Senat hat bei WBM völlig versagt. 04.02.06. Available at: (http://www.morgenpost.de/printarchiv/berlin/article261694/Opposition-Senat-hat-bei-WBM-voellig-versagt.html). [12.12.2011].

effort input as being due to lack of expertise. Instead, I argue that boards can still do a good job if they invest sufficient time. This reasoning was confirmed by one board member. The other board member highlighted that controlling the management is a highly demanding and time-consuming task.

The main reason is to be found in the fact that boards also have to control the work of auditors who they contracted to monitor the management. This hints at the problem, already described, of controlling one agent through another. In the following section I highlight how my interviewees view this important topic for the control of managers.

7.4. Auditors' control practices

In Chapter 3 I explained that the audit of the annual report and the inspection report by auditors are the main control means available to the board. Thus, auditors are contracted by boards to control management disclosure. I also highlighted the complexity of relationships between boards, auditors and managers. Next to annual audits, auditors often work for the same firms as consultants. And managers are the ones who assign the mostly very lucrative consultancy contracts to auditors. Consequently, in the majority of cases, auditors view managers and not boards as their actual principle. Therefore, often interests of auditors and managers might converge to the disadvantage of boards' interests. These complex multiple agent relationships are further complicated by the wide range of accounting law applications that allow some embellishment of firms' financial positions. It is these matters that are the subject of this section.

According to formalities, annual statements have to be compiled by managers and then controlled by the annual auditor. Interestingly, my interviews corrected this assumption. Auditors as well as managers explained that in practice there was not such a clear division of tasks between managers and auditors (WW, TK, JM). Instead, in the vast majority of cases, managers consult auditors for "complicated matters" *during* the compilation of the annual statement "to optimize results and to do everything in the right way" (JM, TK, WW). One auditor said that the management or the controlling department usually calls for advice on how best to go about balancing complicated matters long in advance of the actual audit; this could well be about half a year before (TK). Thus, managers and auditors alike said that managers could get important advice from auditors for the compilation of annual reports. In consequence, we can state that annual reports often are more of a joint product of managers and auditors, i.e. controlled subject and controller. If this is the case, it severely questions the value of the final audit because auditors have already advised on the compilation of the reports. Crucially, this concerns the more delicate matters. So, according to these statements, auditors are involved to a considerable degree in the compilation of annual reports. It is rather unlikely that auditors will invest great effort in scrutinizing a report that is at least partly their "own". Regarding the professional help managers get in compiling their reports we also have to take into account the amount of leeway accounting law offers for its application. As to this aspect, auditors' attitudes towards accounting law are of interest as the following remark of one auditor exemplifies:

> "Well, I would say, through accounting choices you can only influence profit size. Well, yes, but that is the main point. But in the end there is not one Euro more in the cash office. So, what do I do [by applying accounting choices]? I just move profits back and forth between the years. It is nothing more. And also, you can illustrate this reasonably well. And we do this. And board members as well as representatives of shareholders, they will all be informed." (TK).

This explanation of one of the auditors interviewed is telling. First, he says that the main purpose of accounting choices is to influence profit size. At the same time he understates the effect profit size modifications have on the presentation of firms' financial positions. According to him it is just moving profits back and forth between the years – nothing more.

However, studies on accounting practices in German companies prove that, precisely through moving profits back and forth, company data is manipulated.[31] For example, depreciation periods are often artificially prolonged, debts of billions are excluded from the official annual report or inventories are valued too high and risks too low. According to university professor Eberhard Scheffler these embellishing practices are rather simple.[32] At the same time their effect is large. He also states that "aggressive accounting practices" are on the increase. Crucially, this trend is made possible by the German Commercial Law (HGB) that allows the formation and dissolution of hidden reserves within certain rules.

Yet, relatively free modification of the relation between liabilities and assets by increasing benefit numbers or hiding certain financing is not a specifically German phenomenon, as the review of creative accounting literature by Balaciu, Bogdan and Vladu (2009) confirmed. The concept of "creative accounting" or "earnings management" was developed in the 1970s to better grasp practices and impacts of accounting by including their subjective perspective (Balaciu, Bogdan and Vladu, 2009). The theory of creative or positive accounting mainly highlights the fact that corporate financial information is not necessarily or even mainly objective. Instead, the fundamental principle is to reduce the costs of the enterprise projects' financing (Balaciu, Bogdan and Vladu, 2009).[33] Put differently, the purpose of accounting data management concerns the presentation of the relation between debt and capital. Results can be changed in two ways: Either by adding or subtracting certain profits or expenses (which represents a change of the net result) or by transferring a column from the upstream or downstream of the results which serve as a computation base of the results per share. The latter is data management through classification. I have already pinpointed that managers' free choice of

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[31] Mietermagazin (10/2005: 1).

[32] Manager Magazin. Anon., 2002. Arm oder Reich? Wie Unternehmen ihre Ergebnisse beeinflussen können.26.04.2002. Available at: http://www.manager-magazin.de/magazin/artikel/0,2828,196304,00.html. [18.11.2011].

[33] The following is based on Balaciu, Bogdan and Vladu (2009) if not indicated otherwise.

data definition is one of the weakest points of corporate governance regulations including risk reporting.

Balaciu, Bogdan and Vladu (2009) confirm this hypothesis, maintaining that manipulating accounting data is an activity reserved to company managers (even though influenced by shareholders and stakeholders). As causes for accounting manipulation these scholars identified corporate operations and risk sectors as well as enterprises' financial and communication policy.

As summarized by Balaciu, Bogdan and Vladu (2009), interestingly, in creative or critical accounting theory accounting has been defined as "the art of faking a balance sheet" (Bertolus, J.), "the art of calculating the benefits" (Lignon, M.), "the art of presenting a balance sheet" (Gounin, L.), or "the art of saving money" (Ledouble, D.). According to this theory accounting professionals use their knowledge to manipulate the figures presented in the balance sheet.

The above-cited remarks by managers and auditors support this reasoning. All stated that managers' main purpose is to present results in the best light, they and therefore seek professional advice from auditors for "complicated matters". In this respect we have to take into account that many legal possibilities exist to shift profit and form liabilities, and equally there are many legal categories for misrepresenting data. Only outright forgery is forbidden by law. Both factors foster the application of manipulation practices. Research by the accounting professor Karl Heinz Küting also confirmed that deception in accounting practices is systemic.[34] Indeed, this is a global phenomenon.

As I mentioned already, particularly periods of crisis encourage the application of accounting manipulation because bad news increase the need for numbers' embellishment (see also Balaciu, Bogdan and Vladu 2009). However, when

[34] Manager Magazin. Anon., 2002. Arm oder Reich? Wie Unternehmen ihre Ergebnisse beeinflussen können.26.04.2002. Available at: http://www.manager-magazin.de/magazin/artikel/0,2828,196304,00.html. [18.11.2011].

severe risks are covered up in the annual report it is very likely to increase the final corporate damages because no countermeasures are taken early.

Given all the evidence of actual or likely accounting manipulation by managers it is crucial that in the past, in general, auditors mostly failed to detect it (see the huge risk reporting scandals cited in the Introduction). As explained in Chapter 3, the reason for this is rather common low effort input in monitoring managers. The main reason for ineffective reporting control by auditors is that they are often in fact dependent on managers because these assign lucrative consulting contracts to audit firms. This considerable income or its prospects decrease auditors' interest in seriously controlling managers out of fear of losing their favour. This issue is one of the main problems of management control and discipline. In the following section we will look in more detail at what our interviewees contributed to this subject.

> „Well, audits have, how can I put it, a pedagogical, preventive character - to ensure that annual statements are compiled in such a way that they are legal. Because he [the manger] does not gain from compiling a wrong statement, as we have to report that. [...] Therefore, he is more likely to compile an annual report that is correct because the couple of million Euro he gained from making the figures better than they are, nobody buys it anyway."(TK).

This auditor asserted that audits are principally preventive measures to ensure legality. According to him, the purpose of audits is not to evaluate managers' reporting practices and to report the results to the board; instead, auditors agree with managers on the way to go about accounting before the annual report is finished and handed over to the board. In the public perception, audits have a stricter controlling character. The auditor called this perception "nonsense"(TK). According to him the main purpose of audits is to ensure the legality of annual statements. Auditors' control, therefore, seems to focus more on formalities than on content. This implies that even when all legal rules are adhered to, the given view on the corporate financial position and risks does not have to be correct in its content. We have to remember that in all risk reporting scandals, managers adhered to all the legal rules in compiling their annual report, but still misrepresented the financial position of their company to significant degrees. Therefore we cannot take adherence to legal formalities as the main criterion for the identification of "true and fair“ corporate disclosure.

As mentioned above, we therefore have to state that through the use of accounting choices accounting law makes embellishing and manipulating practices possible. For this reason, it is of interest what auditors' attitude towards the application of accounting law might be. The following remark by the same auditor gives us an impression of this:

> “If *nobody* believed his annual report, then I would warn him that I will issue a warning letter. If this does not help, then I send a management letter to the board. And if all this does not make him change his mind, I can still impose the so-called “Redepflicht” (duty to report and explain) on him. At least, then, he has to explain himself.” (TK).

Despite this considerably powerful means of disciplining managers, the auditor quickly added that, in fact, warning letters, management letters and “Redepflicht” are not usually imposed (TK). Also, both auditors said that restricted audit certificates are very rarely issued - if at all (WW, TK). This proved to be the case also in the risk reporting scandals, where all the companies received unrestricted audit certificates. The expression “if *nobody* believed his report, I would warn him...” is also interesting. It implies some manipulation would pass control, even if not all. It also suggests that the red line for manipulative accounting practices is pushed far out if the red line is if nobody (at all) would believe the report.

Nevertheless, we have to consider that an optimistic (to a certain degree embellished) presentation of firms' position is legal (Davies 2006). Optimistic or even over-optimistic assessments of companies' financial position are justified by the need to promote business. This viewpoint is also mirrored in the many legal categories for accounting manipulation, of which only outright forgery is forbidden (see above). However, all these factors provide the basis for data manipulation. The above-cited research on the actual level of accounting manipulation indicates it is more widespread than previously assumed.

Interestingly, a habitus of lax accounting law application is not confined to corporate leaders. Regarding the companies in my case study, one of them was involved in fraud.[35] One auditor had already sued the firm's management in 2002 for accounting fraud. However, the court rejected the charges. Nonetheless, in 2006 the auditor's accusation proved to be right when it became obvious that the company would go bankrupt if the federal state did not save it. It is noteworthy that many politicians were involved in the company, also in matters of corruption and embezzlement. Their political opponents accused them of having known about the mismanagement and severe financial problems long before they were disclosed. This is one example that, although accounting manipulation is practiced by managers, also shareholders or even the court (which in this case was accused of having close relations with ruling politicians, i.e. political board members of the firm) might more or less indirectly support this behaviour.

If actors are themselves to a certain degree involved in operations to be reported on, they are equally likely to be reluctant to report discomforting information in a true and timely fashion as many other incidents, including outside the business world, prove.

If managers' accounting practices are often manipulative (and sometimes with the indirect support of shareholders, mostly public ones because they are not the firm's owner) we have to investigate more closely the effectiveness of their control by auditors by analysing the relationship between managers and auditors (see Chapters 3 and 4). The following remark of one auditor reveals an interesting point:

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[35]For this particular case see *Die Zeit online*, Rose, M. D., 2009. Das ist der Berliner Filz, Filz, Filz., 15.10.2009. Available at: http://www.zeit.de/2009/43/WBM. [12.12.2011].

> "Criticizing managers because they went a little too far in one direction [of interpreting accounting law] ... well, of course, there you have to be careful." (TK).

He also stressed that it was necessary to maintain good relationships with the management because otherwise the annual audit "would be poisoned" (TK). The other auditor confirmed this statement. He also described audits as a highly collaborative process aimed at "always" reaching a "smooth agreement" with the management before the balance meeting with the board (WW). This also holds true for the inspection report which, as the other auditors remarked, is usually reviewed by the management before it is handed over to the board (TK). That control means are checked by the controlled subject before it is handed to the controller or principle (the board) severely diminishes the value of monitoring because the controlled subject is able to adjust part of it suit his own self-interests.

Both auditors justified their close collaboration with managers during audits with the good record of management accounting practices (TK, WW). However, as mentioned above, research has proved otherwise. Moreover, neither auditor explained why they have to be careful when criticizing managers for their accounting practices. This reluctance by auditors seems to be at odds with their contract. They are the controllers and managers the controlled subjects. Accordingly, the power relationship clearly should be in favour of the controller, i.e. auditors. Instead, for audits this power relationship often seemed to be turned upside down.

I explained this peculiarity in Chapter 3, pinpointing the fact that auditors might often view managers as their actual principal even though they are contracted to control them (see also Kitschler, 2005). The principal reason is that managers assign lucrative consulting contracts to auditors, which leads to the latter's dependence on managers. This constellation is also modelled in principal-agent theory through multiple agent relations. If one agent is contracted to control another agent collusion between both is likely and decreases the gain of the principal.

Lack of control of auditors was also confirmed by the manager of the state bank interviewed (UK). Banks are more strictly controlled than firms. In addition to annual audits, they are controlled by the German Central Bank and the Federal Financial Supervisory Agency. This manager observed that both institutions control much more strictly than auditors. The differences can be very large; for example, he recalled that both institutions sent back an annual report already certified by the auditor because of several serious transgressions. This observation thus confirms the above-mentioned research on the ineffectiveness of audits as well as manipulative accounting practices.

So far, most managers as well as both auditors described audits as a collaborative process, but maintained that in general annual reports are not manipulative. It is then interesting what board members, the principal of managers and auditors, said on this subject. Both board members asserted that it is important to control not only managers but also auditors. Concerning the effectiveness of auditors' control of managers and their risk reporting one board member said:

> "...the [main] question is how close was the contact with the auditors, because when you finally get the annual report, then all the files are already closed. And the decision to say, now we will re-open the report that is always very difficult. That's why it is so important to have intensive talks with auditors before [the board's balance meeting]. Well, and my board [control] office served this purpose well."(HW).

Thus, this board member declared that the value of audits highly depends on rather tight control of the controller, the auditor. In the following quotation he further elaborates why both auditors and managers do indeed have to be controlled:

> "Well, if there is still a contentious topic to argue about or if you have the impression, well, now the management is making a 'deal' with the auditors that *you* in fact *do not want,* then it is important that you know that *in advance*. You cannot start discussing this [opposing views on the compilation of the annual report] when they come [into the balance meeting] with the annual report finished. When they come into the audit committee and you then blow your top – 'Oh, what have you done *here*?' Well, *no* that is absolutely impossible! [to then discuss differences]. " (HW)

This board member made two important observations. First, it might be likely that managers make a "deal" with auditors, i.e. manipulate accounting against the will of the board. Second, the balance meeting of the board is just a formal meeting where annual reports are merely presented but not discussed. This was also confirmed by the managers interviewed (see above). As to the first point the board member later in the interview emphasized:

> "You always have to keep tabs on them [managers] or you will not detect the deals they make with auditors". (HW).

The above quotes indicate that first the state of reporting practices and second the effectiveness of auditors' control are highly questionable. This implies that boards have to invest a great deal of effort because they have to control both agents and because their collusion is professional.

The other board member confirmed these observations. According to him, accounting "deals" between managers and auditors against the interest of boards is common practice (JH). Interestingly, he replied to my question how these "deals" can be prevented:

> "You cannot prevent this. Well, if you discover it, and that is rare - we only very rarely noticed it. But you can try to detect it through personal interviews with the auditors. I did this when I was board chair. I invited the auditors on their own to personal talks without the management and I seriously questioned the annual reports. But this causes quite a stir among auditors because of course they also know that their further employment depends on the management. Well, at the end of the day you cannot prevent this [deals between managers and auditors]." (JH).

This statement makes rather strong assertions about close alliance and collusion between managers and auditors in manipulating accounting against the will of boards. This board member also asserted that these practices are common and that prevention is almost impossible. Only when he interrogated auditors alone, without managers being present, could he discover manipulations.

Interestingly, he remarked that these personal talks cause great objections from auditors because they are afraid of implicating themselves and the managers, which would endanger future contract assignments for consultancies. This implies that auditors expect some corrections to annual reports when they have passed judgment. The state bank manager interviewed mentioned this kind of incident (see above).

These statements support the literature on dependence of auditors on managers which decreases their effort in controlling them, because the former views the latter as his actual principal.

Even though the auditors interviewed denied that their effort input in audits was low and biased in favour of managers, my interviews showed that they indirectly confessed dependency, for example, when they said that it is difficult to criticize managers because of accounting practices as this would "poison" audits - which are rather strong expressions.

All in all, the statements from managers, boards and auditors confirm frequent collusion between managers and auditors. Furthermore, the above quote mentions that this is hard to detect because it is done professionally. This is not surprising because even auditors declared that they give professional advice on how to go about accounting, especially for complicated matters (see above). If managers get help from experts for the compilation of their reports it is not surprising that manipulation is hard to detect, especially if boards have no other information besides that given by the management.

This last point is significant. Manipulation is also made possible because only managers have access to the company's actual data and are free to decide how to present it. Thus, they are able to match all the results with the information in the annual reports. Nonetheless, even if manipulation is done cleverly and is hard to detect, this is not impossible as the board member mentioned above remarked. However, it is only possible through personal investigations with auditors on their own. This not only proves that auditors are dependent on managers, but probably they are also somehow involved in accounting and reporting manipulation, as they seem to object to stricter control of their work.

The fact that personal interrogations of auditors by boards seems to be an effective control mechanism is one hint that despite all the advantages of experts, even lay people are able to detect manipulation if they invest sufficient (that is to say, a lot of) time. This argument would support my interpretation that the effectiveness of control depends more on motivation than on expertise. So, auditors are experts but because of often low motivation their control is often ineffective. Both board members were politicians and laymen in business matters. Yet, if they closely watched managers and auditors they could identify manipulation of annual reports.

As to the time factor, we have to take into account that board members often enough do not have much time available to invest in their mandate, especially if they are simple board members and not board chairs, as one of the board members confessed. He also said that this is common practice. Corporate Governance initiatives also acknowledged this problem and therefore restricted board mandates to ten per person. However, this is still a high number as I mentioned in Chapter 3. The above-mentioned board member also confirmed this interpretation, saying that together with board members' original full-time jobs, there is mostly not enough time left to read management reports carefully, in particular if they have several board mandates (JH).

Especially the statements by the board members made it clear that one of the major issues to control managers' reporting are unreliable auditors, the agents contracted for this task. This decreases the value of the principal control means, the annual statement. Furthermore, indirectly one of the auditors revealed that the information value of another control method, inspection reports, is often equally low because they are first handed to the management for review before they are sent to the board (TK).

Before the Corporate Governance reforms, inspection reports often lacked comprehensibility because they were very long, mostly containing vast columns of numbers (TK). Thus, the most important information could often not be extracted easily. Today, inspection reports are substantially shorter. However, sometimes they are so short that they do not include explanations necessary to understand the information properly. Thus, clarity and comprehensibility have not increased substantially. Therefore, transparency of inspection reports is still determined by the author (auditors) and can vary considerably.

All in all, the mentioned propositions on collusion of managers and auditors fit with research results, which likewise pinpoint lack of objectivity of auditors as one of the major problems to ensure reliable (timely and true) risk reporting (see e.g. Kitschler, 2005). Corporate Governance initiatives tried to ensure independence of auditors by recommending that they were not assigned consultancy contracts. (In addition to the recommendation that auditors should "rotate"). None of the companies studied also contracted their auditors for consultancies; however, they made this transparent by enlisting the fees for each contract. as recommended by the CGC. Even though consultancy fees were in every case only slightly higher than audit fees this sum ranged from about €120k to €170k. We can only speculate how exactly this income influenced auditors' independence. Yet some reports, embellished to different degrees, are evidence that the auditors' control was not always very strict (see previous chapter).

Regarding recommendations to restrict consultancies for auditors, both managers and auditors alike were all very reserved towards this point (CB, JM, WW, TK). All of those interviewed claimed that existing legal regulations prohibiting self-assessment were quite sufficient, e.g. when auditors were contracted for book-keeping they are not allowed to audit this. Concerning separation of audits and consultancies, all of them argued that this was not necessary because auditors control and managers report well (WW, TK, JM). Indeed, according to them this prohibition does not make even sense, because firms benefit more from hiring someone as a consultant who already has knowledge about the company through audits, as this saves them money. This argument is in itself logical because it is based on the assumption that auditors do good work and are not biased towards managers. Yet, research proved widespread manipulative accounting practices and the inefficiency of audits. Obviously, among auditors and managers this problem is hardly recognized. Indeed, besides the harsh criticism of auditors by the board members, only the manager of the state bank remarked that auditors' control might not always be of high standard. Instead, he concluded that the Central Bank and the Federal Financial Supervisory Agency control much more strictly (see above).

For the proven relevance of auditors' dependence on managers, I suggest prohibiting audits and consultancies by the same company. With respect to additional costs for firms because consultants would not have prior corporate knowledge, I argue, these are justified because it is definitely necessary to ensure the value of audits as they are an important tool to provide accurate information on firms' financial future position.

In summary, my interviews showed that in contrast to the statements of managers their risk reporting effort was much lower than presented and the analysis of the firms' annual statements proved their lack of quality. However, the interviews also revealed that although control by boards improved over the last years, it is still at a rather low level. This is the more astonishing as boards frankly acknowledged how likely it is that managers embellish corporate numbers and get professional help to do so from auditors, which is why it is so hard to detect.

From these findings as well as from secondary sources I set out to roughly outline a theory of action of managers, boards, and auditors in the risk reporting process and its control in public firms in the following chapter which I conclude with proposals to increase compliance with regulations.

7.5 Summary of interview outcomes

All participants surprisingly agree to the picture: The Shareholder is biggest risk for public sector companies". This is argued because of the politician background of the shareholder representative, the unclear and changing business goals and the problematic relationship between the management and the shareholder in times of stress / crisis. The Shareholder (-representative) as a politician is also an agent, therefore we are facing a multiple Principal-Agent-problem in Public sector companies.

There are psychological influences on risk reporting. These, partly unconsciously, impacts like biases and misestimating of possibilities do have effect on the risk reporting practice - even exacerbating during times of crisis.

Impacts like heuristics and decision supporting schemes from the past are not irrational. These techniques fasten decision-making and therefore save decision-costs. But it makes clear, that "homo economicus"-based rational decisions are not the norm.

Boards control practice also weak, because there are not controlling deeply and do not discuss the corporate disclosure with the auditor alone to increase value and detect possible deals in accounting (made between management and auditor). The board is still politically dominated. The communication between management and board is highly driven and regulated by the management. The board cannot achieve data and information on his own. So the management can steer the flow of information to the board: If, what and when reporting take place. The board has only weak possibilities to control the management real effectively.

The auditors control practice is much more weak than expected. The auditor is more related to the management than to the board and not really independent because they are also hired and paid by the management for consultancy. The auditor is also preselected by the management before board decision and commissioning can take place. The audit of the corporate disclosure only proves legitimacy of the accounting – no detection of manipulation or even embellishment

8. Proposals to solve agency problems for risk reporting in public firms

In this chapter I depict a rough outline of a theory of action of managers, auditors and boards in the risk reporting process and its control. This description points to behavioural tendencies, not a strict and definite course of action, as due to the lack of sources a detailed analysis of reporting and control practices were impossible. My aim is also not to prove fraudulent behaviour, but to focus on embellishment and manipulation to point to some neglected tendencies that should be incorporated into discussions about the implementation of best practice risk reporting and guide reforms as I propose in the last section of this chapter.

8.1. Towards a theory of action of managers, auditors, and boards

Both managers and auditors maintained that the state of risk management and reporting is generally good. Only one manager of the state bank mentioned an annual report certified by the auditor that was sent back because of several serious transgressions by the German Central Bank and the Federal Financial Supervisory Authority that also has to check annual reports of banks. This report was compiled by his predecessor not by himself, and therefore he did not implicate himself by recalling this incident, but still hinted at lack of best practice reporting by his professional group as well as lack of control by auditors. The high evaluation of risk reporting practices by the vast majority of both groups is not very surprising because both give an assessment of their own performance which is highly likely to be biased.

Board members had a different view of the state of reporting. They maintained that quality depends on the manager and can be very poor. Furthermore, they declared that often risk reporting is not as comprehensive as it should be, because managers tend to “hide” risk, e.g. reporting on page 173 under item 27 B while listing numerous countermeasures to create the impression that the impact of the risk will be insignificant (see above). To be sure, this concerns embellishing or manipulating reporting, not forging information.

Boards' further elaborations on this subject, however, pinpointed the fact that managers have to be watched carefully and permanently so that they “don't make a deal” with auditors which boards do not want. Embellishment and manipulation in accounting, therefore, seem to be rather widespread phenomena. Indeed, according to the literature, embellishment is inherent in accounting. Corporate disclosure is not objective but subjective, guided by how to present the firm's financial situation in the optimal manner. This is also what the managers interviewed said, i.e. that they want to optimize results. However, whereas they maintained that this does not affect reporting, the research showed different results. Deception is systematic and accounting practices increasingly aggressive. This diminishes the information value of corporate disclosure.

Embellishing and manipulating corporate figures is made possible through the wide range of accounting choices and the permitting of some over-optimistic presentation of firms' prospective development. Also, only managers have access to the most current company data so that they can feel rather free to apply accounting choices and define parameters and risks as they want without having to justify it.

The literature identified that corporate operations and risk factors as well as firms' financial and communication policy determines the way accounting is manipulated. It is also well researched that accounting manipulation is relatively simple while its effects are large. The auditors interviewed, in contrast, denied this. To them accounting is just shifting numbers back and forth, and has no effects.

So, the findings of the literature as well as the board members' statements are contradicted by managers and auditors. However, questions about the compilation of annual reports and audits revealed some inconsistencies in the latter's propositions. It became apparent that managers get advice from auditors on how to go about accounting, particularly for complicated matters. Interestingly, the board members said that manipulation is done professionally, with the help of auditors, and is therefore hard to detect. This corresponds to the literature, which states that knowledge of accounting professionals is used to manipulate or embellish corporate figures.

Although some over-optimism when presenting prospective corporate development is legal, the research showed that practices are becoming increasingly aggressive. The analysis of the annual reports of my case study showed that, although one firm's annual report for 2010 got an unrestricted audit certificate, it had to be revised because one risk was omitted that turned out to be existential a year later. Some other reports were also embellished, sometimes also neglecting risks. All this proves that managers tend to be over-optimistic about their firm's development, even in the face of risks. It has to be noted, however, that over-optimism is needed to stay focused, also or especially in times of crisis, and constitutes one strong habit in the business world. So, there is some virtue to over-optimism and this attitude is rewarded if it does not depart too much from reality. It will be also more likely that during crises managers resort to embellishment or manipulation when they have much to lose.

Not only the literature, but also my interviews proved that checks and balances on risk reporting are rather weak. Both board members asserted that managers have to be watched permanently. They added that this concerns also auditors, the controllers of management's risk reporting.

According to the research, auditors often fail to detect distortion of corporate disclosure. The board members interviewed even said that auditors were part of the deal and therefore had to be controlled as well. Both managers and auditors talked about relatively close collaboration in the compilation of the annual report which formally should be a task of the manager alone. The interviews made it clear once more how much auditors' effort input in control of managers is determined by their relationship to them. One auditor frankly said that auditors have to be careful in criticizing managers for their reporting, because otherwise the audit is poisoned. These are rather strong expressions illustrating strong dependence on managers.

In general this results in low effort input in control, because it is not in the interest of auditors to lose managements' favour and so lose considerable income from consultancies, as one board member pointed out and the literature confirmed. Stricter rules to prevent alliance between managers and auditors as prohibiting to assign audit and consultancies contracts to the same company were unsurprisingly objected to by both managers and auditors. Both groups seem to benefit from their relationship.

The interviewed auditors also highlighted that the main purpose of their work is to ensure the legality of annual reports. So, if control focuses more on formalities while effort input is often low, in combination with rather indeterminate accounting rules, the content might vary considerably as subjectivity is easy to implement, as the literature also pinpointed.

My interviews also revealed that auditors might have a lax attitude towards the application of accounting law. One auditor said, only when *nobody* would believe in the report would he warn the manager to discipline him. Yet, despite several possible disciplinary methods, he explained that these are rarely imposed. However, if we take into account the research on the state of reporting as well as the reports I analysed, at least we can state that they are often incomprehensive and not transparent, if not actually manipulated (see above) and disciplining should be called for. This interpretation is further supported by the indication of managers in the interviews that risk management systems might not always be all-encompassing, risk analysis methods might not always be refined or risk analysis does not always have a high priority. Research as well as my interviews and the analysis of the firms' reports prove that risk reporting often does not fulfil the requirements of the CGC.

When the board members interviewed stated that they had to tightly control managers and auditors to prevent reporting they do not approve of, they were not only saying that the state of risk reporting is fairly good, but also that best practice in risk reporting depends to a large extent on their effort.

Although it became apparent in the interviews, that on an individual level, board members are more attentive to risk reporting and invest more effort in their task, rather low effort is still common, as the literature also confirms. That managers still often report poorly implies that they do not expect objection by boards, and this indicates that control often seems to be lax. Political board members are also agents, so because they do not lose their own money when risk reporting is late, incentives to invest a high level of effort are not as strong as if they were the firm's owner.

However some increase in control was visible. One board member established a special control office to get data from the second-level management, thus preventing top-management manipulation. The other board member resorted to another irregular control method: he held personal discussions with auditors, seriously questioning annual reports to detect manipulation. (Another indication of poor reporting practices as well as poor control.).Although both control methods were highly effective, it seems to be difficult to establish them. The control office was established only for the low-risk water company, but not for the higher-risk state bank. The interview with the public shareholder representative made it apparent that he strongly disapproved of this institution because it could cause conflict with the management. After the respective board member resigned due to elections it will be dissolved. Apparently, the establishment of best practice in risk reporting does not always have priority for the public shareholder himself.

For example, one board member criticized that even five years after the introduction of the CGC, this had been neither evaluated nor adapted. Also, risk reporting was still very individual. One board member as well as the representative of the public shareholder replied to my question about standardizing rules for firms of the same sector and the same shareholder that this was not feasible because firms' needs are too different. However, this does not hold true for firms of the same industry and the same shareholder.

One board member observed that in general the public shareholder's risk consciousness concerning his firms is considerably lower than that of private owners. This is mirrored in the literature pointing to possible shirking by agents.

Stricter control of risk reporting seems to be more urgent in public than in private firms because of sometimes questionable policies of the public shareholder towards his firms. This concerns unstable business strategies, pursuing uneconomic projects, sometimes violating company contracts or exploiting firms and thus causing financial problems, low risk consciousness as well as low effort by boards, particularly towards the end of election periods (about one-and-a half years before).

So, even though board members seem to know about the likelihood and the professionalism of manipulation, high effort input, e.g. interrogation of auditors, is not common practice because it is very time-consuming and they are already very occupied with their other tasks, as one board member admitted.

All in all, as a rough outline for a theory of action of managers, auditors, and boards in the risk reporting process and its control we can say that some embellishment or manipulation is inherent in accounting. An over-optimistic presentation of firms' prospective development is on the one hand due to the bias to overrate one's own performance and on the other hand to the strong habit to be over-optimistic about business projects even in the face of risks, which is also needed to stay focused and promote success. This is not to say that managers inevitably behave this way, these are rather tendencies.

With respect to board members and auditors we found that effort input in control might often be low. Auditors are very dependent on the good will of managers hoping to get from them lucrative consultant contracts. That is why they are not much interested in strict control or correcting managers. Board members often invest lower effort in their task because they are also agents, which somewhat diminishes their interest, as financial crises would not hurt their own financial situation.

These normal tendencies are yet not adequately addressed in risk reporting rules and its control and guided my propositions to solve or diminish existing issues for risk reporting, which I present in the following.

8.2. Reform proposals

One main reform topic in the Corporate Governance debate was lack of control by boards, which was also proved by my interviews. As a countermeasure, training courses about business and risks were sometimes set up. This training should be made mandatory and should also be evaluated externally and adapted if necessary. The training should make it easier for boards to fulfil their duties due to additional technical knowledge as well as raise their awareness of the importance of paying attention to risks so that they invest more effort in their task.

Lack of time was one reason contributing to common low effort level. Therefore, the maximum number of board mandates should be further reduced from the current ten per person to five. Of these only one may be a board chair mandate. The board chair should be reserved for non-politicians as public shareholder representatives might act against the welfare of their companies. Resisting political influence on public firms is already one main demand of Corporate Governance reforms (Ganske, 2005).

Improved incentives for board members should be developed. Ideally, they should be acknowledged if they do a good job. Also, remuneration should be raised to reinforce voluntary commitment. At the same time, their liability should be more precisely defined actually exercised in the event of deviation from duties.

High performance depends a great deal on the clarity of tasks. Therefore, the control of risk reporting has to be specified and a special risk committee of the board should be established. Its efficiency should be controlled by external auditors, not the annual auditor because he might not be independent.

Clarifying tasks and making it easier to control risk reporting demand uniformity of risk reporting systems - at least for firms of the same industry and the same shareholder. Standardization should encompass: scope of reporting, definition of quality (data selection and grouping), defining risk dispositions, interval of reporting and layout. Uniformity of risk reporting systems makes the data comparable so that it can be easily checked if financial or technical information is withheld or if there are other peculiarities. For example in our case studies, the different handling of the discontinuation of follow-up support would have been easily detected and the over-indebtedness of one firm could have been prevented.

Yet, managers' relatively free choice to practice accounting as well as his sole access to the most current company data remains one major problem in the risk reporting process and its control. It turned out in my interviews that effective means exist to minimize this possibility. One is to collect data from the second-level management and hand it directly to the public shareholder. This should be done by an external public controlling company independent of managers. By circumventing the chief executive, manipulation is hardly possible. However, this solution is not favoured by many, allegedly because it poisons the work and trust relations within the firm. I argue, instead, that the ensuring of timely risk reporting justifies this step. Moreover, if over time, consciousness about the relevance of timely risk reporting is established this measurement will be more widely accepted. In addition, it is important to cultivate an environment where admitting mistakes is encouraged instead of feared. However, this is a long-term process as culture needs time to be internalized.

The second means to put checks on managers' accounting manipulation are personal interrogations of auditors by boards. My interviews proved that then even professionally made manipulations could be detected. It also became apparent that auditors strongly object to these kinds of investigations for fear of losing the management's favour. The dependence of auditors on managers, resulting in low effort input in auditing, is a prevailing issue in Corporate Governance debates, yet so far further restrictions on auditors to break their alliance with managers have not been implemented because of the strong auditor and management lobby.

On the basis of my interviews, which revealed strong alliance and collaboration of auditors and managers in the compilation of annual reports as well as professional accounting manipulation with the help of auditors, I emphasize the necessity to prohibit auditing and consulting being performed by the same firms.

Furthermore, to prevent the establishment of mutual interests between managers and auditors, there should be frequent rotation of auditors, for example every three years.

My interviews also pointed to difficulties in the broader setting of risk reporting, business strategies and goals. Although we are unable to establish a direct relationship between the two, unstable business strategies or deliberately pushing uneconomical projects make efficient risk reporting more difficult. We have seen public firms often suffer from frequent change of business strategies due to change of politicians after elections. Even during the same election period, among public shareholder representatives internal conflict over business strategies often prevails, resulting in lack of coordination and conflicting orders. This type of environment is unfavourable to effective risk management which should have a long-term focus. Therefore, long-term stable business strategies should be established covering more than one election period. Consensus should be implemented and decision-making power specified.

Setting clear business goals demands clear definition of risk disposition. Public shareholder representatives have to define clearly what types of risks they are willing to take and up to what level. Due to possible lack of knowledge among politicians they are advised to seek external consulting, independent from the firms' management.

In summary, on the basis of an anticipated theory of action of managers, boards, and auditors I offer in this chapter several solutions to increase motivation of controllers and managers to put a high level of effort into their task. Part of these incentives concern making their tasks easier to fulfil through the establishment of clear guidelines or additional knowledge (on the part of political board members). Furthermore, I suggest stricter disciplines for boards as this is still lacking. Increase of control of auditors and managers is also important because they are the main actors in the risk reporting process and its control.

Despite all these propositions aiming at the improvement of risk reporting practices we still have to consider that in times of crisis robust psychological mechanisms encourage the withholding of information if too much is at stake for managers. Therefore, we have to be aware of this fact when designing new regulations. Having said that I summarize the main important results of my work in the following conclusion.

9. Informing the debate about psychological influences on risk reporting

Recently increasing risk reporting scandals with increasing damages highlight how crucial 'true and fair' and timely risk reporting is for firms. In crises their survival depends on it, as several bankruptcies or near-bankruptcies have indicated.

If risk reporting is so relevant why did the charged managers not report reliably and on time?

Some scholars try to answer this question by maintaining cases of disclosure manipulation are only a few rotten apples among general best practice. Others try to find the answer in the allegedly prevalent hubris, specifically among CEOs. Both answers appear not to be wholly satisfactory.

With respect to the first answer, the occurrence of disclosure manipulation worldwide, its scope as well as similar features suggests it is a global phenomenon. The second answer is less easily refutable. Why did managers not report on company risks truthfully and in a timely manner? Was it because they did not care about the damage they caused?

At the first glance, it appears that managers indeed acted rather careless. In all cases their actions were driven by the desire to increase their benefits. When losses kept increasing they did not inform on the risks on time but disguised them. Similarly, all cases revealed a rather weak control by auditors. Distortion was not detected through their control although it could have been anticipated long before the final crash.

So, **both managers and auditors did not come up with their duties**. The failure of auditors is easily explained with their strong dependency on managers as a lucrative income source for consultancy contracts. But still, why in the first place did managers distort the annual statement of their companies to such a high degree?

This question raised my specific interest because I myself have worked as a manager for a long time and to explain this phenomenon with specific manager hubris appeared to me too simple, as this did not catch all the facets of managers' non-compliance with their contracts. My own work experience taught me that managers might be caught up in situations so that they do not report risks in time. However, I assumed that non-compliant behaviour in these situations was not specific to managers but to humans in general. From this assumption my research subject and main research questions developed.

In this work I tried to draw the attention to the force of psychological factors on non-compliance with "true and fair" corporate reporting, particularly in times of crisis and answer the question what type of management behaviour is likely to be enacted in these types of situations, what of it is pathological and what is normal.

My aim is, to inform academia about the psychological influences on risk reporting for the first time and develop some reform proposals to risk reporting practices. These findings can also contribute to Corporate Governance discussion.

At the root of the problem of managers non-compliance with their contracts and so to act against company welfare is that they are being agents. They are not the owner of firms and if they harm them, this will not hurt their own financial situation.

In public firms this agency problem is multiplied because of their multiple agent relations. In contrast to private firms, where the owners are involved in business, in public companies the owner (the citizen) is far removed from it. Being themselves agents, public shareholders and boards are as managers also prone to shirking. **So we are facing a multiple principal agent problem in public sector companies which has negative influence on risk reporting – also due to political interest and influences.**

The same holds true for auditors, another agent contracted by boards to control management's risk reporting, as he is very dependent on managers to be awarded lucrative consultancies - much more lucrative than audits. Having spent many years working in the public and private sector, I experienced myself how this main difference plays out in practice. **So auditors do not really help. Auditors are not independent from the management because they are also paid by them for consultancy.**

The specific characteristics of public firms and their impact on timely risk reporting have not yet been dealt with in depth (the main works are Ganske, 2005 and Scholz et al., 2009). However, public firms are structurally more exposed to shirking because all the actors involved are agents who will first and foremost pursue their self-interests, especially during crises, as they will not lose their own money if firms suffer financial damages.

As there is lack of research on this subject I decided to conduct own field search and generate new data. To do so is difficult in the business world because the vast majority of companies are not willing to give deep insights into their business conduction. With my close connections to business I recognized this rare opportunity to add valuable knowledge to the matter of risk reporting practices.

Following my business connections I chose four public real estate companies in Berlin which belong to 100% to the public shareholder. I applied a grounded theory approach conducting qualitative interviews with all parties involved in the risk reporting process and its control: managers, boards, public shareholders and auditors. Next to the four managers of the public real estate firms I interviewed one manager of the federal state bank of Berlin as a contrasting example, two board members, one public shareholder representative and two auditors.

Despite my close connection to this business branch it was still hard to find interviewees and the ones who agreed stipulated that I do not ask any questions on internal affairs. It was therefore neither in the scope of this work to thoroughly investigate their reporting process and management practice nor the psychological factors' impacts on their practices.

To solve parts of this problem I used a mixed approach of grounded theory oriented research and literature analysis. Through this eclectism and the use of concepts from different disciplines such as psychology, behavioural economics, economics, and the social sciences I could overcome some limits on this research to be able to start a discussion about the main issues of impacts of normal cognitive mechanisms on distorting corporate disclosure, particularly in public firms.

Following new academic standards I first made my research methods as well as the research process transparent (Chapter 2). This included a section on my personal reflections on the research process. On the one hand, I was sometimes surprised how reluctant people were to agree to an interview or that some even withdrew their agreement at short notice. On the other hand some interviewees, the board members, were astonishingly open and one very self-critical, providing highly valuable insights. Fortunately, even interviews with participants who were less willing to talk about or admit problems, revealed a lot of useful information. This data I validated with literature as well as the analysis of the annual reports of the firms of my case study that also contain risk reports.

The main issues brought up in the interviews roughly guided my literature research (Chapters 3 to 5 for the theoretical part, and Chapters 6 and 7 for my case studies and interviews).

In chapter 3 I first gave an overview of the conditions of risk reporting regulations and its control with a focus on public firms to provide the reader with a basic understanding of the main issues.

These are first of all that managers have great opportunities to embellish corporate figures because they have the only access to the most current data. Thus, they are relatively free to present the data how they want as reporting rules are indeterminate and mostly voluntary. Second, auditors who control risk reporting in annual reports only check for plausibility by taking random examples which decreases the efficiency of audits considerably. Indeed, generally, only a small percentage (approx. 15%) of distortion of disclosure is detected by auditors.

Because of the great power of the CEO to choose the data he presents and his awareness that it is not very likely that auditors scrutinize it, the danger of arbitrariness remains. Crucially, it is - according to research on accounting - on the one hand very simple to manipulate and on the other hand are affects large.

My analysis of the implementation of the CGC as well as my case studies pinpointed that despite some improvements as e.g. professionalization of boards through business and risk trainings and the recommendation to include at least one financial special expert, general reporting practice is still at a rather low level.

Mangers are still rather free how to present the corporate financial situation and boards and auditors still have enough freedom to exercise stricter control or not. Because the CGC is furthermore predominantly voluntary and legal regulations are as yet undetermined, all agents still have considerable opportunities to pursue their self-interests.

The strong human drive to protect one's self-interest in contractual relationships is very well explained by principal-agent theory. Therefore, I used this model to analyse conflicts of agents' non-compliance with their risk reporting contracts in chapter 4. However, principal agent theory neglects that humans behave more often in a non-rational way than conventionally assumed. This is also true in business settings.

Based on inconsistencies observed in economic behaviour newer research in cognitive theory has emphasized the prevalence of bounded rationality. These scholars claim that when people face uncertain outcomes – for example risk assessment and reporting - their actions often do *not* result in the maximization of the expected value of some situation. This has its roots in the fact that people *systematically* mis-estimate probabilities and do *not always* act on the estimates they make. It cannot be overstated that these biases are normal and not pathological. They are also not always necessarily irrational because in general they save information-processing and decision-analysis costs. Stressing systematic non-rational behaviour resulting from biases inherent in cognitive structure significantly revised conventional decision theory and shifted the focus of analysis from the individual to the situation.

According to new research (Langevoort, 2000; 2006), these cognitive mechanisms can be transferred to corporate organizations where the same decision simplification methods are used because signals from the business environment are often highly ambiguous and delayed, but managers are required to take decisions fast and therefore resort to decision simplification.

Until now it is not widely acknowledged in academia that people resort more frequently than assumed to heuristic means when taking business decisions. However, for our subject that is most important. The behavioural economists referred to throughout this work showed that these types of practices may well lead to non-compliance with risk reporting regulations in times of crisis and stressed that this is *normal* behaviour based on *normal cognitive mechanisms*. It has to be expected instead of being classified as pathological behaviour which I explain in chapter 5.

The most relevant heuristic means derive from the human need to maintain a positive self-image which results in the tendency to be overoptimistic about own actions and underestimate risks. It is noteworthy that this is *not done in bad faith* but people truly believe in their estimations – until they are shaken by overwhelming counter facts such as the final breakdown of firms as it happened in the disclosure scandals.

This implies that people tend to avoid changing their estimations about situations. They like to preserve the *status quo*, particularly when they are faced with changing it to the worse. This is anxiety-provoking and stress is highly resisted.

Nonetheless, over optimism has some overall usefulness. Well established psychological research proves that - especially in times of crisis - this attitude is important to stay focused. With overoptimism (if it departs not too much from reality) it is much more likely to overcome crises. So, in order not to throw out the baby with the bath water it is not advisable to try to eradict it at all.

My interviews brought up some of these behavioural tendencies and indicated that incentives to shirk are still rather high for every agent. Managers might be inclined to embellish company data to present their performance in the best light. **So there are psychological tendencies influencing risk reporting practice – even partly unconsciously. This has to be taken into consideration for every risk report – especially in times of crisis.**

Political board members often do not have much time because they are occupied with their main job as politicians and control of managers' risk reporting is highly time-consuming. Both board members said that managers and auditors had to be watched continuously because embellishment of corporate numbers is frequent and done professionally with the help of auditors so that it is hard to detect.

Furthermore, short-term thinking characterizes politicians. Due to elections, they might not be in their position for long. Additionally, politicians are likely to pursue political goals or uneconomic business strategies which may result in difficulties for their firms. Particularly then they are also likely to be reluctant to early disclosure publication to avoid being held responsible. This fear increases during election times when impacts might be higher.

Thus, in public firms the shareholder is also not always interested in timely reporting because he, like all the other actors, is an agent.

My interviews added much new details and facets of the highly important issue of the public shareholder being a risk to his companies and hindrance to best practice risk reporting because he is not the owner of them. If they have financial difficulties it will not hurt his personal financial situation.

For my case study I did not only conduct interviews, but also analysed the annual reports of the four public real estate companies. I analysed their latest available annual report (2010) with a focus on the management and risk report and then briefly compared the most important issues with the reports of 2003. I chose 2003 as the year to compare because at that time a different shareholder was in place conducting a different policy than the current one.

The focus of my analysis during the case study was how the guidelines and recommendations for risk reporting of the DRS 5 (German Accounting Standard) were implemented. The results confirmed other studies which found that risk reporting practices in Germany still lack quality. In contrast to normative requirements, all the reports in my case study lacked comprehensibility, clarity and completeness. All companies failed to report on the vast majority of risk categories. They also did not give comprehensive information on any risk category, and on the rest only provided low-level information. Furthermore, no risk was quantified or classified which would have made its prospective impact more clear.

In defiance of the recommendations of the DRS 5, the reports also did not give a quick overview of risks. Ideally, they should only appear in the risk report. In our reports, risks had to be extracted from the whole annual statement.

To different degrees, the companies' reports gave too optimistic a view of the firm's financial position by embellishing their numbers. Most crucially, one firm, Company A, had to revise its 2010 annual report because they did not include a legal-financial risk even though it should have been expected for years: the recording of expenditure loans as liabilities. The realization of this risk led to the near-insolvency of the firm. Thus, ignoring it was highly risk-seeking.

Other companies also covered up risks by grouping data differently. For example, one company reported a decrease in rental vacancies but a number of vacancies were not included in this category because they were listed under the rubric 'modernization'. The total sum of vacancies – risk for revenue – however, remained the same. It became, moreover, apparent that often the firms formed rather low or no provisions for risks or did not mention risks e.g. risks of change of interests. This is also an indicator of a risk-seeking not risk-averse attitude.

Unsurprisingly, in the interviews managers portrayed themselves as risk-averse, operating highly elaborate risk management. This was not only disproved by the analysis of their reports, but also by their own explanations of their risk analysis and its priority, which often seemed to be low. As one board member explained, it is interestingly not so much the case that managers omit information on risks, but risk information is often hidden and imprecise. According to him, risk reporting standards differ a lot in quality and some reports are rather poor. He also said that this is still up to managers and they cannot be forced to report in more detail.

However, both board members interviewed asserted that it is absolutely necessary to monitor managers' risk reporting continuously and carefully because they are indeed likely to make a “deal” with auditors which boards do not want. Embellishing and manipulating corporate figures thus seem to be common. As already mentioned, according to the boards this is hard to detect as it is - with the help of auditors - done professionally. Yet, there are some means to prevent it.

One board member held personal talks with auditors alone and interrogated them about their reports. The other board member established a special monitoring office to obtain corporate data from the second-level management. By this means he circumvented manipulation of data by the top management. Nevertheless, the first board member declared that he resorted to talks only when he was board chair because it is time-consuming. In general, monitoring by boards did improve to some degree, but is still at a rather low level.

Concerning the high effort input by the second board member, it is conspicuous that he established a monitoring office for the low-risk water company, but not for the high-risk state bank. The interview with the public shareholder representative made it clear that this kind of institution is unusual and disapproved of by the majority. It will be dissolved now this board member has left office. This is another hint that the public shareholder is often not highly risk-conscious about his firms. This fact is still not fully acknowledged in the literature.

Even though all the interviewees maintained that some improvements had taken place on the part of the public shareholder, such as professionalization of boards, business and risk management training, they all believe that low effort input is still common. However, their task is rather demanding because if they want to be effective they have to monitor both managers and auditors. So, political board members usually focus much on checking formalities as managers indicated. This does not guarantee that no manipulation occurred as the risk reporting scandals proved. All of these managers adhered to formal rules while circumventing their purpose.

The actual need for high effort input because of the need to control auditors as well became apparent during my interviews. Indeed, managers as well as auditors explained that some collaboration between them in the compilation of annual reports is practiced. This confirms the statements of the boards that embellishment and manipulation is made professionally with the assistance of auditors. Yet, we have to take into account that an optimistic outlook on prospective corporate development is legal. According to creative accounting theory, manipulation is inherent in accounting. This is reflected by the many legal categories for accounting manipulation of which only outright forgery is forbidden. Although the auditors interviewed denied any manipulative effects of accounting they indirectly agreed with this interpretation. According to one auditor, accounting refers to shifting numbers back and forth over the years. This is exactly the main way of manipulating firms' financial positions. This is a crucial issue because research on accounting manipulation in Germany has proved that it is systematic, increasingly aggressive and more wide-spread than conventionally assumed.

Despite these findings, the auditors declared that disciplinary measures are very rarely imposed against managers. The purpose of audits is different and criticizing managers for their accounting is a delicate matter. One board member completed this sentence: It is a delicate matter because auditors know that their further employment depends on the goodwill of the management. This dependency is also reflected by the way control is implemented. The inspection report, designed as a means to control the board, is first handed to the management before it is sent to the board. If control information is first reported to the controlled subject and only then handed to the controller, the value of monitoring is seriously minimized. Ineffective control of one agent by another because of likely collusion between them is an issue conceptualized in principal-agent theory.

Effective risk management and reporting is also affected by the public shareholder. Interestingly, *all* interviewees regarded him as “the biggest risk” to his firms. Effective risk management depends on clear, long-term business goals. In public firms, this condition is not always given because public shareholder representatives might frequently change due to elections and in the vast majority of cases no consensus on long-term business plans is established. Instead, internal conflict is frequent, making it difficult to conduct business. This contributes to lack of coordination of decision-making structures, causing conflicts and tension. Moreover, communication policies between public shareholders and managers are also rather poor. Often, managers learn about changes in business strategies only from the press. Furthermore, public shareholder representatives as politicians also pursue other goals besides the company's welfare. In some cases this can be to the disadvantage of firms. This concerns, for example, uneconomic projects and other violations of company contracts.

In some cases, for example during election times, public shareholder representatives might themselves have reservations about disclosing risks fully and in a timely manner, in order not to implicate themselves. One board member indicated that in general public shareholders are less risk-conscious towards their firms than private owners. One indicator is the lack of evaluation of the Corporate Governance Code, even though five years have passed since its introduction. Risk reporting systems even for firms of the same sector and the same shareholder are still individual and standardization is not planned. Standardization of systems, however, is necessary to detect omissions or peculiarities easily. The lack of interest on the part of public shareholder representatives in improving risk reporting in their firms is well recognized in the small amount of literature available. However, in practice it is not sufficiently dealt with even though reformers call for political influence on public firms to be resisted.

How can this situation be improved? In the past, solutions to agents' shirking in risk reporting focused mainly on monetary incentives. Being extrinsic motivational factors they proved to be of rather limited success because high effort input depends more on intrinsic motivation.

Based on my research I propose as solutions increasing training for boards to make their task easier for them, raise their risk awareness and so increase their effort input. Complementarily, their liability should be increased and in fact exercised if necessary. Also, risk reporting control should be specified and a special risk committee of the board established. It is also important that board members have sufficient time to seriously control risk reporting. Thus, board seats should be further limited to five.

To ensure independence of auditors, it should be forbidden to audit and consult for the same firm. Further, frequent rotation of auditors should be made mandatory. However, the most effective and necessary measure seems to be to circumvent managements' data manipulation by obtaining data from the second-level management – as done by the control office mentioned above. This should be done by an external controlling company.

As far as the public shareholder is concerned, long-term business goals including clearly defined risk policies should be established based on a broad consensus. This also concerns better coordination of decision-making power.

These propositions are focused on improving conditions for the fulfilment of respective tasks and stricter control. This does not mean that the establishment of a corporate culture where risk reporting is highly valued and is believed to be to the best of the firm and its agents is unimportant. Indeed, this is the most effective means of ensuring best practice risk reporting. However, it is a long-term process.

The optimal corporate culture should also incorporate values where one is encouraged to admit mistakes. These studies should include how to build trust, particularly in public firms. How this change can be best implemented by integrating all agents in this process was not in the scope of this study and remains a subject for further research.

For all the sort of pessimistic information on the robustness of the mentioned cognitive biases and that they are hardly likely to be washed out – if we keep them in mind when developing reforms of risk reporting regulations in public firms promises considerable improvements to ensure better sustainability of the welfare of companies.

The contribution to academia of this research is, that this is the first research about psychological impacts on risk reporting in public sector companies. The interviewees are high potential stakeholder of the research process (former ministers, Boards, auditors and shareholder representatives). This new generated data on decision making and psychological influences might also be useful for other researchers.

9.1. Personal reflections

When I started the research I was on the way to analyse the practical doing of risk reporting in the Berlin public sector companies with focus on the risk reports, board minutes and interview outcomes. After the withdraw of support by the State of Berlin the research aim shifted to analysing the psychological impacts impeding the correct and timely risk reporting in public sector companies. I was surprised about the support-withdraw but it made my even more interested in this topic because I argued that this must be an interesting topic if someone wants to hamper this research.

During the "journey" of this research I have learned a lot. The very vital political influence on this companies combined with the multiple Principal-Agent-Problem surprised me.

I also learned about the psychological influences on risk reporting and that on the first view "no rational" behaviour by cognitive conservatism and heuristics also have an rational background (decision cost saving). I read really a lot of books around the topic.

I have discussed to very interesting persons during the interviews. Some were very close and caution, others more open and informing. It was very valuable to learn from the different viewpoints and backgrounds.

At the end because of my ongoing research my personal relationship to the public shareholder degrades so I had to move to a private sector company for work. But that has not affected the research – I was more surprised about the development.

For my own work I have learned different things. Corporate Governance and Compliance are now very important for me. As a CFO of a stock listed company I increased the risk reporting of this company and add quantifications.

The research was guided by Sheffield Hallam University in a very good way. The different stages from the taught lessons in the very beginning, the DB2 after 2,5 years and the support of the supervisory team during the doing of research was very valuable for me. The different stages of the process kept me going on. It was very helpful to learn from the supporting team of "just finished" doctorates because these are very close to the own situation.

This journey will not be the end I think. There is a question generated by my research about the Principal-Agent-problem of the public shareholder representative – the politician and his relationship to the parliament and the citizen. This could be goal for further investigation. I will also keep the link to universities to stay informed and perhaps can help other students and doctorates.

Word-count incl. case study 71.507 words.

10. Appendix Case Study

Methods of Analysis:

Annual reports

The primary source for financial circumstances and profitability of a company is the financial statements of a company. It is also here where liabilities for risks have to appear. The legal requirements for the annual report are laid out in the German Commercial Code (HGB).§ 246 HGB sets out the regulations on completeness, content, accounting prohibitions and principles of assessment. § 249 HGB stipulates that provisions for uncertain liabilities and imminent losses from pending transactions must be formed. Similarly, liabilities must be formed for deferred maintenance expenses (in the fiscal year). This is also obligatory for warranties that were provided with no legal obligation. According to these regulations, an ample probability is mandatory for the formation of accruals. Otherwise, no liabilities are to be made. § 251 stipulates that liabilities for exchange, guarantees and contingent liabilities are not allowed to be declared in the balance itself, but they must be indicated in reports. It follows from the above that a variety of risks arising, for example, from pending transactions or low estimated probability are not allowed to be included in the balance.

Pursuant to § 264 corporate enterprises to which the housing companies belong have to include an appendix to illustrate the balance sheet and the management report.

I analysed the annual reports under the following aspects: formal, focus on risks, statement of compliance to the Corporate Governance Code and objectivity. Specifically, the following questions guided my analysis.

The formal aspect:

a) Was an unrestricted audit certificate issued?

b) Does positive company capital exist?

The focus on risks:

a) Are high intangible assets indicated (are these only of limited value and therefore an indication of an embellished company capital)?

b) Are there activated claims against the shareholder?

c) Are liabilities clearly described, assessable and comprehensive, and are there residual risks?

d) Are there losses or cumulative value adjustments?

e) Other economic risks? Do guarantees and other commitments (e.g. bonds) exist outside the balance sheet?

f) Has the risk management been described? Are there any peculiarities?

g) Corporate Governance: Comply or Explain: If not fully complied with, what was not implemented? Are there any peculiarities? For example, limits of board mandates? Have committees been formed? Are there any peculiarities concerning qualifications of managers?

The objectivity of the report: Was the report objective or euphemistic? Is there any implausibility between balance sheet, income statement, annual report and appendix? Are there any abnormalities or lack of transparency?

Management reports and risk reports

For the analysis of the management reports I looked at how prospective essential risks were reported and compared this with the regulations of the KonTraG (see Chapter 3). For this purpose, I adapted to our public real estate firms the evaluation scheme of Gulden (2003) who did a similar analysis for the (private) German automobile industry. Gulden's evaluation indicators were useful because he based them on the guidelines and recommendations of the DRS 5 (German Accounting Standard for Risk Reporting). Although the DSR 5 is non-obligatory it is the basis for a standardization of the application of accounting law, and was developed in coordination with the German Ministry of Justice. For the latter's authority, it serves well as the basis of an analysis of how the managers in my case studies implemented these normative claims.

In Chapter 3, on legal regulations of corporate governance, I outlined the legal requirements and recommendations for the management report as defined in § 289 HGB. In summary, the main purposes of these reports were to present a true and fair picture of the course of business as well as business results. Moreover, the prospective corporate development has to be assessed and explained. In addition, the underlying assumptions have to be indicated. Furthermore, the essential features of the internal control and risk management systems have to be described with regard to the accounting process. According to these disclosure topics, the management report consists of the following parts: a) presentation of the economic situation, b) developments after the deadline for balancing until the compilation of the annual report, c) assessment of the prospective development of the firm.

As mentioned above, I adapted Gulden's table of indicators to the specifics of my case studies. The focus of the analysis was how the firms reported on the various reporting matters. These matters, i.e. risk categories, I prioritized according to their significance for our specific companies from top to bottom (column one of the table below). In column two, the matter reported is indicated (it is imported to note that managers are autonomous as to how they define these categories). In column three the item of the DRS 5 is indicated, and the last column indicates if regulations are mandatory (m) or not (n).

Table 1

Priority	Matter Reported	Item of DRS 5 (German Accounting Standard for management reports)	Mandatory (M), Non-mandatory (N)
1	**Existential Risks**	15	M
2	**Risk quantification**	20	M
3	**Financial risks**	17	M
4	**Legal Risks**	Not included	
5	**Other risks**	17	M
6	**Performance risks**	17	M
7	**Industry Risks**	17	M
8	**Strategic business risks**	17	M
9	**Environment risks**	17	M
10	**Personnel risks**	17	M
11	**Information technology risks**	17	M
12	**Specific conditions of the corporate group**	11	M
13	**Description of the risk management (strategy, process, organization)**	28, 29	M
14	**Formation of risk categories**	16, 17	M
15	**Concentrations of risks**	13, 14	M
16	**Risks of individual business segments**	19	N

17	**Interdependencies between risks**	25	N
18	**Chances**	27	N
19	**Management measures for identified risks**	21	M
20	**Significant changes from previous reporting periods**	36	N

Table adapted from Gulden (2003: 33) to real estate companies.

To better understand the goal of these risk categories, I define them below.

Existential Risks: These refer to risks that will endanger the existence of the company in the short, medium or long term. They also include matters that could develop rapidly into existential risks, even if at present they do not amount to a risk but are judged to be manageable. However, it is noteworthy that managers are relatively free to decide how to define essential risks. In general, this is not examined by the board or auditor, as all the groups interviewed confirmed (see Chapter 7).

Risk quantification: As the name indicates, this refers to the quantification of risks as opposed to verbal statements. However, this is only to be done if recognized and reliable methods are available.

Financial risks: Here, it has to be considered if sufficient funding is available, prolongations are possible, sufficient banking partners are available, interest rate risks are acceptable, and if sufficient liquidity is available for the future planning period.

Legal Risks: concern impacts resulting from new legislation, changes in opportunities for rent increase (profit-making), recognition of liabilities of e.g. expenditure loans, and legal accounting regulations and rules etc.

Other risks: refer to various risks not mentioned above, such as reputational risks, risks for the public mandate etc.

Performance risks: relate to deficiencies in work performance, for example, error in renting, construction defects etc.

Industry risks: concern risks such as e.g. renting risks, construction costs or other risks as sustainability issues, renewable energy, etc.

Strategic business risks: designate deviations between actual and planned business strategies and risks that endanger the implementation of proposed strategies in the future.

Environment risks: refer to environment risks that are not caused or influenced by the shareholders such as market risks, regional risks, other stakeholders (unions, suppliers, tenants, etc.).

Personnel risks: relate to employee turnover, employee quality, problem of finding suitable successors for the management, corruption risks etc.

Information technology risks: refer to availability and reliability of IT systems, need for improvement, data management (accessibility, storage etc.).

Specific conditions of the corporate group (including shareholder environment) concern the following questions: Does the shareholder exert influence? Are there factors caused by the shareholders that other companies (private and public) do not face? In this case they have to be explained.

Description of the risk management (strategy, process, organization): This includes whether collection of data is decentralized or centralized, as well as where in this system operational responsibility is located; for example, who compiles the risk reports? Who controls the process? Is this the CEO, a divisional manager or a subordinate department head?

Formation of risk categories: On the basis of quarterly risk reports compiled during the fiscal year, risk categories already used in these reports should be transferred to the management report, but in an aggregated form. (Summaries are to some extent useful to avoid confusion and ensure clarity and transparency of the information).

Concentrations of risks: This concerns the situation where, in relation to single risks, other risk positions aggregate or if existent risks significantly increase in danger.

Risks of individual business segments: refers to a division of risks according to business unit; the previously mentioned technical risks from e.g. investment, rentals, financing or maintenance are partially taken up again (to avoid double indication).

Interdependencies between risks: concerns whether risks reinforce or counterbalance each other. For example, high inflation leads to rises in interest rates and construction costs as well as an increase in rent.

Chances (are supposed not to offset risks): relate to e.g. increasing opportunities for rents, use of synergies, cost reduction potentials etc.

Management measures for identified risks: designates registry of individual measures for each risk deposit as well as indication if they are merely decided upon or already in implementation.

Significant changes from previous reporting periods: For each risk significant changes (negative or positive) in relation to previous times have to be indicated. Ideally, this has to be done through quantification of their increase or decrease.

In the following section I turn to an analysis of the annual and then the management and risk reports of the four real estate companies studied.

10.1. Company A

The annual report of 2010 of this firm had to be revised because of a court decision making the recognition of liabilities of expenditure loans mandatory. The original report for 2010 (compiled before this court decision) contains 69 pages (incl. 21 empty pages, photos or portraits). Effectively, the report contains 48 pages of information relevant for disclosure. This amounts to 70% of the overall information.

The final updated report contains 36 pages including one empty page, meaning that 97% of this report is devoted to relevant disclosure information. However, the risk report of the management report contains only one page and does not list all the risks. Instead, remaining risks are mentioned throughout the annual report, but are not always clearly indicated as such.

In the following table I classify the various parts of annual reports (which might differ to a certain degree for every firm) according to their susceptibility to manipulation in column 1, ordered from top to bottom. Number one indicates the part that is most susceptible to manipulation. The parts with the higher numbers are less easy to manipulate because they are more based on numbers. Column 2 indicates the respective part of the annual report, column 3 the number of pages, and column 4 indicates which information value the parts have or should have for risk reporting. This column follows an order from top to bottom, with number one indicating the highest priority.

Susceptibility to manipulation	Part of the annual report	Number of Pages	Priority for risk reporting
1	Report of the Management Incl. risk report	14 0.75	4

2	Report of the Board	2	5
3	Portrait of the corporate group	1	13
4	List of Shareholdings	1	11
5	Organigram	1	12
6	Consolidated accounts		3
7	Balance sheet	2	1
8	Income statement	1	2
9	Appendix	9	6
10	Cash-flow statement	1	7
11	Liabilities report	1	8
12	Assets analysis	1	9
13	Company capital statement	1	10

Annual report 2010, Company A

As mentioned above, in the following section I analyse the annual report of the firms according to their formal, risks, and aspects of objectivity.

With respect to formal aspects, the annual report for 2010 received an unrestricted audit certificate. As to positive company capital, this was negative at the amount of € 140 million with total assets of € 1,620 million (annual report 2010: 22). In the previous year the firm had a positive equity of € 98 million.

This rapidly increased debt overload originated from new statutory legislation making the passivation of expenditure loans as debts mandatory. In the past, a special regulation allowed companies to list these debts outside the balance sheet as contingent liabilities, because repayment requirements were determined by the economic data of properties and also because the Federal state bank had issued a letter of subordination.

These expenditure loans and the special balance regulations were set up to finance housing projects which formed part of the previous political goals. However, these projects were not economically viable – therefore the special balancing regulations were established.

The other firms of my case study had already shown these loans as liabilities in previous years in anticipation of legal changes, and could thus keep their equity positive. Here, we witness that the legal power of the public shareholder was first used to make specific business operations possible, as he was interested in them despite their being unprofitable otherwise. When political circumstances changed, in this case the need to restore the state budget, these legal favours were dropped by the court. At the end, instable legal policies caused at least one of the firm's considerable financial difficulties.

The net loss of € 266 million is mainly due to expenditure loans being shown as liabilities- but only to the amount of€ 236 million. The company has a permanent deficit of about € 30 million (in the previous year€ 26 million). For 2011, a surplus of€ 9 million is expected (annual report 2010: 29).It is furthermore evident that the firm is also actively involved in property development (probably in order to generate additional income). However, in 2010, revenues from the sale of real estates of € 33.2 million have to be charged up against asset reduction of real estate for sale to the amount of € 14.6 million as well as expenditures for sale plots of € 10.8 million. In sum, this business sector made a profit of only € 7.8 million in 2010. It is noteworthy that public real estate firms do not have the expertise needed for property development. This might explain why profit from this business is rather low. The reason for going into this business despite its risks might lie in the financial difficulties of the firm.

Concerning aspects of risks, such as high intangible assets (these are of limited value and therefore an indication of embellished equity) and activated claims against the shareholder, these are insignificant for this company.

In relation to accruals, of the relevant ones totalling € 36. 8 million, € 13 million were formed for pending losses because of the omission of follow-up support (annual report 2010: 35). These accruals seem to be rather low, in particular in comparison with the rest of the companies studied. So, for 2010, revenue reduction due to the abolition of follow-up support amounts to € 1.7 million. In 2010, provisions were raised by € 3 million, yet no provisions were formed for other risks because of termination of general lease contracts (annual report 2010: 17).

Losses due to rent claims increased from € 1.7 to 1.9 million.

With respect to other economic risks, it is indicated that the firm has an average interest rate of 3.28 % p. a. Liabilities towards banking institutions amount to € 1.316 million. Even if the interest rate of the credit portfolio is largely hedged (evidence is not given), because of the low surplus increasing interest would develop into an essential risk for the firm. As revenues cannot be increased in the short-term, rise in interest would be difficult to compensate (even if these rises occurred with some time delay). Regarding this point it is crucial that interest sensitivity analysis (cash-flow-at-risk) is not conducted. Moreover, it is explained that no interest hedging operations were done (derivative operations - annual report 2010: 9). Still, we can assume from the low interest rate that there might be a considerable inventory of short-term fixed interest rates (most probably the firm benefited from the recent decrease in interest rates).

Concerning guarantees and other commitments, none were mentioned.

In regard to the firm's risk management, the management report mentions a planning and control system documenting and assessing industry-specific and company-specific risks. As I lay out below, the risk management system of this firm seems to be more a by-product of the planning and control system, instead of being encompassing and prospective.

In relation to the Corporate Governance Code, the board report states compliance with the Code; no further information is given.

All in all, this report obviously somehow embellishes the firm's position. For example, decrease of vacancies (i.e. risks) is reported. However, part of the vacancies was only grouped differently because they were modernized (annual report 2010:10). In fact, the sum of vacancies did not change. Again, information on risks was somewhat distorted.

In regard to reports on chances, on page two the term "profitable rental units“ is mentioned, but not explained. In accordance with the above-cited example, one might assume that this in fact could again mean vacancies. The increasing reduction of revenues is attributed only to modernization; other reasons are not mentioned.

As to another important topic, necessary investments, it is pointed out that these cannot be made because it is not possible to increase rents. Yet, even though the problem is recognized it is not indicated if provisions were formed (annual report 2010: 16).

The Corporate Governance Code tries to ensure independence of auditors by recommending them to list all their fees. This firm complied with this regulation. Of € 321k total fees, € 169k was paid for the audit (annual report 2010: 36). Thus, income from consultancies was slightly higher than from the audit. Still, we might have to consider that the audit might have supported the auditor's assignment as consultant, and so increased his income.

In summary, Company A's annual report for 2010 paints too optimistic a picture of its position. In general, rather low provisions for risks were formed. Additionally, for some risks (e.g. change in interest rate) no risks at all were mentioned. Most crucially, the company has severe difficulties because of the new legislation demanding that expenditure loans be shown as liabilities. Because this firm already had deficits of about € 30 million in the previous years, it was impossible to show these loans as liabilities successively and so preserve positive equity. In contrast, the other firms in my case study had no deficit and thus were able to take this more cautious step.

In 2010, all potential to increase rent was fully exploited. Yet, the revenues of this firm were negative even before the expenditure loans were reported as liabilities. Recently, the Federal State restricted potential for rent increase. Due to its rather severe financial difficulties this company does not seem to be able to adhere to these new regulations. At the end, the report states an expectation of increase of rent revenues of 1% p.a. This forecast is rather cautious. However, it is still maintained that stable positive results are expected (annual report 2010: 18). In this regard it is crucial that the report does not indicate at all that the firm is almost bankrupt because of its debt overload. The firm's position is so precarious that it seems fairly certain that the public shareholder will have to provide financial means for its restoration.

After having analysed the annual report according to its formal, risks and objectivity aspects, I now look more closely at how risks were reported in the management and risk report by using the above table of risk categories. After the summary of my findings in the table below, I go on to discuss my results.

Indication of risk categories in the management and risk report, Company A

Priority of Risks	No Information	Priority of Risks	Low Information	Comprehensive Information
1	Existential risks	3	Financial risks	
2	Risk quantification	7	Industry Risks	
4	Legal risks	10	Personnel risks	
5	Other risks	12	Specific conditions of the corporate group	
6	Performance risks	13	Description of the risk management	
8	Strategic business risks	15	Concentration of risks	
9	Environment risks	18	Chances	
11	IT risks	19	Management measures for identified risks	
14	Formation of risk categories	20	Significant changes from previous reporting periods	
16	Risks of individual business segments			
17	Interdependencies of risks			

Sum	11		9	0

As the table indicates, for no risk category is comprehensive information given. Instead, for nine categories the information is of low value and for most of them, eleven, no information is given at all.

To better investigate the firm's reporting practices I place them in the context of their business operations, i.e. public mandate and profitability.

The firm seems to focus on the public mandate. On page two of the annual report the public mandate – to "secure quality housing for broad sections of the population " - is mentioned as the only goal of the business strategy. Yet it is also indicated that the potential for rent increase was fully exploited, but in accordance with the law for local specifics and specific objects (annual report 2010: 11, 16). So, after the termination of rental bonds, rent was raised.

The company also confirmed it had adhered to political restrictions on their profit-making, e.g. the ban by the senate of Berlin on selling housing objects en bloc (03.07.2007). However, single apartments were sold to investors (annual report 2010: 12).

As to the property value of real estate objects, this was given by book value, i.e. purchase and production costs minus depreciation and plus write-ups. Crucial in regard to manipulation of the firm's financial situation is the fact that the book value differs from the current market value. In Germany the Commercial Law (HGB) follows conservative accounting principles demanding indication of the lower book value. In contrast, the IFRS (International Financial Reporting Standard) follows the fair value principle, where the current market value has to be determined (Esser, 2002)[36]. One of the main incentives to underestimate the financial situation of a firm is a reduction in tax payments (Esser, 2002). However, the central guidelines of corporate governance demand that the corporate financial situation should neither be overstated nor understated.

Regarding the company's risk management system, it is described in rather general terms: e.g. "through monthly or quarterly analysis of plan deviation, risks are identified and measures taken" (annual report 2010: 19). In addition, responsibilities are not mentioned. However, this information is important to clarify responsibility for results and the overall functioning and effectiveness of the system.

I tried to arrange an interview with the management to investigate this point further. However, this was strongly denied "for reasons of time." Instead, I could only schedule an interview with the head of the controlling department who was also in charge of the risk management. He told me that this job was more or less "accidently" assigned to him. This can be taken as a hint that risk management does not have the highest priority for this firm, as I discuss in more detail below and in the following chapter.

The actual risk report is rather short and confined to a simple comparison of old and new planning. The risk management seems to focus solely on risks specific to objects (e.g. construction, restoration etc.). Other risks were not considered, e.g. general market risks, legal or interest rate risks. Only the credit portfolio is continuously analysed. This rather narrow selection of the goal of the risk management seemed to have been confirmed during my interview when the risk manager talked, in great detail, only about these types of risks.

[36] http://www.ifrs-portal.com/Dokumente/unterschiede_ifrs_ifrssme_hgb.pdf [05.11.2012].

Regarding the prognosis horizon (an indication of the forecast's accuracy), this was divided into short-term (up to one year), medium-term (up to five years) and long-term planning (over five years). However, the prognosis horizon was not made explicit as demanded by corporate governance norms. Indeed, it had to be extracted from the text where years were not explicitly indicated. Yet, all prognoses remain very general statements of low information value; underlying assumptions and details were not included.

In the risk report itself, no risks are described. In the section on medium-range chances and risks, only some types of risks were briefly mentioned as examples, e.g. the termination of general rent contracts by the local municipalities (however this risk is neither quantified not qualified regarding its prospective impact on the firm's development). Other risks have to be extracted from the text.

Most risks originate in some way from the public shareholder. This view was also shared by all of my interviewees including representatives of the public shareholder. So, under the columns "specific conditions of the corporate group including shareholder environment" and "legal risks", politically limited rent increase is named as a risk leading to revenue deficits for subsidized apartments and having an impact on investment (annual report 2010: 17, 15). Yet it remains unclear to what extent low rents constitute a risk. Limits on rent increase are together with oversupply of apartments also identified as an industry risk. Crucially, although oversupply indicates the existence of vacancies, this risk is not mentioned.

Another risk caused indirectly by the public shareholder is the new recording of expenditure loans as liabilities that resulted in significant changes from previous reporting periods. This risk was accompanied by the abolition of follow-up support and is indicated as concentrations of risks (annual report 2010: 15).

All in all, it is striking that from 20 risk categories, none is reported according to the guidelines of the Corporate Governance Code, which demands that they be accurate, comprehensive and not arbitrary. Most crucial, however, is the fact that, in the report, the management did not make clear statements on actual severe financial difficulties after the recording of expenditure loans as liabilities, even though these amount to an existential risk. In short, this disclosure is a rather poor record.

10.2. Company B

The annual report for 2010 contains 75 pages (incl. empty and portrait pages and presentation of projects). The structure of the report is as follows:

Susceptibility to manipulation	**Part of the annual report**	**Number of Pages**	**Priority for risk reporting**
1	Preface of the management	1	8
2	Report of the board	1.5	5
3	Report of the Management Chances and risk report Forecast report	20 2.5 1.5	4
4	Appendix of the management report (only information on compliance with the Corporate Governance Code)	5	7
5	Balance sheet (incl. appendix)		1
6	<u>Consolidated accounts</u>	12.5	3
7	Income sheet	1	2
8	Appendix of the annual statements	13	6
9	Audit reports	2	9
10	List of group's own stock	1	10

As indicated above, this report contains several empty pages. Effectively, 57 pages are of relevant disclosure information; this amounts to 76% of the whole report.

Under the section "annual statements", 6.5 pages are included for a limited company. To be able to compare the companies interviewed, I did not include these 6.5 pages, and considered only the numbers for the corporate group. Thus, for this company, the report contains 68.5 pages; minus the non-relevant information, this leaves 50.5 pages of information relevant for disclosure, i.e. 74% of the total report.

Annual report 2010, Company B

As with the previous company, I first analyse the annual report according to its formal, risks and objectivity aspects.

Like the annual report of the former firm, this report received an unrestricted audit certificate.

As to positive equity, this amounts to € 344 million with total assets of € 1.743 million (annual report 2010: 53). The equity ratio of 20% is in general sufficient, although not particularly high. The company capital is not endangered on a structural level due to the positive annual net income of € 15.9 million. However, to a significant extent the net profit originated from special effects (annual report 2010: 23). Thus, only a net profit of € 10 million is likely to be sustainable.

Regarding risks, high intangible assets and activated claims towards the shareholder which are only of limited value and thus an indication of embellished company capital are insignificant.

Provisions, including their clear descriptions and assessment, amounted to € 62 million. Of these, € 32 million are assigned to pending losses due to the omission of the follow-up support (annual report 2010: 66). € 11 million were set aside for uncertain liabilities from the sale of one object. Provisions were raised by € 2.2 million in 2010. However, the basis on which all these provisions were formed is not explained, so it cannot be assessed by the reader if they are indeed sufficient.

As to cumulative adjustments, these were done in a total of € 1 million for rental revenues.

Regarding further economic risks, we will first look at the interest rate. Company B had an average interest rate of 4.1 % per annum. Liabilities towards banking institutions amount to € 1.219 million. As was the case with the former firm, even if the interest rate of the credit portfolio is hedged (evidence is not given), rising interests would result in an essential risk for the firm. So, the sustainable annual net income of € 10 million corresponds to an increase in interest of

0.82 % p.a. Due to the impossibility of increasing revenues in the short term, increase in interest is difficult to compensate (even if the interest rise occurs with a time delay). Strikingly, interest sensitivity analysis (cash-flow-at-risk) is not conducted; here the firm might face considerable prospective risk. As a general guideline, a company should be able to handle an increase in interest of 1% p.a.

The terms of financing agreements are also conspicuous. So, long-term capital assets are not completely financed for long terms (annual report 2010: 27).As to guarantees and other commitments outside the balance, none are indicated.

The risk management system is presented as a monthly reporting system (annual report 2010: 37). Further explanations are not given.

More revealing are explanations of the company's compliance with the Corporate Governance Code. One board member resigned in 2010 because he exceeded the maximum number of board seats. Interestingly, this board member is the manager of one bank with which both company B and its competitors have business relations. Although this is mentioned under the category of conflict of interests, it is emphasized that a conflict of interest has never occurred. To evaluate this contradictory statement we have to remember that board members are obligated to only pursue the welfare of the firm of which they are a board member. Therefore, it is not permitted to assign somebody to the board of a firm if he holds positions in related firms or competitors. Thus, the above-mentioned board member clearly violated the Corporate Governance Code. In his position as manager of the firm's bank he decides whether or not to grant loans and arranges interest conditions, matters very vital for companies. He also grants or denies loans to the firm's competitors. All these factors lead to conflicts of interest because the board member is not focused solely on the welfare of the firm, but influenced by the interests of his bank and of the firm's competitors.

This was not the only conflict of interest. Since 2007, a member of the management has been on the advisory board of a software company with which the firm has business relations (annual report 2010: 38, 39). Again, this constitutes a conflict of interest because the manager has to arrange for prices and may have to claim guarantees. So, this clearly constitutes a conflict of interest between this firm of which he is the manager and the software company of which he is member of the advisory board. Again, although this fact is mentioned it is strongly emphasized that a conflict of interest has never existed.

In regard to the objectivity of the report, it does not obviously embellish the situation; however, the risk of rising interest is neglected, although at the start of 2011 it was in fact already a pending scenario. Instead, the report focuses on company-specific matters and real estate management (annual report 2010: 17).

In relation to the independence of the auditor, all his fees are listed. In total he received € 245k. From this € 118k were paid for the audit. As with the former firm, the auditor received a slightly higher sum for consultancies. Again we can only speculate how this affected his independence of the management (see Chapter 3; I discuss this topic in more detail in the following chapter).

In conclusion, the annual report of company B gives an optimistic impression of the position of the firm. In relation to its comprehensibility, provisions are set aside for some risks. Yet, it is impossible to identify on what basis they were formed and if they are indeed sufficient. Moreover, for some risks, e.g. rise of interests, no provisions were formed. Crucially, these risks are neither described verbally nor even mentioned.

The most striking point is the conflicts of interest of members of the management and the board. One of the main purposes of the Corporate Governance Code is to reinforce the sole adherence to the firm's welfare by its most significant stakeholders. Here, this was clearly not the case.

After having analysed the annual report according to its formal, risks and objectivity aspects, I now look in more detail at how risks were reported in the management and risk report by using the above table of risk categories. After the summary of my findings in the table below, I then go on to discuss the results.

Indication of risk categories in the management and risk report, Company B

Priority	No information	Priority	Low Information	Priority	Comprehensive Information
2	Risk quantification	1	Existential risks		
4	Legal risks	3	Financial risks		
5	Other risks	7	Industry risks		
6	Performance risks	12	Specific conditions of the corporate group		
8	Strategic business risks	13	Description of the risk management		
9	Environment risks	15	Concentration of risks		
10	Personnel risks	18	Chances		
11	IT risks	19	Management measures for identified risks		
14	Formation of risk categories	20	Significant changes from previous reporting periods		
16	Risks of individual business segments				
17	Interdependencies of risks				
Sum	**11**		**9**		**0**

Rather similar to the previous firm, this company's report gives no information about most risk categories (eleven), and low-level information on nine of the 20 categories.

In the following section I take a closer look at the risk report, investigating the risk categories listed above and placing them in the firm's business context.

According to the report for 2010, the core business of company B consists of renting and managing residential and commercial real estate (annual report 2010: 16). Referring to the firm's public mandate a so-called "social balance" is mentioned (annual report 2010: 16). This is confined to enlisting the use of subsidies according to their recipients; however, subsidies to fulfil the public mandate (i.e. to avoid raising rent) are not mentioned. Instead, the social balance reports on investments and costs for improving the position of neighbourhoods. These costs are grouped under the rubric "tenants“ indicating public services have been pursued. Interestingly, the population receiving social welfare benefits is identified as a risk for new rent contracts, as opposed to being part of the firm's public mandate. As to this risk identification we have to take into account that new rent contracts allow considerable increase in rent and thus profit. In summary, although this firm seems to be eager to show that they take their public mandate seriously by presenting a social balance, they do not understand this mandate to be a service for the lower classes. In relation to the clarity of the social balance it would have been far more revealing to know how much subsidy the firm received and how it was invested. Unfortunately, this kind of information is not provided.

As with all the previous companies, the lower book value and not the fair value is indicated for the firm's property. With respect to the sale of one object, it is mentioned that there remains a risk; however, it is not quantified and its impact remains unknown.

With regard to the risk management system, the strategy, process and organization including the internal control and early warning system are mentioned (annual report 2010: 31). Although it is revealed that the instruments for internal risk control are also the basis for the quarterly reporting to the board and the shareholder, no further details are given. Like the former firm, this one also does not indicate where in this system the functional responsibilities are located. Again, in case of problems this could support the tendency that no one admits responsibility for specific results. Indeed, this was one of the main goals of corporate governance reforms: to prevent manipulation and fraud through more transparency.

Moreover, like the former company, this firm does not list all risks. Instead, only some risks are mentioned as examples. This concerns the inability of some tenants to pay their rent (in certain areas). However, it is not indicated how much the current debts of 1.4% of all rent contracts might increase and how this will impact the corporate development. This lack of information is especially conspicuous because private bankruptcies of tenants are even considered a concentration of risks (annual report 2010: 32). This is also the case with political limits on rent increases for social housing (annual report 2010: 32). Limits on the single source for profit - rent - is the main risk for this and all the other companies. Thus, it is listed under various categories, e.g. specific conditions of the corporate group, industry risks, and risks of individual business segments. Accordingly, chances are seen in possible rent increase in one neighbourhood (annual report 2010: 32). Yet, as with the firm mentioned above, problems caused by vacancies or low rent from housing and business are not mentioned.

In summary, although this report was not obviously embellished like that of the previous company, it also lacked clarity, comprehensibility and completeness. For example, only a selection of risks was indicated, and the information cannot be regarded as sufficient for any of them. Crucially, of 20 risk categories, eleven are not reported, and for nine only low-level information is provided. Even the information given on risks is never quantified so that the precise impact cannot be assessed. Thus, in sum, this disclosure of risks is of rather low value for the reader, i.e. the shareholder.

10.3. Company C

The annual report for 2010 consists of 69 pages (incl. empty pages). The structure is as follows:

Susceptibility to manipulation	Part of the annual report	Number of Pages	Priority for risk reporting
1	Company data of the corporate group	2	12
2	Preface of the management:	0.5	22
3	Report of the Board	1.5	7
4	Management report of the corporate group	5	6
5	Business development	8	9
6	Situation of the company and the group	13	10
7	Information on the prospective development of risks and chances Risks Chances	4 2.5 1.5	11
8	Prognosis	1	13
9	Corporate Governance Code	4	14
10	List of groups own stock	1	24
11	Group balance sheet (incl. appendix)		3

12	Balance sheet	2	1
13	Income sheet	1	2
14	General information	0.5	8
15	Basis of consolidation	4	20
16	Methods of consolidation	0.5	21
17	Accounting and valuation methods	4	16
18	Explanations for the balance and the income sheet	5	5
19	Group income sheet	1.5	4
20	Liabilities, other financial obligations, operations not included in the balance	2	15
21	Other information	3	19
22	Cash-flow	1	17
23	Assets	1	18
24	Audit certificate	1	23

The report includes several empty pages. Effectively, it consists of 60.5 pages of relevant disclosure information amounting to 88% of the entire report.

Annual report 2010, Company C

As with the analysis of the aforementioned companies, I also first analyse the 2010annual report of company C under its formal, risk, and objectivity aspects.

This report also received an unrestricted audit certificate.

With respect to positive equity, the firm has total positive company capital of € 473 million with total assets of € 2.379 million. An equity ratio of 20% is in general sufficient, even though not particularly high. As the annual surplus is positive (€ 16.7 million), the equity is not structurally endangered (annual report 2010: 19). However, this result is significantly burdened by extraordinary expenses of € 46 million. Of these, € 15 million are in fact to be qualified as non-recurring.

With regard to risks, intangible assets and activated claims against the shareholder are insignificant. These are only of limited value and thus an indication of embellished company equity.

Concerning provisions and their clear description, the relevant ones amount to € 48 million. Of these€ 38 million are classified as other provisions and include accruals for pending losses because of the abolition of follow-up supports (annual report 2010: 87). However, a detailed itemization of other possible risks is not provided, except for accruals for building maintenance in the amount of € 13 million. Because provisions for risk positions are only verbally mentioned it is impossible to determine if they are in fact sufficient. In addition, it is conspicuous that provisions seem to be rather low especially because of the omission of follow-up support, in particular in comparison with the provisions the much smaller company B set aside for this risk.

What is more striking is that accruals of a subsidiary of € 2.8 million were reclassified as equity and subsequently recognized in the amount of € 3 million.

This step improved the results. Thus, here clearly an option to improve results was exercised.

With respect to capital adjustments, outstanding bills on rents(rental income) are mentioned only verbally, but are not quantified. Thus, their impact on corporate development remains unknown.

In relation to other economic risks, the company has an average interest rate of 3.57% p.a. Liabilities against banking institutions amount to € 1.711 million p.a. Even if the credit portfolio were mostly interest secured (evidence is not given), rising interests would amount to an essential risks for the firm. The sustainable annual surplus of about € 30 million corresponds to an increase in interest of 1.75%. Crucially, it is not clear if interest sensitivity analysis (cash-flow-at-risk) was conducted.

According to the decrease in subsidies, it is mentioned that these cannot be compensated through an increase in rent revenues (annual report 2010: 28). As to this point, it is interesting that turnover decreased despite an improved market (annual report 2010: 15).

In relation to necessary investments, it is indicated that for the future these amount to € 49 million per year. This seems to be considerably higher than at present (annual report 2010: 32). However, a comparison of modernization and maintenance costs in 2010 with 2009 reveals that these were reduced by 14%. Similar to the regrouping of provisions under equity for a subsidiary, this step improves the firm's results.

Most important in relation to risks, under the column "work in progress" unbilled operating costs of € 110 million are listed (annual report 2010: 56). This seems to be significantly high, because it amounts to 30% of the revenues from property management. These allowances have to be billed within twelve months, so, because of the lapse of time and the considerable amount of claims, essential risks could develop. It is not clear if accruals were set aside for these risks.

As to guarantees and other commitments outside the balance, significant ones are indicated (annual report 2010: 61, 62). Essential risks are related to funds of € 70. 8 million, joint and several guarantees of € 28.5 million as well as several letters of responsibility. The overall volume could reach the level of an essential risk.

Regarding the description of the risk management system, this is only briefly described (annual report 2010: 31). Yet, single risks were described on page 32 and 33 (see above).

It is stated that the firm adhered to the Corporate Governance Code. For example, the board established various committees (audit committee, asset committee, building committee and personnel committee).

As to the objectivity of the report 2010, it is obviously embellished. The description of risks is to some extent contradictory. For example, the firm portrayed a positive corporate development but somehow neglected the outstanding bills for operating costs, or the fact that turnover decreased despite an improved market. Moreover, provisions are not clearly described and comprehensible and seem to be low. Most crucially, the described steps taken to improve the results support this interpretation.

Nevertheless, implausibility of financial statements, income sheet, management report and appendix is not evident. However, as these parts of the annual report are all compiled by managers this is not a clear indication of reliable risk reporting, as mangers are able to prepare all the data and match it up.

In conclusion, the annual report of company C gives a rather optimistic view of the corporate financial position. Risks are visible for which accruals were set aside, however it is not clear if these are in fact sufficient. Furthermore, there are significant risks outside the balance; however, these are not existential. Most importantly, accounting measurements were taken to improve the results. As to the latter, we have to take into account that in the core business minor reductions in revenues have occurred despite an improved rental market. This might have been one motivation to improve results.

After an analysis of the annual report according to its formal, risk and objectivity aspects, I now look more closely at how specifically risks were reported in the management and risk report by using the above table of risk categories adapted from Gulden. After the summary of my findings in the table below, I then go on to discuss the results.

Indication of risk categories in the management and risk report, Company C

Priority	**No Information**	**Priority**	**Low Information**	**Priority**	**Comprehensive Information**
2	Risk quantification	1	Existential risks		
4	Legal risks	3	Financial risks		
5	Other risks	7	Industry Risks		
6	Performance risks	12	Specific conditions of the corporate		

			group		
8	Strategic business risks	13	Description of the risk management		
9	Environment risks	18	Chances		
10	Personnel risks	20	Significant changes from previous reporting periods		
11	IT risks				
14	Formation of risk categories				
15	Concentration of risks				
16	Risks of individual business segments				
17	Interdependencies of risks				
19	Management measures for identified risks				
Sum	**13**		**7**		**0**

As with the two previous firms, the report of this company gives no comprehensive information on any risk categories; in seven from 20 categories low-level information is provided, and in most categories, thirteen, no information is given at all (see table above).

In the following section I take a closer look at the risk report, investigating the risk categories listed above against the business background of the firm.

The annual report of company C mentions several times that it values their business goal (profit-making) as equal to their public mandate (annual report 2010: 4, 12, 16). To emphasize their activities towards promoting public services, a so-called “Stadtrendite“(social profit or city return) was compiled indicating the social profit produced by this firm.

As to the disclosure of the firm’s property value, this company – like all the others– indicated the lower book value for their properties. Thus, they understated their property value, which is not in accordance with the central guidelines of corporate governance.

Regarding the risk management, it is mentioned that plan deviation analysis (strategical and operational) is continuously conducted. This is also done for personnel contracts, financial risk management as well as shareholder controlling (annual report 2010: 31). It is also indicated that data collection is decentralized, but functional responsibilities are centralized (i.e. by the management). This organization and division of tasks correspond to the theoretical model. Also, the internal revision is in charge of auditing the risk management.

The business plan is set up for a period of five years, even though this is not explicitly stated. However as to the principles of completeness and accuracy, risks in the risk report are only mentioned as examples (all other firms practiced this in the same way).

The 2010 report of this firm mentioned vacancy risks in the housing sector caused by the high unemployment rate in Berlin. However, vacancy or low rent in the business sector is not mentioned. In relation to rent revenues, the single source of profit for real estate companies, limits on rent for subsidized apartments are named as an industry risk. In this relation, limits on rent increases also reduce potential investments and thus constitute a risk under the category “specific conditions of the corporate group” (annual report 2010: 32).

Investments for the coming five years are estimated as being € 49 million per year. However, the basis on which this number was assessed remains incomprehensible. What would have helped to understand this number better would have been a comparison with the previous year, other firms or market data, but this kind of information was not provided.

Although interest rate swap transactions are mentioned, negative market values or existing risks of interest changes are not considered in the report. Furthermore, hedging tools are not described (e.g. cash-flow-at-risk-analysis).

As to significant changes from previous reporting periods, the report indicates that all expenditure loans are now recorded as liabilities. As to this point, in contrast to Company A, this firm practiced a much more cautious risk management.

In summary, this firm described its risk management system more precisely, also indicating where responsibilities are located. Yet, in relation to reporting on risks, these were neither quantified nor was it comprehensible how they were assessed. Evaluation methods were not explained. Crucially, it became obvious at least twice that the firm had embellished its results. Moreover, accruals formed seemed to be low. This is an indication that managers were not overly risk conscious.

In the following section I analyse the report of my last case study company, company D.

10.4. Company D

The 2010annual report of this firm consists of 59 pages (incl. empty pages, photos and portraits). It structure is as follows:

Susceptibility to manipulation	Part of the annual report	Number of Pages	Priority for risk reporting
1	Preface of the management:	2	5
2	Report of the Board	2.5	6
3	Business and Environment	3	7
4	Forecast	1	9
5	Supplementary report	0.2	12
6	Risk report	1.25	8
7	Financial management	0.5	11
8	Personnel	2	14
9	Stock and earnings management	10.5	10
10	Group annual report		1
11	Corporate Governance, incl. Appendix	5.65	13
12	Consolidated accounts	1	2
13	Consolidated balance sheet	2	3
14	Income sheet	1	4
15	Cash-flow	1	16
16	Equity	0,5	15
17	Key data of the	1	17

	corporate group		

Because of several empty pages and presentation of projects or interviews, the report contains only 34,1 pages of information relevant to disclosure. This amounts to 58% of the whole report.

Annual report for 2010 of company D

As with the previous companies, I first analyse the 2010 annual report of this firm according to its formal, risks and objectivity aspects, before I investigate its risk reporting in more detail.

As for all other companies of my case study, this firm also received an unrestricted audit certificate.

With respect to positive company capital, this amounted to € 451.5 million with total assets of € 1.690 million (annual report 2010: 38). In the previous year, company capital amounted to € 437 million and thus slightly increased. An equity ratio of 26.72% is sufficient and presents a positive development. Because the result of the general business operations is positive (€19.2 million), company capital is not endangered on a structural level (annual report 2010: 34), but this result is reduced by extraordinary costs of € 53 7 million. However, these resulted from the first consolidation of subsidiaries (according to the new accounting law BilMoG) and are therefore non-recurring.

It should be noted that revenue from the operative business operations from property development (rent) are decreasing, despite a positive market development. Regular returns decreased by € 1.3 million and the rest of the proceeds by € 7.7 million. The result of this business segment exceeds that of the previous year only because positive effects from the first consolidation of the subsidiaries of € 10 million were generated (annual report 2010: 36). Thus, contrary to the description in the management report, the firm's earning position is not as sustainable (annual report 2010: 33).

As to focuses on risks, intangible assets and activated claims are insignificant. If they were high would this be a hint on embellished company capital because they are only of limited value.

Regarding provisions, they are described only in very general terms, although they are rather high (€ 63 million). Compared to the previous year, liabilities decreased by € 7 million. However, reasons for this development are not given (annual report 2010: 38). In this connection it should be taken into account that the reduction in provisions improved the overall results of the firm. Thus, we might assume that this improvement in the financial position of the firm has non-recurring causes, as without these steps, the firm's earnings would have decreased. It is also conspicuous that provisions for pending losses were decreased from € 5million in 2009 to € 0.1 million in 2010. Here, we can assume that negative results from business operations exist. From the information given it is not possible to check whether the low provisions for 2010 are sufficient.

It is also important to note that a non-authorized provision of € 1.1 million was given by a manager of a special purpose company to a third party. As to this action, the detailed circumstances need to be seriously questioned. This should also include investigating if ad hoc information was given. Unfortunately, I could not address these questions to the manager because he refused to discuss internal affairs.

Regarding other economic risks, the report mentions an average interest rate of 4.74 % p.a. However, external capital of € 944 million is indicated. According to this figure, the interest rate is in fact 5.69 % (including newly consolidated special purpose companies), so the interest rate for 2009 works out at 3.65 %. These differences lead one to the assumption that the special purpose companies that are consolidated for the first time have a considerably higher interest rate. This concerns sale and lease-back arrangements that are not included in the balance, nor are their financial risks mentioned in the management report.

The report also mentions that increasing maintenance costs are expected from now until 2015 (annual report 2010: 46). Lower interest rate conditions are mentioned as a hedging tool, but it is not made clear if these are already included in the planning. Because of the relative long-term commitments of interest arrangements for debts it is doubtful whether this hedging tool will be successful

.

Regarding guarantees and commitments, these are not indicated.

The paragraph on the risk management states that an "effective" planning and control system exists that documents and assesses industry risks (annual report 2010: 44). It is further mentioned that the system concentrates on core business risks; financial risks are not mentioned.

This firm also included a statement on its compliance to the Corporate Governance Code. This paragraph is of rather general content. However, it is mentioned that one board meeting was devoted to an evaluation of the efficiency of the board. This is one recommendation of the Corporate Governance Code, but is not widely practiced. This action is a sign that the firm is interested in adhering to best practice regardless of how effective a self-evaluation is.

All in all, this annual report does embellish the situation. For example, the fact that revenues have fallen despite market rent levels rising is not mentioned. Furthermore, significant decrease provisions that considerably improve the firm's earnings are also not mentioned. These steps lead to the impression that 2010 was a successful year, and no mention is made of the fact that the increase in profit only resulted from non-recurring effects. Moreover, decreasing liquidity is also not indicated.

However, there is no implausibility between balance, income sheet, management report and appendix, In particular, the report does not clarify transactions resulting in losses or unique profits. This makes it difficult to accurately assess the prospective profit situation of the firm.

As to other non-transparencies, it was not indicated if the auditor received further fees for other contracts. This information would have been important to assess the auditor's independence.

In conclusion, company D's annual report gives too optimistic a view of the firm's earnings position. Decreasing revenue from rent – despite rising market prices – is not mentioned. It also remains unclear if the provisions for increasing maintenance costs are sufficient. Although these risks are mentioned, they are neither clarified nor quantified.

Indication of risk categories in the management and risk report, Company D

Priority	**No Information**	**Priority**	**Low Information**	**Priority**	**Comprehensive Information**
1	Existential Risks	3	Financial risks	18	Chances

2	Risk quantification	12	Specific conditions of the corporate group		
4	Legal risks	13	Description of the risk management		
5	Other risks	15	Concentration of risks		
6	Performance risks				
7	Industry Risks				
8	Strategic business risks				
9	Environment risks				
10	Personnel risks				
11	IT risks				
14	Formation of risk categories				
16	Risks of individual business segments				
17	Interdependencies of risks				
19	Management measures for identified risks				
20	Significant changes from previous reporting periods				
Sum	**15**		**4**		**1**

Although this company gives comprehensive information on one category of reporting, this is one at the lower end of the scale, namely the 18th of 20 categories. Most crucially, it refers to chances. As to this point, we have to remember that it is not permitted to mention chances in a manner that risks are offset. In this case we have the impression that this might be so, because the firm has financial problems. Moreover, of all the firms studied this firm has the highest number of risk categories for which it gives no information at all, namely 15. All in all, this already suggests that this report is of rather low information value to the shareholder.

Having assessed the information value of the various risk categories, I analyse in the following section the firm's risk reporting in relation to its business context.

As with the firms analysed earlier, both the public mandate (affordable housing) and profit-maximizing (rent increase) are mentioned as being the firm's business goals. In common with these firms, this company also gives their property value as the lower book value; thus understating it.

Regarding the risk management system, it is indicated that the risk management database is continuously updated and reported by the management information system on a monthly or quarterly basis (annual report 2010:41). Although the report mentions that decentralized or centralized assessments are made, it is not clearly indicated where responsibilities in this system are located. The internal revision is in charge of auditing this system.

Further, it is explained that increase in maintenance costs will be hedged by decreasing interest rates. Increase in rent is not mentioned as a possible hedging tool.

Concerning planning, a middle-range horizon of five years is followed (2011-2015); however, this planning period is not explicitly indicated, but has to be extracted from the text. Liquidity planning, in contrast, encompasses 15 months.

Like the reports of the previous firms, this company's risk report mentions only some risks as examples; an entire list of risks is not provided. Risks mentioned include risk caused by claims on rent. As hedging tools, claim management and deposits are mentioned (annual report 2010: 44). This is a very general statement. The effectiveness of these hedging measures has to be seriously questioned as it constitutes already widespread practice. It has also proved to be comparatively inefficient. Moreover, it is not indicated how much the percentage of these claims is, by how much it is expected to increase, and how to deal with remaining risks.

In relation to the total inventory of commercial rentals, it is remarked that in the middle range lower rent increase, termination of rent contracts, changing vacancy periods and increasing necessary investment are to be expected, yet, the concrete impact of these factors on corporate development is not mentioned. It also remains unclear how further risks are affected.

It is furthermore conspicuous that this firm disclosed more information on the general market than on company specific risks. However, it is of much more interest to the reader how specifically this firm is performing. Thus, information on the general market seems to distract from the original purpose of reporting.

In summary, this firm has the highest number of risk categories on which they did not report at all, namely 15. Moreover, even where they did provide comprehensive information on one category, this concerns chances. The purpose of reporting is specifically to clarify the prospective risk position and development; reporting on chances is less valuable, especially when we take into account that this firm is still suffering from its near insolvency in 2006.

Having analysed the risk reporting of all four companies on the basis of their annual, management and risk reports, I now compare the most important results.

10.5. Comparison of all companies

First I compare the 2010annual and risk reports of all four companies according to their quantity, i.e. page numbers (see table below). Then I proceed to look at their quality.

Scope of annual and risk report 2010

Company	Total Pages of annual report	Net Pages of annual report	Pages of Risk report
Company A	36	35	0.75
Company B	68.5	50.5	2.5
Company C	69	60.5	2.5
Company D	59	34.1	0.75

The scope of the various reports differs greatly. According to net pages, i.e. those relevant to disclosure, Company C provides the most information in quantity, followed by company B (ten pages fewer), then Company A and last Company D. Regarding the number of pages, the risk report is most extensive for company B and C (both 2.5 pages). Both Company A and Company D provided a much shorter risk report of 0.75 pages each. As length alone is not an indicator of the quality of reports, the following table indicates the degree of information value of the risk categories, because this is much more revealing than the length of the reports.

Information value according to risk categories

	No information	**Low information**	**Comprehensive information**
Company A	11	9	0
Company B	11	9	0
Company C	13	7	0
Company D	15	4	1

The companies‘ risk reporting shows the following order (from top to down):

Companies A and B lead, giving low information in nine of 20 risk categories. However, both companies’ risk reports are rather short (0.75 pages). For Company A, it is most crucial that this report is a correction of the original report and the original report did not even mention the risk that led to near insolvency. Company C reports low information in seven categories, and Company D only on four. That the latter reported comprehensively on one category is diminished by the fact that this referred to chances. Chances were reported on extensively, whereas reports on risks lacked much detail and clarity and thus the picture was blurred. Company D was also the firm that used most prose and thus distracted from the original purpose of the report.

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