Article Title: ARCHIVE | Criteria | Corporates | Industrials: Exploring the Link Between Accounting Principles and Ratings Penetration in Germany Data: Despite its position as the leading European economy, Germany boasts relatively few rated issuers. Changes are afoot, however: the introduction of the euro, tighter banking rules, and investor demands for greater transparency look set to expand the ratings population. At the same time, more companies in this market are expected to make the switch from German Commercial Code, or Handelsgesetzbuch (HGB), accounting principles to standards that are more widely recognized by the capital markets, their task being eased by legislation. With a GDP of more than €2.0 trillion ($1.8 trillion) in 2000, Germany is by far the largest economy in the EU, generating 40% more GDP than either France or the U.K., the next largest European economies. Nevertheless, ratings penetration among Germany-based companies remains low, totaling just 38 credits at Dec. 31, 2001. Of these, 27 are assigned investment-grade long-term corporate credit ratings ('BBB-' and above), eight are in the noninvestment-grade (speculative ratings) category, and there is one default (see chart). Chart 1 Until recently, only a limited number of German companies have accessed the capital markets on a regular basis, predominantly multinational blue-chip companies with investment-grade corporate credit ratings and the recognition of investors worldwide. They include Deutsche Telekom AG (A-/Negative/A-2), DaimlerChrysler AG (BBB+/Negative/A-2), Siemens AG (AA/Negative/A-1+), and Bayer AG (AA-/Watch Neg/A-1+). Two other well-known companies-- BMW AG (--/--/A-1) and Wella AG (--/--/A-2)--have also tapped the capital markets, but are assigned short-term ratings only (see table). Germany-Based Rated Issuers in 2001 COMPANY INDUSTRY SECTOR CORPORATE CREDIT RATING* ACCOUNTING STANDARD BASF AG Chemicals AA-/Stable/A-1+ U.S. GAAP Bayer AG Conglomerate AA-/Watch Neg/A-1+ IAS BMW AG Motor vehicles --/--/A-1 HGB¶ Bosch (Robert) GmbH Capital goods AA-/Stable/A-1+ HGB Brokat AG IT software D/--/-- U.S. GAAP Callahan Nordrhein-Westfalen GmbH Telecommunications B+/Stable/-- HGB Celanese AG Chemicals BBB/Stable/A-2 U.S. GAAP Coca-Cola Erfrischungsgetränke AG Beverages A-/Stable/A-2 HGB Cognis Deutschland II GmbH & Co. KG Chemicals BB/Stable/-- IAS Continental AG Automotive supplier BBB/Stable/A-2 U.S. GAAP DaimlerChrysler AG Motor vehicles BBB+/Negative/A-2 U.S. GAAP Deutsche Bahn AG Rail transportation AA/Stable/A-1+ HGB Deutsche Telekom AG Telecommunications A-/Negative/A-2 U.S. GAAP DFS Deutsche Flugsicherung GmbH Air traffic control AAA/Stable/A-1+ HGB Deutsche Lufthansa AG Airline BBB+/Stable/A-2 IAS Dyckerhoff AG Building materials BBB-/Stable/A-3 IAS E.ON AG Electric utility AA/Watch Neg/A-1+ U.S. GAAP eKabel Hessen GmbH Telecommunications B/Negative/-- U.S. GAAP Energie Baden Wuerttemberg AG Electric utility A+/Stable/-- HGB EPCOS AG Electronic components BBB+/Stable/-- U.S. GAAP Franz Haniel & Cie GmbH Holding company A-/Stable/A-2 HGB Fresenius Medical Care AG Health care BB/Positive/-- U.S. GAAP Grohe Holding GmbH Building materials BB-/Stable/-- HGB Heidelberger Zement AG Cement manufacture BBB+/Watch Neg/A-2 IAS Henkel KGaA Chemicals AA-/Negative/A-1+ IAS Kamps AG Consumer products BB+/Stable/-- HGB Kolbenschmidt Pierburg AG Motor vehicle components BBB/Stable/A-2 HGB¶ Linde AG Industrial gases A-/Stable/A-2 HGB Messer Griesheim Holding AG Industrial gases BB/Stable/-- IAS Metro AG Retail BBB+/Stable/A-2 IAS Rheinmetall AG Engineering services BBB/Stable/A-2 HGB¶ RWE AG Electric utility AA-/Negative/A-1+ IAS Siemens AG Conglomerate AA/Negative/A-1+ U.S. GAAP Sirona Dental Systems SARL Dental equipment B+/Stable/-- HGB ThyssenKrupp AG Steelmaking and capital goods BBB/Stable/A-2 U.S. GAAP Volkswagen AG Motor vehicles A+/Stable/A-1 HGB¶ Wella AG Consumer products --/--/A-2 IAS Adolf Wüerth GmbH & Co. KG Retail A/Stable/A-1 IAS *At Jan. 14, 2002. ¶Company has adopted IAS from financial year 2001 onward. IAS--International Accounting Standards. HGB--German Commercial Code (Handelsgesetzbuch). In 2001, however, this group gained a few additional members, including Robert Bosch GmbH (Bosch; AA-/Stable/A-1+) and Franz Haniel & Cie GmbH (Haniel; A-/Stable/A-2), both of which were assigned long-term ratings. At the same time, Bosch announced a €2 billion medium-term note program, while Haniel made its first appearance in the bond markets by issuing €280 million of unsecured exchangeable notes. Meanwhile, LBO transactions have also spawned new issuers willing to tap the debt markets for capital. Examples include Sirona Dental Systems SARL (B+/Stable/--), Messer Griesheim Holding AG (BB/Stable/--), and more recently, Cognis Deutschland II GmbH & Co. KG (BB/Stable/--). Small and midsize companies (SMEs) that previously might not have considered the capital markets for debt funding are now showing an increased interest.

IT software producer Brokat AG (D/--/--), for instance, issued a €125 million bond early in 2001 when its turnover was less than $50 million. The most recent example of a rated SME in this market is Austria-based technology and consulting group Plaut AG (B/Stable/--), which had sales of $270 million in financial year 2000 and is listed on the Neuer Markt, Germany's technology stock market. Both companies use the U.S. GAAP accounting standard, as these, or the International Accounting Standards (IAS), are a regulatory requirement for listing on the Neuer Markt. Germany's Accounting Standard Offers the Option of a Conservative Picture of Profits and Equity Beside the legal requirement of presenting the annual accounts, HGB accounting procedures allow companies to give stakeholders such as banks, investors, and employees a more conservative picture of a company's earnings and shareholder equity. As a result, there can be significant discrepancies between the presentation of these aspects according to HGB guidelines, compared with U.S. GAAP and IAS standards. There are two main reasons for applying the options allowed under the HGB accounting framework: creditor protection and the reduction of tax commitments in prosperous times. Creditor protection looks at smoothing income volatility over the cycle. Historically, in years with good financial results, companies tend to understate profits in order to build up reserves for more difficult periods and minimize their tax bill at the same time. In difficult financial years, or in a recession, companies can use these hidden reserves to offset profit deterioration or losses. In 1993, for example, before the formation of DaimlerChrysler AG, Daimler-Benz AG became the first German company to switch to U.S. GAAP as its accounting standard, representing a major step toward better transparency with regard to the company's financial policy. At that time, Daimler-Benz released both HGB and U.S. GAAP accounts, adopting the latter to gain its listing on the NYSE. In 1993, net income under HGB amounted to €314 million, while under U.S. GAAP the outcome was a net loss of €940 million. Volkswagen AG (A+/Stable/A-1) will now publish full-year reports under IAS. In the first nine months of 2001, the automaker's pretax earnings were €2.5 billion under HGB, but significantly higher under IAS at €3.7 billion. From financial year 2001, a further three companies have decided to join Volkswagen and the 10 other corporates that apply IAS accounting rules. Of the 38 German issuers rated by Standard & Poor's, 15 at present prepare their financial statements according to HGB, while 12 apply U.S. GAAP because of their listing on the NYSE (see table). EU Legislation Will Require IAS Standards Since the introduction of the §292a HGB Code in 1998, companies have had the option of preparing their consolidated financial statements in accordance with internationally recognised accounting standards such as IAS or U.S. GAAP. This also exempts them from the requirements of HGB in respect of their consolidated financial statement. Several factors are influencing German companies to move away from HGB accounting standards toward greater transparency in financial statements: Pressure from international investors, who are used to a high level of transparency in capital markets outside Germany. Legislative steps by the EU Commission, which wants to harmonize financial reporting across Europe and realize a single, efficient, and competitive securities market. In this way, it is hoped that the adverse stakeholder effects that arise from noncompatability of financial statements can be avoided. On Feb. 13, 2001, the EU Commission put forward a proposal (COM [2001] 80 final) that all listed EU companies in a regulated market should present their consolidated financial statements in accordance with a single set of accounting standards, namely IAS, from 2005 at the latest. This proposal ratified a similar proposition contained in a report entitled "EU Financial Reporting Strategy: The Way Forward" (COM [2000] 359), published on June 13, 2000. In December 2001, however, the mandatory switch to IAS was delayed for a further two years until 2007. The delay was mainly due to the German government's demand for a longer transition period for German companies currently reporting under U.S. GAAP standards. Nevertheless, many participants involved in this discussion believe that U.S. GAAP will be equivalent to IAS and that they, therefore, already comply with the EU requirement. The latest proposal also provides an option for EU member states to either require or allow nontraded companies to publish financial statements in accordance with the same standards as those for publicly traded companies. Consequently, each member state can command a uniform application of IAS procedures, regardless of whether companies are listed or not listed. According to the Commission, however, this proposal does not cover the vast majority of SMEs (defined in the sidebar at the end of this article), although member states may permit SMEs to use IAS accounting standards if they so wish. Historically, the majority of German SMEs have been financed directly by the banks. Therefore, the SMEs, and some smaller, less international companies, remain vulnerable to changes in both bank lending policy and the banking industry. Other companies, however, have part-funded their expansion through bond issues. These include Adolf Wüerth GmbH & Co KG (A/Stable/A-1) and Kamps AG (BB+/Stable/--), both of which have generated strong growth over the past few years. Despite the two-year delay in the introduction of IAS, Standard & Poor's expects that nonlisted companies will need more time to change their accounting standard from HGB and views it unlikely that this transition period will be finalized by 2007. To be in a position to present IAS-compliant statements in 2007, companies covered by the EU requirements will either have to start preparing consolidated financial statements according to IAS, or restate them, well before the 2007 deadline. Accounting Rules Comparison to Remain for Some Time Yet Although IAS financial statements will likely become the norm among an increasing number of companies, it is expected that specific HGB practices will remain among those firms that are not immediately affected by the EU requirements, particularly over the next three-to-five years. Irrespective of whether the IAS or HGB standards are used, the analytical rating team will need to critically examine the individual entity's financial profile to determine its credit quality against a group of international peers or competitors. These cross-border comparisons naturally require additional care, given the differences in accounting conventions and other financial systems. Key rating factors considered by Standard & Poor's in its rating analysis are absolute cash flow and debt, and the financial ratios calculated from cash flow and indebtedness, both sets of criteria being less sensitive to the different accounting interpretations. (A future article, expected in April 2002, will examine Standard & Poor's approach to analyzing cash flows in HGB-formulated accounts.) Tightening Bank Regime Heralds Boom in Ratings Population The move toward the general use of IAS accounting disciplines in Germany is inevitable, not least because market and regulatory pressures such as the Basel II agreement are forcing changes in the German banking system. Historically, there has been a low level of intermediation among German banks, including the Sparkassen (savings banks). This has led to the majority of companies being financed directly by the banks on favorable credit terms. To date, the reputation and recognition of a company, together with the banks' knowledge of its debtor and creditor structure were (and to some extent still are) the major determinants for allocating credit lines. Furthermore, the lack of sufficient transparency in a company's existing financial statements has seldom constrained the receipt of funding. The low returns generated from company loans and credits, however, are no longer acceptable for the banks (see commentary article entitled "Bank Industry Risk Analysis: Germany" published on RatingsDirect, Standard & Poor's on-line credit research service, on Dec. 4, 2001). An increasingly tight regulatory environment will also enforce risk-adjusted returns for company loans, resulting in higher interest rates for a significant number of German industrial companies. To some extent, certain sectors and market segments in Germany are already under pressure as lenders become aware of the need to reduce the credit risk of existing credits and loan portfolios. Consequently, companies will increasingly consider the need for a credit rating in order to gain access to alternative sources of funding in the capital markets. Sidebar: Small and Midsize Enterprises The qualitative characteristics used by Standard & Poor's to define small and midsize enterprises (SMEs) are: Strong links between the entity, the owner, and the owner's family. An organizational structure that features owner management, or the owner or the owner's family members, on the supervisory board. An organizational structure with historically close relationships between management and employees. Existing funding availabilities that are based predominantly on bank facilities and loans. Limited or no access to the equity or capital markets. Limited financial flexibility due to restrictions in the company's capacity to raise new equity. Most owners have only limited capital resources to support capital increases, or may be unwilling to provide support. The entity's brands and products are well-known in one or more relatively small markets or niche industries.