

Translation of the  
**Activity Report**  
for the period from 1 July to 31 December 2005

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**Our mission:**

*With the interests of the capital markets in mind, our objective is to make a contribution to truthful and transparent financial reporting by publicly traded companies. Our activities are governed by the true purpose behind financial reporting and the applicable standards relating thereto, the highest levels of professional quality, personal integrity and independence, excellence of work performed and a judicious sense of proportion.*

## 1. Functions and objectives of the Enforcement Panel

### a) *Enforcement of accounting standards*

For those who provide capital to companies and group organisations, one of the most fundamental requirements for the purpose of making decisions is the availability of properly prepared and meaningful financial reports. Therefore, participants in the capital markets expect measures to be in place through which appropriate accounting standards are enforced. With this in mind, a *two stage enforcement procedure* has been introduced in Germany through the *Bilanzkontrollgesetz* (Financial Reporting Compliance Act), dated 15 December 2004.

The Financial Reporting Enforcement Panel (FREP), an association organised under civil law, which has been approved by the *Bundesministerium der Justiz* (BMJ - Federal Ministry of Justice) in conjunction with the *Bundesministerium der Finanzen* (BMF - Federal Ministry of Finance), is active in the first stage, whereas the *Bundesanstalt für Finanzdienstleistungsaufsicht* (BaFin – German Federal Financial Supervisory Authority) becomes involved in the second stage, performing an examination and enforcing the publication of any accounting errors with the aid of state funding (§ 342b et seqq. HGB [*Handelsgesetzbuch* – German Commercial Code] and § 37n et seqq. WpHG [*Wertpapierhandelsgesetz* - German Securities Trading Act]).

The FREP examines whether

- the *latest adopted annual financial statements* and the related management report  
or

- the *latest approved consolidated financial statements* and group management report of publicly traded companies comply with the respective applicable accounting standards. *Publicly traded companies* are defined as companies whose securities (shares, bonds and the like) are authorised for trading on a German stock exchange in an official or regulated market. Financial statements with a year-end as at 31 December 2004 became subject to possible examination by the Enforcement Panel for the first time.

An examination by the Enforcement Panel is initiated

1. if specific indications exist that accounting standards have been infringed (*indication-based examination*)
2. at the request of the BaFin, if it becomes aware of any such indications,  
or
3. without the existence of any particular cause, by way of selection for examination based on random sampling techniques (*sampling examination*).

No examination is made, if a complaint of invalidity pursuant to § 256 *Aktiengesetz* (AktG – German Stock Corporation Act) is pending with respect to the circumstances or financial statements that are subject to examination or if a special examiner has been appointed in accordance with § 142 or § 258 AktG with respect to the same circumstances (= *impediments*).

In addition, the Enforcement Panel only performs an examination if the company to be examined is prepared to cooperate in the examination process. If the *willingness to cooperate* is declared, then the legal representatives of the company - and any other individuals who are named by them as sources of information – are under obligation to provide correct and complete information as well as correct and complete documentation. The other sources of information include the auditors of the financial statements if the company releases them from their duty of confidentiality when dealing with the Enforcement Panel.

If the company elects not to cooperate, or if cooperation is revoked at a later date, then no examination is performed by the Enforcement Panel, or respectively, any examination proceedings that have been commenced are terminated. The Enforcement Panel then reports such refusal to the BaFin, who may then enforce the performance of a second stage examination using state funding. In such a case, the BaFin may also elect to use the Enforcement Panel for the purposes of its examination; the Enforcement Panel then assists the BaFin in a supportive role.

*b) High standards required of the Enforcement Panel and its members*

The objective of the Enforcement Panel is to increase public confidence in the financial reports of publicly traded companies and to help ensure that applicable accounting standards are observed by companies and group organisations as well as to ensure that the quality of financial reporting is improved. Above all, the Enforcement Panel expects that its activities will have a preventive influence.

In order for the activities of the Enforcement Panel to be carried out in an independent, impartial and professionally qualified manner, high standards are required as regards the professional knowledge and experience of the Enforcement Panel members and also with respect to their independence and integrity. As the examinations carried out by the Enforcement Panel are not full-scope audits of financial statements, as defined by § 317 HGB, then analytical skills, extensive knowledge of business administration processes and practical accounting experience are particularly required. Members of the Enforcement Panel need to take autonomous responsibility on an individual case basis to assess which critical factors necessitate further investigation.

The *Presidential Board* (the President and the Vice President) and other full-time *members* are selected by the FREP's Nominating Committee and are appointed with the endorsement of the BMJ in conjunction with the BMF. It has been possible for the Enforcement Panel to obtain qualified members, who have extensive knowledge and experience in the accounting field, particularly in the area of international accounting standards. Thus, the Enforcement Panel is well equipped to competently and impartially fulfil the tasks that it has been assigned to perform.

## **2. Structure of the Enforcement Panel**

### *a) Staffing*

The *Presidential Board of the Enforcement Panel* officially commenced its activities on 1 July 2005. From this date onwards, and to some extent previously, the Presidential Board was involved in deliberations and preparations concerning the infrastructure of the Enforcement Panel. In this connection, it was able to benefit from the preparations made by the Executive Board and the Management of the *Trägerverein* (Governing Body), which had been in existence since May 2004. Preparatory activities covered not only the Enforcement Panel's personnel and technical equipment requirements but also procedural processes and other organisational measures.

The other full-time *members of the Enforcement Panel* commenced their activities for the second half of 2005, from 15 July onwards. As of 15 August 2005, the Enforcement Panel had the minimum number of five members available and was able to finalise its Code of Procedures on 16 August 2005; this was approved by the BMJ, in conjunction with the BMF, on 24 August 2005. As of 1 January 2006, the Enforcement Panel had 11 members in addition to the Presidential Board. Two further members will commence their activities in the first half of 2006, at which time the Enforcement Panel will have reached its planned complement of members.

The staff of the Enforcement Panel also includes the general manager and an office manager as well as a technical accounting specialist, an EDP specialist for the technical infrastructure, an assistant and a secretary.

The Enforcement Panel can engage external examiners if these possess the necessary personal and professional prerequisites (independence, professional expertise and discretion). In order to have access to qualified examiners, if needed at short notice, the Enforcement Panel has concluded framework agreements with nine large and medium-sized auditing firms with international experience; these framework agreements regulate the provision of qualified professionals on a fee basis. The audit firms have designated specific individuals for this "*pool of examiners*" and have provided information concerning their professional and technical qualifications. The framework agreements and the lists of examiners have been acknowledged by the Nominating Committee, which has signalled its approval. The pool of examiners covers some 180 individuals. In addition, if necessary, the Enforcement Panel would also call upon recognised technical experts for other subject matter areas.

b) *Main administrative activities during the period reported*

The *Code of Procedures* regulates the processes related to the Enforcement Panel's examination activities as well as requirements for independence and the areas of responsibility of staff members of the Enforcement Panel and other persons called upon to be involved in the examination proceedings. The Code of Procedures is published on the FREP's website ([www.frep.info](http://www.frep.info)).

By the end of August 2005, the internal rules of procedure were finalised for the various committees foreseen in the Code of Procedures. Simultaneously, measures were taken with regard to quality assurance and quality control.

The *Principles for Random Sampling* were finalised on 5 September 2005 following a process of coordination with the BaFin and approval by the BMJ and the BMF. These principles have also been published on the FREP's website.

Practical *documentation procedures* were developed to assist examination proceedings together with standardised sample document formats for recurring communications, working papers and reports on examinations.

The Presidential Board provided assistance to the Executive Board in preparing the FREP's *budget for 2006*. It has a total volume of some EUR 5 million. Of this amount, some EUR 3 million is for personnel expenses, almost EUR 1 million is for professional advisory fees and EUR 1 million is for expenditure on materials and other infrastructure-related costs.

Total expenditure of approximately EUR 3 million was planned for the period from May to December 2004 and for calendar year 2005, of which EUR 2 million was for personnel expenses and EUR 1 million was for expenditure on materials and other infrastructure-related costs. Actual expenditure for this period totalled EUR 1.1 million and EUR 0.8 million, respectively.

Regularly updated information and training material, together with regular meetings and discussions in the FREP's plenum and meetings with external accounting experts, all serve to provide *professional training for staff* of the Enforcement Panel. In addition to this, a number of events were visited and ongoing contact was maintained to various institutions that are involved in accounting.

During the fourth quarter of 2005, the President and the Vice President gave a number of *presentations with subsequent discussion forums* to provide an introduction to the Enforcement Panel and its activities and to provide answers to related questions. Participants at these events were board members of publicly traded companies and other companies as well as their auditors. We are able to state with some gratification that the participants at the events welcomed the establishment of the Enforcement Panel and expressed their expectation that the Enforcement Panel will perform its function successfully with the necessary diligence - but also with an appropriate sense of proportion - with the interest of the capital markets in mind.

*c) Advisory group*

The new type and rather complex tasks with which the Enforcement Panel is confronted prompted the Presidential Board to contact a number of outstanding personalities, who - due to their experience and reputation - were in a position to provide ongoing support and strategic advice to the Enforcement Panel with a view to fulfilling the Enforcement Panel's assignment in the best possible manner. We are extremely grateful to *Dr. Karl-Hermann Baumann, Prof. Dr. Theodor Baums* and *Dr. Manfred Gentz* that they have agreed to support us in the role of "elder statesmen".

### **3. Cooperation with other national institutions**

*a). Contact to the BMJ (Federal Ministry of Justice)*

The Code of Procedures and the Principles for Random Sampling were developed in close cooperation with the Federal Ministry of Justice (BMJ) and were swiftly finalised in agreement with the Federal Ministry of Finance (BMF). The same applies to the agreement reached on the members of the Enforcement Panel that were selected by the Nominating Committee. Furthermore, a number of legal and other issues were discussed with the BMJ.

Early experience gained by the Enforcement Panel and its activities were discussed at a meeting held on 13 December 2005 between the Presidential Board and representatives of the BMJ.

*b) Cooperation with the BaFin (German Federal Financial Supervisory Authority)*

The Presidential Board of the Enforcement Panel made its first visit to meet the President and the Vice President of the German Federal Financial Supervisory Authority (BaFin) on 22 April 2005.

At this meeting, particular discussion points were the joint tasks to be accomplished and future cooperation; it was agreed that regular meetings would take place between representatives of the BaFin and the FREP. The Presidential Board of the BaFin provided assurance that the BaFin would fully support the activities of the Enforcement Panel.

The Financial Reporting Compliance Act has resulted in the BaFin having to perform additional tasks, which will be carried out by a new department. During the period reported, some very useful contacts were established between the BaFin and the FREP. These culminated in a further meeting with the Presidential Board of the BaFin, two further meetings at a working level as well as frequent contacts in the form of telephone conferences and telephone conversations.

The Enforcement Panel communicates the examination results to the BaFin using completed questionnaires which provide documentation of the subject and purpose of the examination, the propriety of the examination proceedings and the results of the examination in such a manner that these can be validated by the BaFin.

As further documented under section 4 a) below, the BaFin also involves the FREP when maintaining its international contacts.

The relationship with the BaFin is to be regulated by a *memorandum of understanding* that is currently available in draft form.

c) *Cooperation with APAK (German Audit Oversight Commission) and the WPK (German Chamber of Public Accountants)*

Various discussions were held with the German Audit Oversight Commission (APAK) and the German Chamber of Public Accountants (WPK) on the subject of cooperation. The WPK has agreed to notify the Enforcement Panel of any accounting errors which come to its attention. The Enforcement Panel will notify the WPK if it identifies facts which indicate auditors of financial statements have not complied with their professional responsibilities. General agreement was reached that the two bodies would support one another where appropriate - e.g. in making contact to other supervisory bodies.

d) *Relationship to the DRSC (Accounting Standards Committee of Germany)*

A spirit of helpful cooperation exists with the Accounting Standards Committee of Germany (DRSC). Outside of its examination proceedings, the Enforcement Panel makes use of the special professional experience of the members and staff of the *Deutscher Standardisierungsrat* (DSR – German Standardisation Board).

#### **4. International cooperation**

a). *Foreign enforcement agencies*

The Presidential Board of the Enforcement Panel and representatives of the BaFin paid joint visits to enforcement agencies in France (AMF), the UK (FRRP/FCA), Italy (Consob) and the USA (SEC). The objective of these visits was to provide information about the two stage enforcement procedures, as well as about the FREP and its activities, and at the same time to gain more detailed insight into the manner in which enforcement functions within these foreign agencies. A further point of discussion covered possible information and coordination with regard to companies that are doubly listed - both on domestic and foreign stock exchanges.

Burdens on companies that arise from double enforcement situations should be avoided where possible. In addition to bilateral coordination, a general solution could be that the home territory of the respective company would be responsible for enforcement. The Enforcement Panel is making a recommendation for related amendment to the European Transparency Directive.

The atmosphere at the discussions was very open and cooperative. They provided a good overview of the different forms of organisation and modes of procedure of the various enforcement agencies. With the exception of the UK FRRP, all the agencies were purely government bodies, which - unlike the FREP - have access to state funding.

The activities of the Enforcement Panel - and the initial experience that has been gained from them - need not fear comparison with those carried out by foreign agencies. It is worth mentioning in this connection that the normal form of audit report on financial statements produced by audit firms in Germany (long-form report) - which is requested for all examinations conducted by the Enforcement Panel - provides a very efficient basis for the activities of the Enforcement Panel.



## *b) Cooperation at a European level*

Through its connection to the BaFin, the Enforcement Panel is also involved in cooperation with the Committee of European Securities Regulators – CESR). The Enforcement Panel participated in the *European Enforcers Coordination Sessions (EECS)* during 2005. Monthly meetings of the EECS are planned during 2006, in which the Enforcement Panel will be actively involved.

The purpose of the EECS meetings is to discuss current developments in the area of accounting and to discuss case decisions that are currently under consideration using anonymous data. One of the most important purposes of these meetings is to ensure uniform application of IAS/IFRS within Europe. A database has been set up for this purpose in to which decisions made by enforcement agencies in the participating territories can be input in an anonymous form. The plan is to make this database open to the public in the medium term.

## **5. Examination proceedings**

### *a) Organisation within the Enforcement Panel*

With the approval of the BMJ and the BMF, the Enforcement Panel has produced its own *Code of Procedures*, which particularly regulates its form of organisation and the processes involved in the examination proceedings. The Code of Procedures provides for the formation of so-called chambers and the setting up of a number of different committees.

The *chambers* are responsible for the examination proceedings which are allocated to them and, in particular, determine the final results of the examinations. They consist of the members of the Presidential Board and one further member of the Enforcement Panel. There is, therefore, the same number of chambers as there are members of the Enforcement Panel, excluding the Presidential Board. The chambers are alternately chaired by the President and the Vice President of the Enforcement Panel. Each chamber is responsible for specific examination proceedings in accordance with a scheduled allocation of duties. The fact that the Presidential Board belongs to every chamber is designed to ensure that the decisions reached are consistent across all chambers.

The activities of the various *committees* that have been established under the terms of the Code of Procedures are regulated individually by internal rules of procedure. The most important committees are mentioned below.

The *Media Analysis Committee* follows relevant reports in the business press and other media relating to publicly traded companies. Any indications of possible accounting errors are passed over to the Pre-Review Committee.

The *Pre-Review Committee* examines any indications for non-compliance with accounting standards that are received from the Media Analysis Committee or from third parties to assess whether these are substantial enough and whether there is sufficient public interest for the performance of an examination by the Enforcement Panel. If this is affirmed, then examination proceedings are instigated by the FREP.

The *Sampling Committee* develops the general principles covering sample selection processes and is concerned with sample selection, examination strategy and the planning of sampling examinations.

The *Compliance Committee* is responsible for ensuring the necessary independence of the individuals who are involved in examination proceedings. Independence and impartiality are required with respect to the company that is being examined, its representative bodies and its auditors. Reasons for exclusion have been established by reference to the grounds for exclusion of auditors of financial statements in pursuant to § 319 and § 319a of the HGB. No relationships of a professional, financial or personal nature should exist, which would give grounds for concern about prejudice. Such relationships also apply to spouses and spousal equivalents. It is not permissible for examiners to have been a member of an administrative body of the company or to have worked for its firm of auditors in the previous three years.

#### *b) Initiation of the examination proceedings*

Before an indication-based examination or a sampling examination is initiated, the Enforcement Panel notifies the BaFin of its intention to carry out an examination proceeding. If there are no known obstacles to prevent the examination, then the company concerned is notified by the FREP of its intention to perform an examination and is asked, under notification of its statutory right to refuse to give evidence, whether it is willing to cooperate in the examination by the Enforcement Panel.

The Enforcement Panel cannot perform its examination function *without the cooperation of the company to be examined*. If cooperation is refused, then the case is referred to the BaFin. In such a case, the Enforcement Panel does not initiate an examination proceeding. The BaFin has the power to enforce an examination using public funding. The BaFin may use the Enforcement Panel for the purposes of this examination.

c) *Persons involved in the examination proceedings*

The persons who are involved in the examination proceedings must be independent of the company to be examined and the auditors of that company. If grounds for exclusion of a member of the Enforcement Panel exist, then another independent member of the Enforcement Panel is brought in to perform the respective examination proceedings. The same situation applies to members of the Pre-Review Committee and to other individuals who are involved in the examination proceedings.

The chamber that is responsible for the case must designate a *Panel Member-in-Charge* who must be a member of the Enforcement Panel but who is not a member of the responsible chamber. He is in charge of the actual examination. He is responsible for the performance of the examination procedures and reports back to the chamber on the progress and results of his examination, in order that the chamber may decide in a sound and proper manner whether or not there are accounting errors in the financial reports of the company or the group concerned.

A further member of the Enforcement Panel, who does not belong to the chamber with responsibility for the examination, provides assistance to the Panel Member-in-Charge in a role as so-called *Quality Control Review Panel Member*; this person provides critical support during the performance of the examination and with respect to the findings deriving from the examination, particularly by performing a review of the examination documentation and by discussing any technical accounting aspects involved; this person comments on the results of the examination presented by the Panel Member-in-Charge and also reports back to the chamber.

Finally, it is possible for the chairperson of the chamber to appoint further members of the Enforcement Panel, or further external specialists on a fee basis (*specialist examiners*), if the Panel Member-in-Charge determines that, due to the expert knowledge necessary or the extensive time required, he is unable to perform the examination solely on his own.

d) *Indication-based examinations*

*Indications* of accounting errors may result from information provided by concerned parties, i.e.. from shareholders or creditors, but also from third parties, press reports and other sources of information. "The circumstances that justify a suspicion that an accounting error has been made must be specific and factual. Mere presumptions, speculations or hypotheses are not sufficient" (paraphrased translation of the justification contained in a government exposure draft relating to the Financial Reporting Compliance Act). The indications must be plausible and permit the conclusion that a particular accounting standard may have been infringed. A further prerequisite for an examination is that the indications derive from the latest set of adopted annual financial statements and management report or the latest approved consolidated financial statements and group management report.

An indication-based examination is not performed if it is obvious that there is no *public interest* in the examination because the possible consequences arising from the error are minor. Immaterial infringements of accounting standards are regarded as trivial if they are collectively of minor importance for the purpose of forming an opinion as to the financial situation of the entity and are immaterial in relation to the amount of sales revenue, profit or net assets of the entity and if they have no impact on factors that would influence the share price. The consequences are deemed to be of overall insignificance if the view presented of the entity's net assets, financial position and results of operations, and its future prospects, is not falsified in any manner.

The *scope of the examination* for an indication-based examination is limited to those areas for which indications of errors in accounting treatment exist. There is, however, nothing to prevent the Enforcement Panel increasing the scope of the examination if further indications of accounting errors arise.

e) *Examinations at the request of the BaFin*

The BaFin may request the Enforcement Panel to perform an examination if specific indications exist that an accounting error has been made (§ 37p (2) in conjunction with § 370 (1) sentence 1 of the WpHG). The BaFin then provides the initial impulse for a stage one examination. Again, the Enforcement Panel will only commence its activities if the entity to be examined agrees to cooperate in the examination.

f) *Sampling examinations*

Sampling examinations are initially the remit of the Enforcement Panel (§ 37 (1) sentence 1 of the WpHG). If an entity refuses to cooperate in a sampling examination, then the Enforcement Panel notifies the BaFin, which may then order an examination to be carried out and may engage the Enforcement Panel for the performance of the examination. In such a case, the Enforcement Panel assists the BaFin in a supportive role.

The principles underlying the *random sample selection process* have been defined by the FREP in consultation with the BMJ and the BMF. They conform to the "Standard 1 on Financial Information" issued by the CESR and also to the "CESR-Fin" discussion paper. The principles have been published on the FREP's website. Amongst other things, they are intended to provide assurance that every publicly trade company is examined within a defined period (full coverage).

Taking into consideration the resources available to the FREP, as defined by its budget, it is only possible to examine a proportion of the publicly traded companies in any one year. The samples are determined on a “layered” basis, according to respective stock market segments, such that DAX-, MDAX-, TecDax- or SDAX-listed companies are examined every four to five years and other publicly traded companies are examined as smaller companies within a period of eight to ten years. On the other hand, precautions have been taken to ensure that a company that has already been examined cannot assume that it won't be included in the next sample selected.

The random samples selected are also designed to give consideration to a *risk-oriented approach*, in order to include particularly critical accounting problems and business situations, even though specific indications for accounting errors do not exist. The risk-orientated selection gives consideration to factors such as an initial stock-exchange listing, critical developments within an industry or an entity, as well as to the complexity of - or significant changes in - the activities of the business or the manner in which the business is organised.

15 to 20% of the sampling examinations are chosen based on risk-based criteria. The remaining samples are chosen using a random number generator.

Again, a sampling examination does not constitute a full-scale audit pursuant to § 317 HGB. As a general rule, the examination does not include a review of the actual accounting records and the company's internal monitoring system. The enforcement examination does not cover all financial statement reporting line items; on the contrary, efforts are concentrated on selected items that are deemed to be critical to the business or which are prone to error. This particularly applies to large companies and groups of companies.

In order to counteract a gap in expectations that might otherwise arise, it must be emphasised that the examinations carried out by the FREP do not constitute full audits but are limited instead to particular areas of enquiry. This limitation of scope is consistent with the purpose of enforcement which is designed to cover all publicly traded companies within a reasonable period and is designed such that the findings of the Enforcement Panel have relatively current validity. Moreover, the resource capacities available to the Enforcement Panel only permit it to cover a narrowly limited selection of items to be examined.

The focus of the examination is on the consolidated financial statements or the group management report which are the prime source of information for participants in the capital markets. The separate financial statements of companies are only examined in special circumstances or on a sample basis. As a rule, the examination of consolidated financial statements does not include an examination of the annual financial statements of any subsidiary companies.

*g) The result of the examination*

After the examination is completed, the chamber determines the final result of the examination. If the result of the examination is that the financial reporting is erroneous, then this needs to be explained. The FREP notifies the company of the result of the examination and at the same time asks the company whether it agrees with the findings.

The Enforcement Panel then informs BaFin of the result of the examination as well as whether the company has agreed to the findings. If the company does not agree with the result of the examination, then the BaFin becomes active in the second stage of the enforcement process. The BaFin also becomes active if the company refuses to cooperate in an examination made by the FREP.

If the result of the examination by the Enforcement Panel or the BaFin is that the financial reporting is erroneous, then the BaFin directs the company to publish information both about the discovered error and the most important reasons for it having occurred. If the examination by the BaFin gives no cause for objection, then this is communicated to the respective company by the BaFin.

*h) Reporting by the Enforcement Panel and the related duty of confidentiality*

The Enforcement Panel reports to the BaFin that it intends to initiate an examination. It also reports, where applicable, that the company refuses to cooperate in the examination. Finally, it reports on the result of the examination and whether the company accepts the results of the examination in cases where an accounting error has been identified.

All members and employees of the Enforcement Panel must maintain confidentiality with respect to all company and business secrets and with respect to any knowledge about the company which they have acquired during the course of their activities in connection with the examination. The knowledge acquired also includes the examination result. .

If any facts arise in connection with the accounting carried out by a company that form the basis for a *suspicion that a crime has been committed*, then the Enforcement Panel is required to file a complaint with the relevant authority that has responsibility to pursue the matter. Any facts that arise, which lead to the conclusion that the auditors have *neglected their professional duties*, are communicated by the Enforcement Panel to the German Chamber of Public Accountants (§ 342b (8) HGB).

The duty of confidentiality also extends to the fiscal authorities (but does exclude the duty to provide information to investigating authorities relating to tax-related crimes).

The Enforcement Panel has received advice in the form of a detailed expert opinion with respect to the scope of its duty of confidentiality and to legal issues relating to the procurement and treatment of information that is relevant to the examination.

## **6. Development and status of examination proceedings**

### *a) Companies subject to examination proceedings*

All entities whose securities (shares, certificates issued in lieu of shares, bonds, profit participation certificates, option certificates and other comparable securities) are authorised for trading on a German stock exchange in an official or regulated market are subject to enforcement procedures. At the end of 2005, there were some 1,200 of such publicly trade companies.

Of these companies, some 250 are not only quoted on German stock exchanges but are also quoted on one or more foreign stock exchanges, so that they may be subject to double or multiple enforcement procedures.

### *b) Examination proceedings initiated*

The first examination proceedings were initiated directly after the Code of Procedures was finalised. Commensurate with the staff resources available within the Enforcement Panel, the bulk of the examinations were initiated in the fourth quarter of 2005. In the period reported a total of

7 indication-based examinations, and  
43 sampling examinations

were commenced. All the companies that were to be examined agreed to cooperate in the examination to be carried out by the Enforcement Panel. In the majority of cases, the auditors of the companies concerned were named as information sources.

In two cases, the information that led to the initiation of the indication-based examinations was received from third-parties; in the other five cases, the indications of accounting errors were identified by internal research performed by the Enforcement Panel, within the remit of the Media Analysis Committee.

The main sources of documentation used in the examination consist of the audit reports prepared by the auditors of the respective companies together with additional information requested, usually in written form, and other documents. In addition, any interim reports that have been published since the balance sheet reporting date are also requested. Where practicable, or if desired by the company being examined, meetings are held with representatives of the company under examination to clarify any complicated issues or similar problems.

As there is always a time delay between the request for information made by the Enforcement Panel and the replies received from the company concerned, a Panel Member-in-Charge reviews several cases concurrently. On average, a period of three weeks - including the time required for questioning of the company as to whether there are any obstacles which might hinder the examination - is required from the time at which notification goes to the BaFin that an examination is to be initiated until final receipt of the reply from

the company concerning its willingness to cooperate; this reply is usually accompanied by copies of the respective financial statements, the management report and the report by the auditors. If complex issues and difficult accounting problems are involved, the subsequent examination of the documents and the process of obtaining additional information and documentation also require a certain amount of time - as is natural in the circumstances.

In a few - albeit critical - cases, attempts were made "to play for time". However, the Enforcement panel does not possess any possibility to apply pressure to speed up the examination process. If, however, the delays had become improper, then the willingness of the respective company to cooperate in the examination would have been subject to question; in such cases, the Enforcement Panel would have had to terminate the examination and refer the case to the BaFin.

Overall, however, our experience was that companies cooperated with the examinations willingly and efficiently.

### c) *Examination findings*

Up to the end of 2005

3 indication-based examinations, and  
4 sampling examinations

were brought to an end. The findings of the examinations were communicated to the BaFin and the respective companies.

In two cases, *accounting errors* were discovered. The errors identified related to:

- incorrect accounting for business acquisitions (IAS 22 and IFRS 3) relating to acquired goodwill, so-called "bargain purchase", and changes in fixed assets
- missing note disclosures relating to business combinations (IFRS 3, 66-73)
- incorrect accounting for barter transactions (US-GAAP; EITF 93-11)
- incorrect disclosure of payments made to customers (US-GAAP; EITF 01-09)

In one case, the BaFin directed the company to make the error public in an announcement. In the second case, the BaFin is considering whether publication of the error can be waived in the company's legitimate interest.

In both cases in which the Enforcement Panel discovered an accounting error, the WPK was notified of possible neglect of professional duty on the part of the auditors. In a further case, the WPK was made aware of possibly incorrect circumstances surrounding the selection of an auditor.

In accordance with the Enforcement Panel's preventive role, abnormalities in accounting that are not subject to examination, insights obtained from the review of interim reports or impacts on subsequent financial statements are regarded by the Enforcement Panel as grounds to provide guidance on new accounting standards that are to be observed (e.g. when converting to IAS/IFRS-based reporting) or to provide guidance on the treatment of critical issues. The same situation applies, where relevant, to examinations in which infringements of accounting standards existed in the view of the Enforcement Panel, but where, due to their immateriality, such infringements did not qualify as errors that impacted the overall validity of the financial statements.



Such guidance provided by the Enforcement Panel related inter alia to:

- required improvements to comments in the management report, particularly in the area of risk reporting
- determination of the scope of consolidation
- required improvement to segment reporting disclosures
- disclosures concerning cash-generating units
- definition of costs included as production costs
- accounting treatment of government grants
- treatment of dividend entitlement rights in accordance with IAS 39
- the appropriateness of the discounting factor used for measurement of pension provisions in accordance with IAS 19
- accounting for credit notes from suppliers as other income
- recognition of deferred taxation relating to tax loss carry forwards.

## 7. Examination-related problem areas

In the first half-year of the Enforcement Panel's activity, which was influenced by its gradual establishment, it was only natural that the Enforcement Panel gained its first experience in some areas that cannot be regarded as representative. This also applies to the errors that were identified.

### a) *More difficult application and interpretation of IAS/IFRS*

*Missing justification* for significant amendments to existing standards or the introduction of new standards can result in considerable difficulties in the application and interpretation of the rules. A typical example is provided by amendments, which were made in two stages, to the accounting for and measurement of intangible assets included in the later version of IAS 38 (2004), as compared to the earlier version - IAS 38 (1998) - with respect to internal development costs that may be recognised and transitional arrangements<sup>1</sup>.

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<sup>1</sup> In a draft dated in December 2002, the text content of IAS 38.54 (1998) was considerably amended as regards costs of internal development. Due to the fact that commentary by the IASB is missing, it is debatable whether, as a result, the scope for inclusion as development costs was changed. In the appendix to the amended version of IAS 16, dated December 2003, the changed text to IAS 38.54 is shown and it is noted there that if an election for early application of IAS 16 (2003) is made, then the changed version of IAS 38 should be applied. The appendix does not contain any special transition provisions so that "IAS 38 (2003)" should have been amended retrospectively, pursuant to IAS 8, with respect to costs of internal generation. Again, the IASB provides no commentary on these provisions.

A further version of IAS 38 was adopted in March 2004, which carries over the description for development costs that was included in the previous drafts. For the transition to IAS 38 (2004), IAS 38.129 provides for prospective adjustment. In this connection, there is also no justification or commentary provided by the IASB. The collective edition "IAS/IFRS 2003" does not include the amended version of IAS 16 and the related appendix, because this new version was not approved until December 2003. In the collective edition "IAS/IFRS 2004", versions of IAS 16 (2004) and IAS 38 (2004), which have been amended yet again, appear in connection with the new IFRS 3 ("Business Combinations"). It was possible to omit the appendix to IAS 16 (2003) because of the new version of IAS 38. No accompanying commentary or direction is provided by the IASB.

The *inadequate hierarchy structure for principles* and definitions within IAS and IFRS make interpretation of the text content of the standards more difficult for the purpose of financial reporting if these are not clearly worded or if their literal application results in disclosures in the financial statements which make little economic sense. An example of this is a bias in the distinction between equity and liabilities under IAS 32, which is binding for companies which apply IAS/IFRS.

The IAS and IFRS partly allow considerable *discretionary latitude* for those who apply them. This is particularly the case as regards the approach to *fair value*, if this does not correspond to a market value or cannot be derived from such a market value. With the increasing extension of cases in which fair value measurement is applied, there is a danger that discretionary latitude will proliferate uncontrollably. The Enforcement Panel cannot replace the discretionary powers exercised by the preparers of financial statements with its own discretionary powers; the Enforcement Panel will, however identify contradictory and implausible assumptions and obviously unreasonable and arbitrary proliferations and question these, where necessary.

The Enforcement Panel presents cases involving important problems at EECS meetings (refer to section 4 b) above) to which representatives of the IASB are invited as necessary; thus, in this respect, it is possible to provide feedback to the standard setters.

*b) Involvement of the auditors*

As a consequence of the voluntary nature of the cooperation by the companies that are subject to examination, there is no provision in the first stage of the enforcement process for the automatic involvement of the auditors in the examination proceedings. As indicated above, however, the auditors may be named as a general source of information by the companies. This does happen in many cases and in most cases it is very advantageous as a means to quickly clarify the pertinent facts and circumstances. Such involvement appears also to be appropriate as there is no reason why information sources in the first examination stage should be restricted if they are available during the second examination stage.

In certain circumstances, it may be helpful to have access to the auditor's working papers in order to gain an understanding of the facts involved in the case and the related accounting treatment. If such access is denied, then this has to be viewed as lack of cooperation. Even though the company itself is not responsible for the refusal of access, the Enforcement Panel would have to terminate its examination if such refusal hampers its ability to identify possibly existent errors.

*c) Examinations during the "financial reporting busy season"*

The first quarter of the calendar year constitutes the main accounting season for annual reporting purposes. A presumption can be made that many companies would like to postpone or delay an examination by the Enforcement Panel due to the work that is being carried out at this time on the preparation of the financial statements. It is possible that the question might be asked whether there is any point in examining the old financial statements in circumstances where the new financial statements will be available in a few weeks.

Nevertheless, the Enforcement Panel will continue to have to insist on the expeditious performance of its examinations also during this period, as it cannot temporarily cease working whilst trying to perform its duties. It is also not possible to switch its activities to

those few companies that have a financial year that does not correspond to the calendar year. If the accounting function is properly organised and its records are properly documented, then it should prove possible to reply to the requests made by the Enforcement Panel without any excessive effort in terms of time.

## **8. Outlook and closing comments**

In January 2006, we completed a further 9 examinations and initiated 15 new examinations. At present, we are working under the assumption that we can complete some 30 to 40 examinations for each quarter of the calendar year. This presupposes that it is not necessary to set other priorities due to more time-consuming indication-based examinations.

The European Transparency Directive includes provisions that half-yearly and quarterly financial statements should also be the subject of enforcement procedures. It certainly makes sense to couple such enforcement with that surrounding the annual financial statements, so that it is likely that the Enforcement Panel will need to take on new responsibilities when the directive is transposed into German law. In due course, it will be necessary to examine how such extended enforcement requirements are dealt with and what additional resources are required in order to accomplish the new tasks.

We should like to take the opportunity to thank all those who made themselves available for discussions, as representatives of the above-named institutions and bodies, for their helpful support and cooperation. They have made us confident that we shall be able to fulfil the mandate that was mentioned at the outset of this document both reliably and well.

Berlin, 6 February 2006

The President of the Enforcement Panel

(Prof. Dr. Eberhard Scheffler)