Dr. Herbert Meyer

Annual Activity Report 2008

Berlin, 28 January 2009

1. Overview

- The FREP achieved its goals by completing 138 examinations in 2008 (previous year: 135).
- The number of accounting errors remained high, at 37 cases (error ratio: 27%; previous year: 26%)
- The error ratio at small and medium-sized companies was above-average
- Primary reason for the high error ratio: the scope and highly complex nature of IFRSs.

In 2008 the FREP completed 138 examinations (previous year: 135), of which 118 were sampling examinations and 19 were indication-based examinations, the latter including 8 examinations of half-yearly financial reports. Since its establishment in mid-2005, this means that the FREP has completed 389 examinations, covering almost 40% of all publicly traded companies that fall within its remit. This has given the FREP extensive data to enable it to assess the application and quality of IFRS accounting in Germany.

The ratio of cases involving accounting errors remains persistently high at 27% (previous year: 26%) and continues to be concentrated in small and medium-sized companies.

The primary reason for the high error ratio is the extremely complex nature of many IFRSs. Correspondingly, one starting point for reducing the error ratio must be the simplification of IFRSs. We have forwarded the relevant results and insights from our examinations to the standard-setters.

2. Examinations in 2008

2.1 Completed examinations

In 2008, the FREP completed a total of 138 examinations (previous year: 135; see Figure 1), of which 118 were sampling examinations (previous year: 118). We are thus more or less within our target corridor of approximately 120 – 140 sampling examinations per year. We must conduct this number of examinations if we want to ensure that all companies listed in an index are examined every 4 to 5 years, and all other publicly traded companies are examined every 8 to 10 years. This examination cycle corresponds to the current code of procedures agreed with the German Federal Ministries of Justice and Finance.

In addition to the 118 sampling examinations, we conducted 19 indication-based examinations, of which 8 cases related to half-yearly financial reports. One examination was also completed at the request of the *Bundesanstalt für Finanzdienstleistungsaufsicht* (BaFin – German Federal Financial Supervisory Authority).

We referred four cases (all involving companies domiciled outside Germany) to the BaFin in which the companies concerned were unwilling to cooperate voluntarily. The BaFin then initiated the corresponding examinations.

Overall, the financial crisis that has affected the global markets since mid-2007 has also been influenced the FREP's work. Our Media Committee put more focus on analysing the annual and half-yearly financial statements of financial institutions in 2008. As a result of this analysis, we then initiated an indication-based examination in individual instances. Additionally, we specified relevant examination issues in the focus areas for our examinations in 2008 (financial statements for the period ended 31 December 2007). These included measurement of financial instruments, consolidation of special purpose entities, asset impairment testing, management reporting and risk reporting.

We will also concentrate on the effects of the financial crisis to an even greater extent in 2009. In this light, we have again included the relevant issues in the focus areas for our examinations in 2009 (financial statements for the period ended 31 December

2008) (see chapter 3.2). We report on the results of our examinations of financial institutions in 2008 in the following chapter.

2.2 Examinations involving accounting errors

At the end of an examination, the FREP must determine whether the financial statements of the company it has examined comply with the applicable accounting standards, or whether they contain errors. Accounting errors are defined as material infringements of financial reporting requirements or immaterial – but intentional – departures from these requirements..

Compared with the previous year, the number of cases involving accounting errors increased by two to 37 (= 27%). This means that the error ratio has grown again over the previous years (2007: 26%; 2006: 17%, see Figure 1) and remains at a high level. This situation urgently demands countermeasures, which we describe in chapter 3. Before doing so, however, we must analyse and differentiate between the types of errors that have occurred so that we can identify steps for improvement.

First, we note that the error ratio for indication-based examinations (84%, see Figure 2) is significantly higher, which is logical in light of the nature of indication-based examinations. Of the 19 cases completed, a total of eight indication-based examinations related to half-yearly financial reports; the error ratio for these examinations was similar to the other indication-based examinations. For sampling examinations, the error ratio is 18% – which is still high, considering that it means that one in five financial statements of publicly traded companies in Germany contain errors. This result must be broken down into a greater level of detail.

Significant differences emerge when the companies are classified by size (see Figure 3). 73% of all identified accounting errors occur at small and medium-sized companies with annual revenues of up to EUR 250 million – a figure that is significantly above the average.

The financial statements of large companies tend to be of better quality than those of small and medium-sized companies.This is also illustrated by the further classification of error ratios by the corresponding stock market index (see Figure 4): The six examinations completed at DAX companies did not identify any accounting errors (since mid-2005, we have identified only one DAX company with financial statements containing errors). The 18 to 20%. error ratio for companies in the other indices (MDAX, SDAX and TecDAX) is also below the average error ratio of 27%. Examinations at companies that do not belong to any specific index resulted in a higher error ratio (32%). Companies domiciled outside Germany also have an above-average error ratio of 32%.

If we identify an error in a company's financial statements, we ask the company if it accepts our findings. This official inquiry is normally preceded by very intensive discussions with the company. It is important for us to give the company and its auditors an opportunity to present their views and arguments and to enter into open discussions with them. Compared with the previous year, the ratio of companies that accepted the errors we identified increased further to 82% (see Figure 5). We believe that this is significant evidence of the quality of our work.

We refer all cases where we have identified errors to the BaFin. The BaFin completed 33 stage-2 cases in 2008, including proceedings from previous years; it concurred with the identification of errors in 32 cases (= 97%) (see Figure 6). 30 of these 33 cases were published (= 91%).

We examined 12 financial institutions in 2008. We identified accounting errors in five cases, which is above the average.

2.3 Types of error and analysis of errors

The 37 cases involving accounting errors contained an average of 4 individual errors per company. To enable suitable measures to be developed to reduce the number of errors, these errors must be analysed by type, frequency and cause. To do this, we have defined certain categories of errors (clusters) to which frequently occurring individual errors are assigned.

Figure 7 shows the eight error categories with the most frequently occurring individual errors. These errors relate to accounting for acquisitions and disposals, the various narrative reporting obligations (including management, risk and segment reporting), the recognition of deferred taxes, general notes disclosures, cash flow statements, the cost of equity transactions, consolidation and the measurement of investment property. We address these issues as follows:

Acquisitions and disposals (see Figure 7): At 24 cases, this represents the most common category of error. Errors occurred primarily in connection with purchase price allocation, the measurement of goodwill (including subsequent measurement) and accounting for discontinued operations. A more detailed analysis shows that of the 24 errors, eight alone (= 33%) arose in the course of purchase price allocation. The applicable standard (IFRS 3) has now reached such a level of complexity that users are often overwhelmed.

This high number of errors occurs in purchase price allocation despite the fact that external support was often obtained; the main source of error relates to the allocation of the purchase price to intangible assets that were mostly not recognised previously at the acquiree.

The standard requires purchase price components to be allocated to intangible assets such as trademarks, customer lists, etc., which in turn requires these intangibles to be measured individually. In practice, this cannot be done objectively and reliably in the vast majority of cases because the P&L contributions of each of these assets are not only inextricably linked with each other, but are also intertwined with the effects of many other performance factors such as the quality of the workforce and product quality, which are almost impossible to separate out in practice. The frequency of errors demonstrates the weakness of the standard in this area.

Narrative reporting (see Figure 7): We identified infringements of the provisions governing management and risk reporting in six out of a total of 15 cases. For example, one financial institution did not report risks arising from the assumption of liabilities for, and liquidity commitments to, unconsolidated special purpose entities.

Deferred taxes: The most common error here relates to the recognition of deferred taxes on loss carryforwards (5 cases out of a total of 12). In these cases, the reporting entity was unable to provide convincing evidence as required by the standard that sufficient taxable profit will be available in the future despite a history of losses.

Other weaknesses in IFRSs identified in the course of the FREP's examinations:

Investment property: The relevant standard (IAS 40) allows investment property to be measured at cost or fair value subsequent to initial recognition. Fair value measurement of property is extremely complex in practice and can lead to abuses. In the course of our examinations, we identified cases in which fair values recognized shortly after initial recognition were significantly higher than the purchase price, although they did not in any way appear to be justified by market conditions. However, this is very difficult to prove in practice, which is why we only rarely determine that an accounting error has been made.

Capitalisation of development costs: in this area, too, our examinations show that the highly complex nature of this standard (IAS 38):

- results in very high cost and significant uncertainty for preparers;
- produces an extremely wide variation in results within the same industry despite comparable conditions (e.g. automotive industry, software industry);
- does not allow any clear guidelines to be established for enforcement examinations (see Figure 8 for the reasons for this); and
- does not result overall in improved transparency.

The search for the main causes of the identified accounting errors is derived directly from the preceding analysis (see Figure 9). The key cause is the enormous scope and the highly complex nature of IFRSs, which overwhelm small and medium-sized companies in particular.

We have the impression that a small number of companies were trying to bypass the accounting standards in order to produce the results they wanted in their financial statements. We identified these few 'black sheep' and published the relevant errors in a timely manner.

These conclusions from the errors identified in 2008 are also confirmed by an analysis of the entire period since the establishment of the FREP (i.e. since 1 July 2005). We have completed 389 examinations in this period, meaning that we have already examined close to 40% of all publicly traded companies that fall within our remit. As far as the error categories are concerned, errors in the area of 'acquisitions and disposals' take the lead, with a total of 47 individual errors, followed by errors in the area of 'narrative reporting disclosures', with 41 individual errors in total.

To sum up, we can say that the enforcement examinations have helped build up a unique wealth of experience about the application and quality of financial reporting under IFRSs in Germany. The key findings from this are as follows:

- the primary reason for the high error ratio is the scope and highly complex nature of IFRSs.
- a number of these complex standards do not enhance transparency for capital market participants (the most important users of IFRSs).
- in many cases, these standards can only be implemented at significant cost and effort, and they overwhelm small and medium-sized companies and their auditors in particular.

3. Measures to avoid errors

3.1 Providing feedback on results of examinations to standard-setters

The preceding analysis shows that the most important measure that could be taken to reduce the high error ratios identified in enforcement examinations would be to simplify IFRSs. As a first step, we have forwarded the detailed results and insights from our examinations in our role as an enforcement body to the standard-setters in Germany, in particular the German Accounting Standards Board. The task for the standard-setters is now to incorporate these insights into the standards development process, together with the relevant international bodies up to and including the International Accounting Standards Board (IASB).

We have identified relatively clear ways in which IFRSs could be simplified, based on the results of our examinations:

- by simplifying purchase price allocation for business combinations through eliminating purchase price allocation to intangible assets;
- by discontinuing the capitalisation of development costs – at least in the form contained in today's standards;

- by removing the option to account for investment property at fair value subsequent to initial recognition.

3.2 Preventive measures

The preventive effect of our activities is particularly important to us – and the impact is now being confirmed to us in a variety of ways. Accounting issues are being discussed much more intensively by supervisory boards and in particular by audit committees, as well as by corporate governing bodies and auditors, and they are doing so frequently with reference to the newly introduced enforcement procedure in Germany. This in turn helps auditors ensure compliance with and implementation of the increasingly complex accounting standards in practice.

The FREP's own examinations have also emerged as a successful preventive instrument. During the examination period, which normally lasts between two and seven months, we give the companies we examine – if appropriate –additional guidance about discrepancies in their financial statements that may also be significant in the financial statements in the future. Overall, we can already say that the quality of financial reporting has tended to improve at the majority of companies we have examined.

Guidance in 2008

To further its preventive activities, the FREP gives the companies examined guidance on new pronouncements to be complied with, or the accounting treatment of critical issues, if it sees a need to do so in individual cases. This includes guidance on immaterial errors that could be material for future financial reporting. This procedure is designed to prevent errors in financial reporting in the future.

Figure 10 shows the most important categories of guidance given by the FREP in 2008 and their frequency. The breakdown into the various categories is similar to that for the types of error identified, which is not itself unsurprising.

Focus areas for examinations in 2009

Before the beginning of a new calendar year, we establish the focus areas of our examinations for the new year that will be addressed as a matter of principle in each sampling examination, to the extent that they are relevant in each individual case. As in the previous year, these focus areas are significantly influenced by the financial crisis that arose in mid-2007 (see Figure 11). This applies to the focus areas : consolidation of special purpose entities, measurement of financial instruments and impairment testing of assets.

This focus area leads directly to the second group of examination issues that have been selected in light of the effects of the expected significant deterioration in economic prospects: provisions for restructurings and risk reporting.

3.3 Public relations work

We pass on the experience and knowledge that the FREP has gained from enforcement examinations to audiences by giving a large number of presentations at relevant business and accounting events and congresses. For example, the Presidential Board of the FREP gave around 30 such presentations in 2008.

We placed special emphasis last year on providing the most important users of IFRSs – the shareholders, investors and analysts who are active on the capital markets – with specific information on the results of our work, for instance at investor conferences as well as events organised by the DVFA, the Society of Investment Professionals in Germany.

4. International cooperation

All enforcement bodies are currently structured on a national basis. However, global capital markets and global companies demand globally structured and coordinated enforcement bodies. We still have a long way to go here, including at a European level.

The Committee of European Securities Regulators (CESR) organises the 'European Enforcers Coordination Sessions' (EECS), to which the FREP also belongs. The EECS is primarily designed to discuss IFRS application cases that are of cross-border interest and thus tend to result in the convergence of IFRS application and interpretation issues.

There is hardly any discussion in this body about harmonising or standardising enforcement processes and structures. So that we can move forward in small steps, we started initiating bilateral talks with individual enforcers together with the BaFin, for example with the enforcement organisations in the United Kingdom, Switzerland, Spain and the USA (SEC). These talks have significantly improved the common understanding of how we implement enforcement in the individual countries, as well as revealing concrete opportunities for how we can better work together.

5. Costs of enforcement

The costs of the two-stage enforcement procedure were budgeted at approximately EUR 7.8 million for 2008, of which EUR 6.3 million was earmarked for the FREP. The FREP only used EUR 4.5 million of this amount (i.e. around 30% less), which we also attribute to our overall cost-effective budget management.

The total budget for 2008 of approximately EUR 7.8 million was raised by a charge levied on the around 1,000 publicly traded companies. The charge amounts to an average of approximately EUR 8,000 per year per company; each individual company's contribution is generally based on the exchange volume of its securities. The unused funds will be reimbursed accordingly to the companies in 2009.

6. Outlook

Pre-clearance, i.e. the opportunity for companies to make preliminary inquiries to the FREP on complex issues before preparing their financial statements, would be another key preventive measure in our work. This is not currently provided for in the FREP's remit. We are working on the development of a simplified procedure together with the relevant bodies.

The FREP will be four years old on 1 July 2009 and the limited-term contracts of several of our examiners will expire then. This will lead to considerable fluctuation in our team, which we will have to manage in 2009 without affecting the quality of our work. The new staff needed to maintain a total of 16 panel members is already being recruited.

In 2008, our work continued to be successful because again we could count on effective support from many parties. We would like to take this opportunity to extend our special thanks to the examined companies; the FREP's members and its Executive Board and Nominating Committee, as well as our advisers; the responsible bodies at the German Federal Ministries of Justice and Finance, and in particular the BaFin; the audit firms, the *Institut der Wirtschaftsprüfer* (IDW – the Institute of Public Auditors in Germany) and the *Wirtschaftsprüferkammer* (WPK – German Chamber of Public Accountants). Our particular thanks go to the FREP's panel members and the staff at our office for their consistently dedicated and exceptionally professional work.

Berlin, 28 January 2009

FREP President
Dr. Herbert Meyer

DPR FREP

DEUTSCHE PRÜFSTELLE FÜR RECHNUNGSLEGUNG
FINANCIAL REPORTING ENFORCEMENT PANEL

Appendices to the Annual Activity Report 2008

28 January 2009

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Figure 1: Completed FREP examinations, error ratio trend (%)

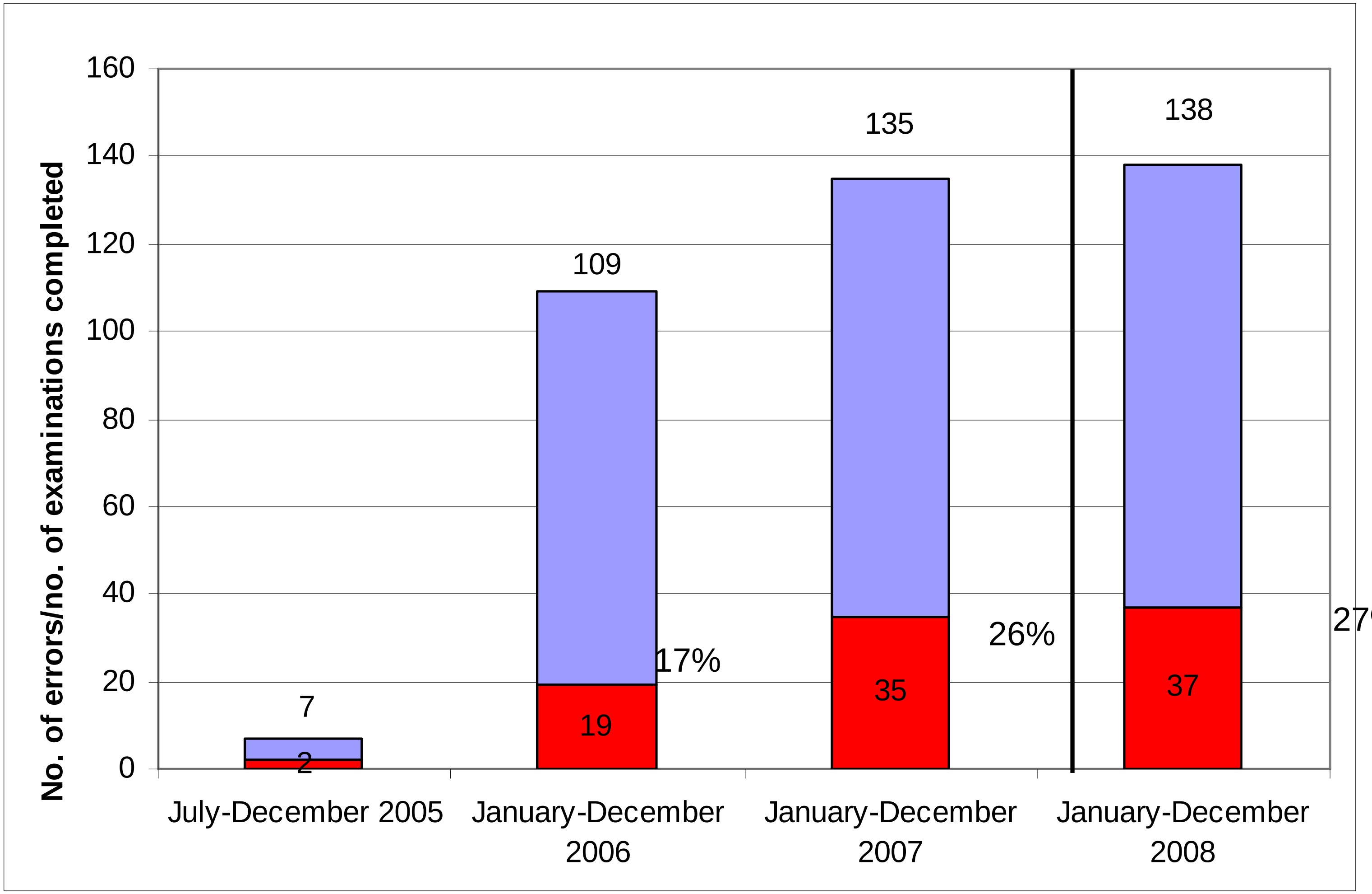

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Figure 2: Completed FREP examinations by examination type and error ratio (%) (2008)

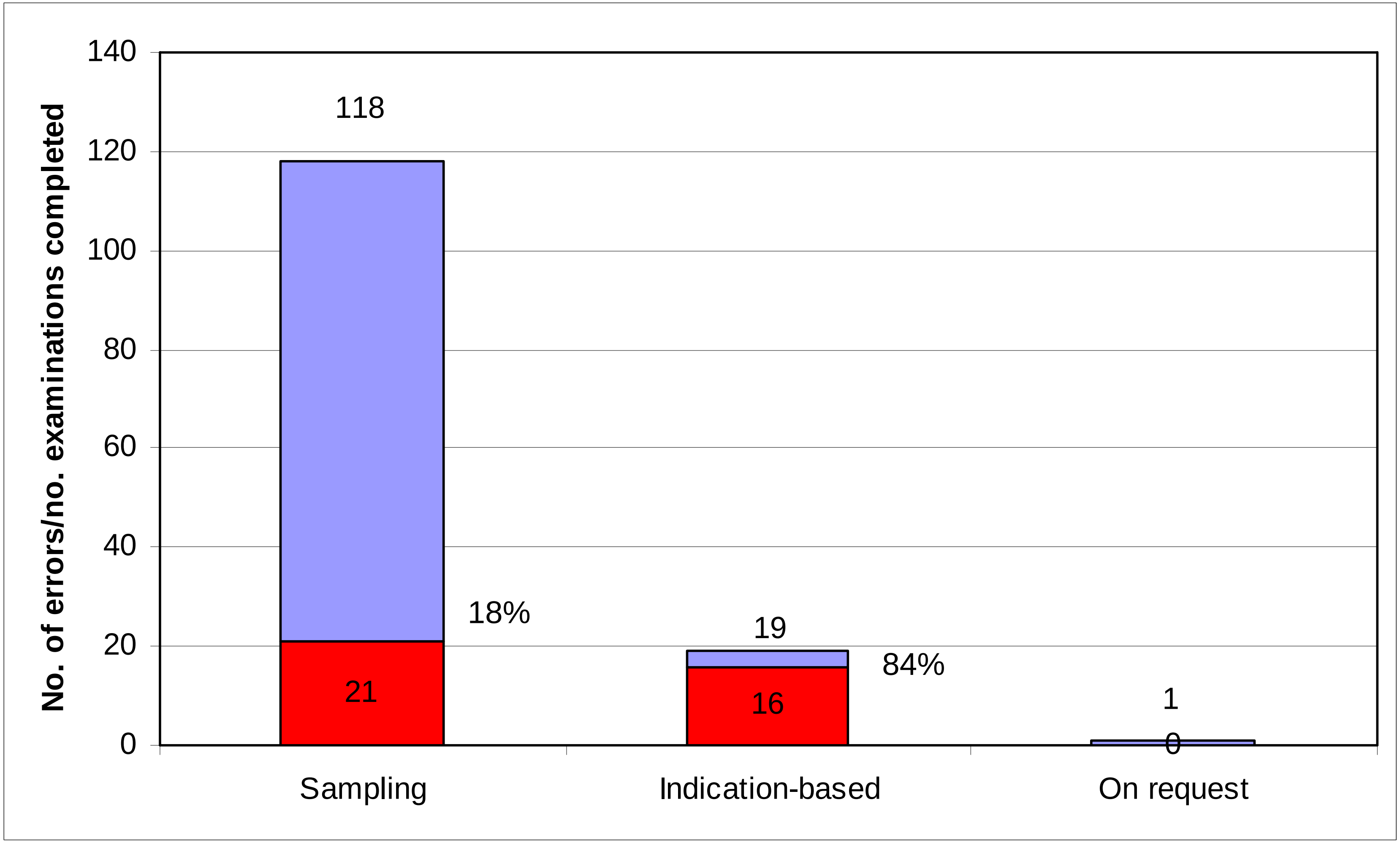


Figure 3: Breakdown of identified errors by revenue of the companies (2008)

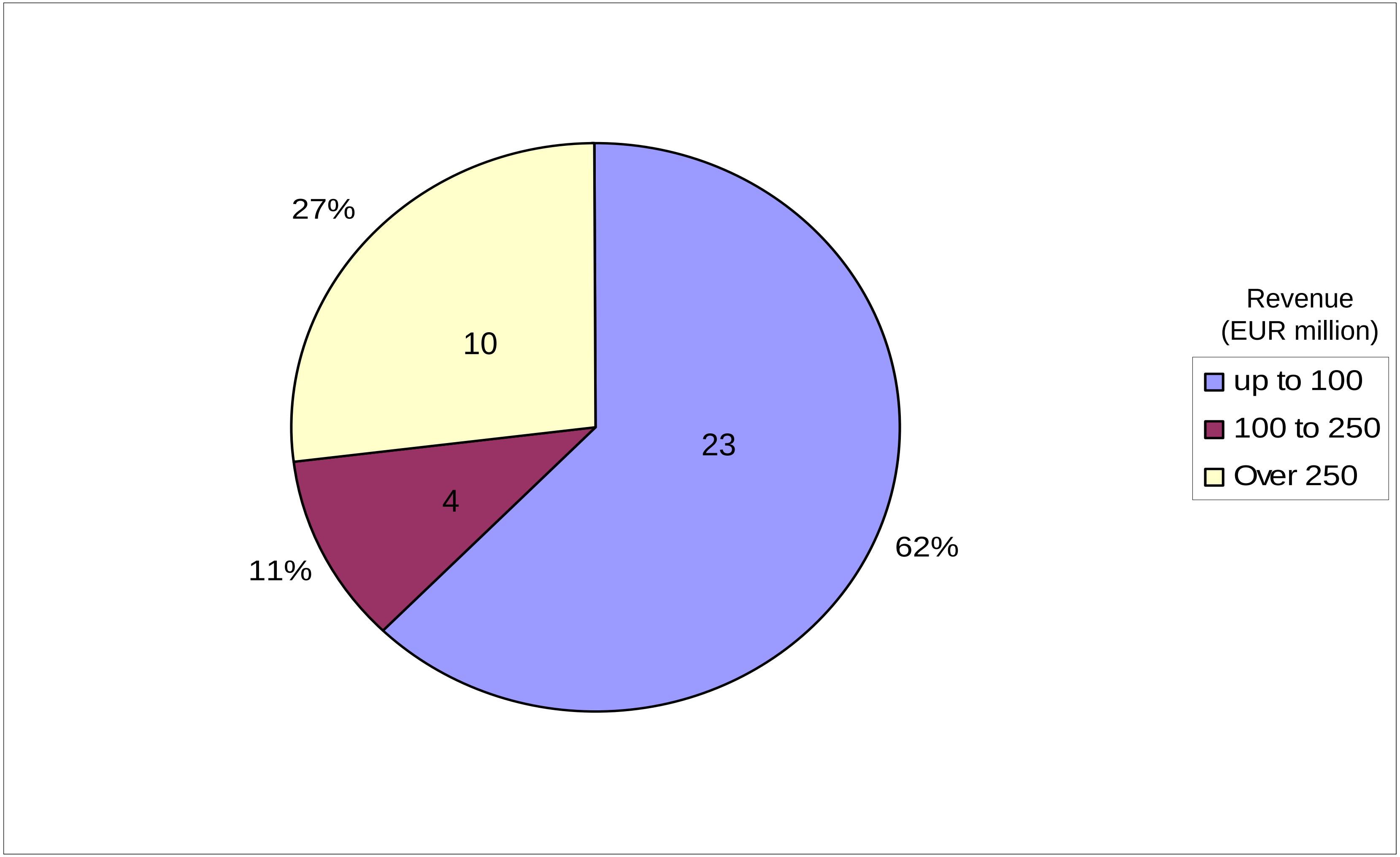


Figure 4: Completed FREP examinations by indices, error ratio (%) (2008)

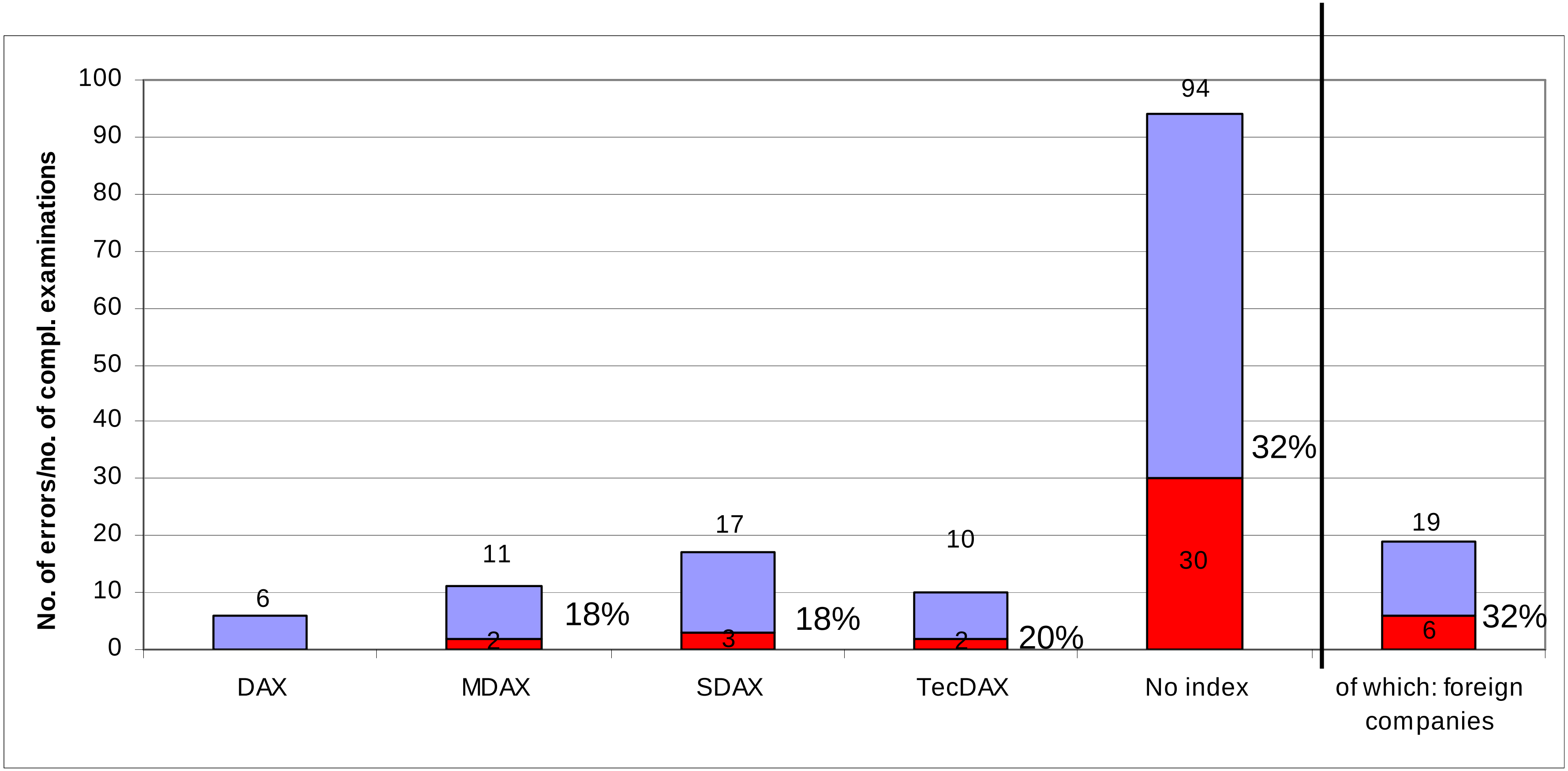


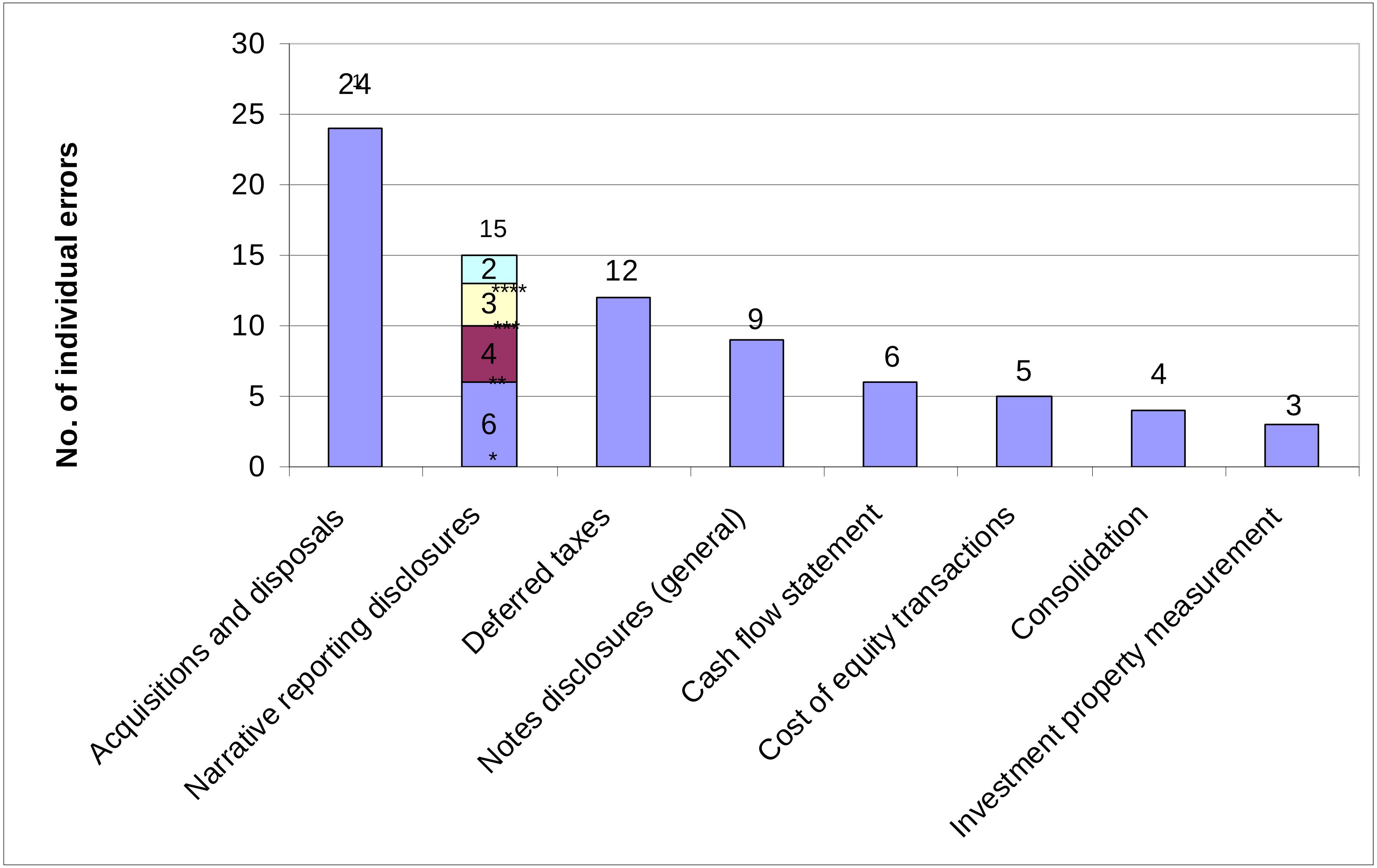
Figure 5: Change in acceptance ratio for errors identified by the FREP

	2006	2007	2008
Acceptance ratio of companies as % of errors identified by the FREP	52	80	82

Figure 6: Results of stage 2 (BaFin) in 2008

- Completed procedures at the BaFin: 33
  - of which: same assessment as the FREP 32 (= 97%)
  - of which: published 30 (= 91%)

Figure 7: Most common types of errors (2008)



[1] PPA, goodwill, information, discontinued operations, impairment tests

**** Segment reporting
*** Related party disclosures
** Disclosures on governing body remuneration
* Management and risk reporting

Figure 8: Capitalisation of development costs

- Management's judgement in recognition of development costs
  - The evidence of future economic benefits and technical feasibility is normally based on an estimate by management that cannot be objectively verified
- Uncertainty about the timing of capitalisation of development costs, despite the specific criteria in IAS 38.57
- No binding guidance for different industries on how to capitalise development costs
- Uncertainty about the definition of development costs that are eligible for capitalisation
- Uncertainty about the scope of production costs
- Consequence: the objectives of IFRS accounting, such as transparency and comparability, are not achieved

Figure 9: Main causes of errors

- Scope and complex nature of IFRSs
- Small and medium-sized companies and their auditors are often overwhelmed
- A small number of 'black sheep'

Figure 10: Most common guidance given to examined companies (2008)

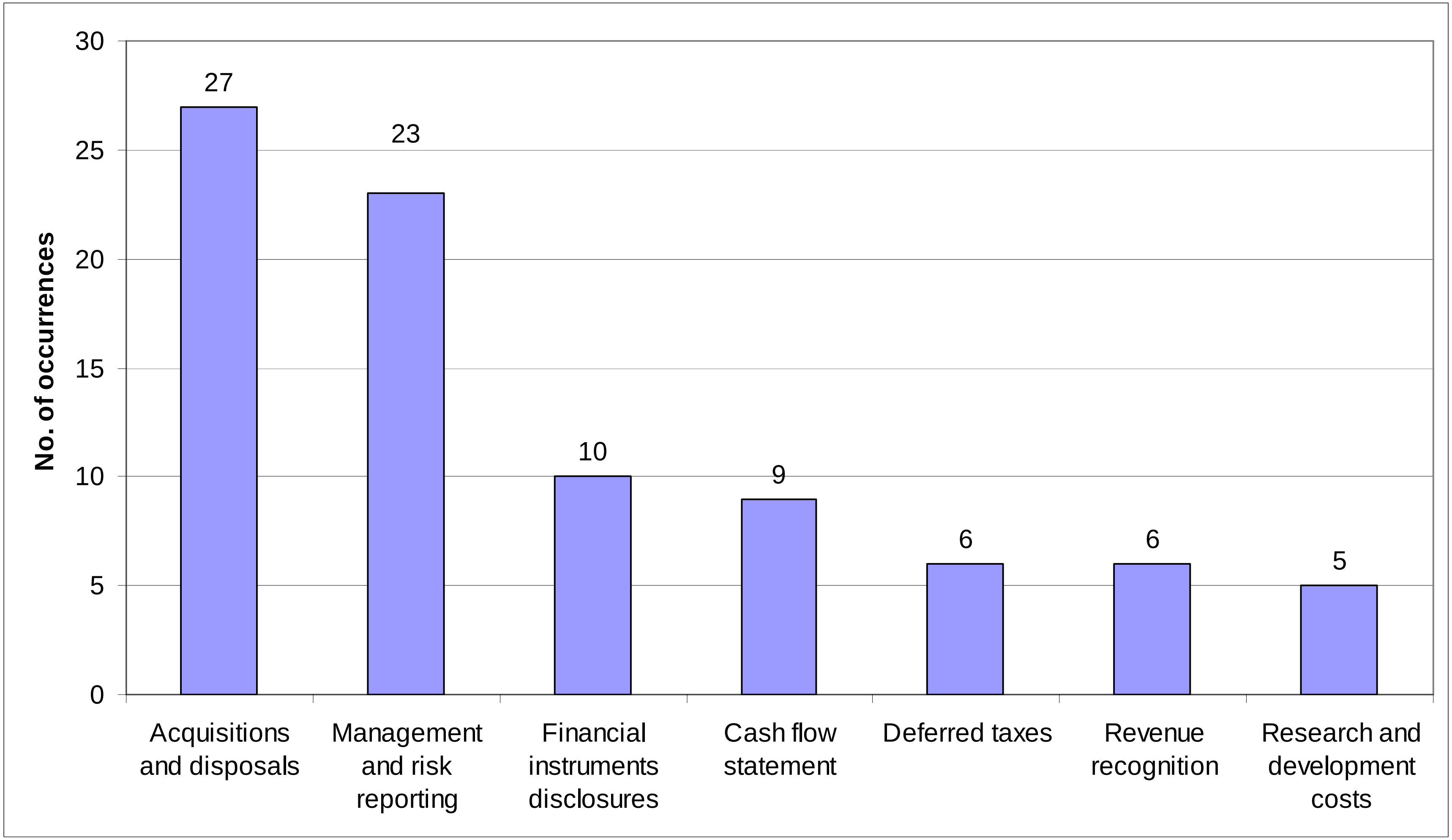


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Figure 11: Focus areas for examinations in 2009

- Impairment testing of assets (IAS 36) in the light of the weak economic climate (including supportable documentation, notes disclosures)
- Measurement of financial instruments (IAS 39), presentation of valuation techniques, disclosures on sources of estimation uncertainty (IAS 1) and notes disclosures (IFRS 7)
- Business combinations (IFRS 3), especially purchase price allocation and notes disclosures
- Consolidation of special purpose entities (IAS 27; SIC 12)
- Restructuring provisions (IAS 19 and 37)
- Segment reporting under IFRS 8 – if already applied – including documentation of the key factors used to identify the reportable segments
- Risk reporting in the management report

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