

**Annual Activity Report 2015**

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## 1 Overview

- In 2015, the error rate has stabilized at a low level similar to the last three years.
- The FREP completed 81 examinations (prior year: 104), including 71 sampling examinations, six indication-based examinations, and four examinations performed at the request of the *Bundesanstalt für Finanzdienstleistungsaufsicht* (BaFin – Federal Financial Supervisory Authority) in 2015. At 15%, the rate of financial reporting errors found was slightly higher than the prior year rate of 13%.
- Once again, a normalized error rate was determined to facilitate a more refined presentation. This normalized rate reflects adjustments for duplicate errors as well as for examinations confirming known errors and amounted to 10% in 2015, less than the prior year rate of 12%.
- The follow-up on 2014 shows that nearly all errors identified were corrected in the subsequent financial statements. The vast majority of FREP recommendations were implemented the following year, as well.
- As in prior years, attending the meetings of the EECS was a key component of the international cooperation with ESMA in 2015. The April 2015 EECS meeting was hosted by the FREP in Berlin.
- The FREP celebrated its tenth anniversary with a ceremony attended by approximately 180 representatives from politics, business, science and government at Konzerthaus at Gendarmenmarkt in Berlin on 3 July 2015.
- The FREP's expenses of EUR 4.91 million were lower than in the prior year (EUR 5.33 million).

## 2 Examinations in 2015

### 2.1 Examination results

In 2015, the FREP completed a total of 81 examinations (prior year: 104). 12 out of 81 examinations identified errors. This corresponds to an error rate of 15%, slightly above the prior year rate of 13% (Fig. 1).

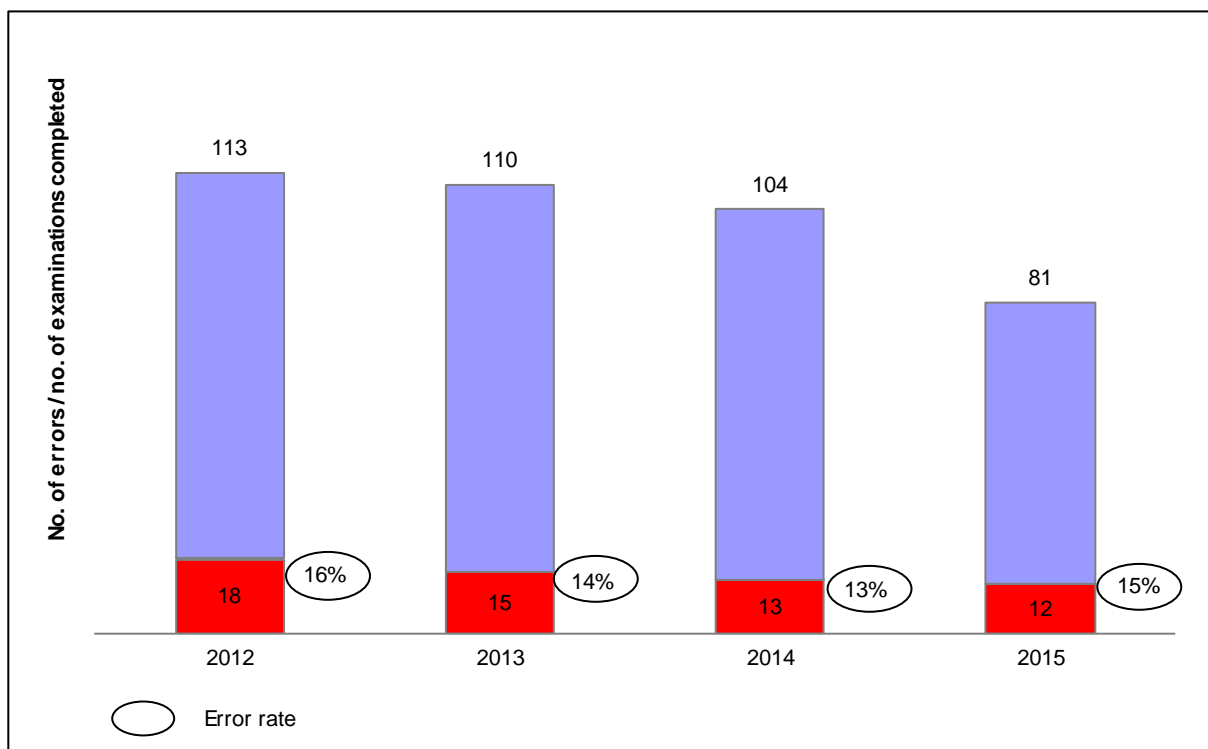


Figure 1: Completed FREP examinations, error rate trend

As in the past, a normalized error rate was determined in order to facilitate a more refined presentation and analysis, reflecting adjustments for duplicate errors and for examinations confirming known errors. The normalized error rate declined to 10% (prior year: 12%) in 2015 (see Fig. 2).

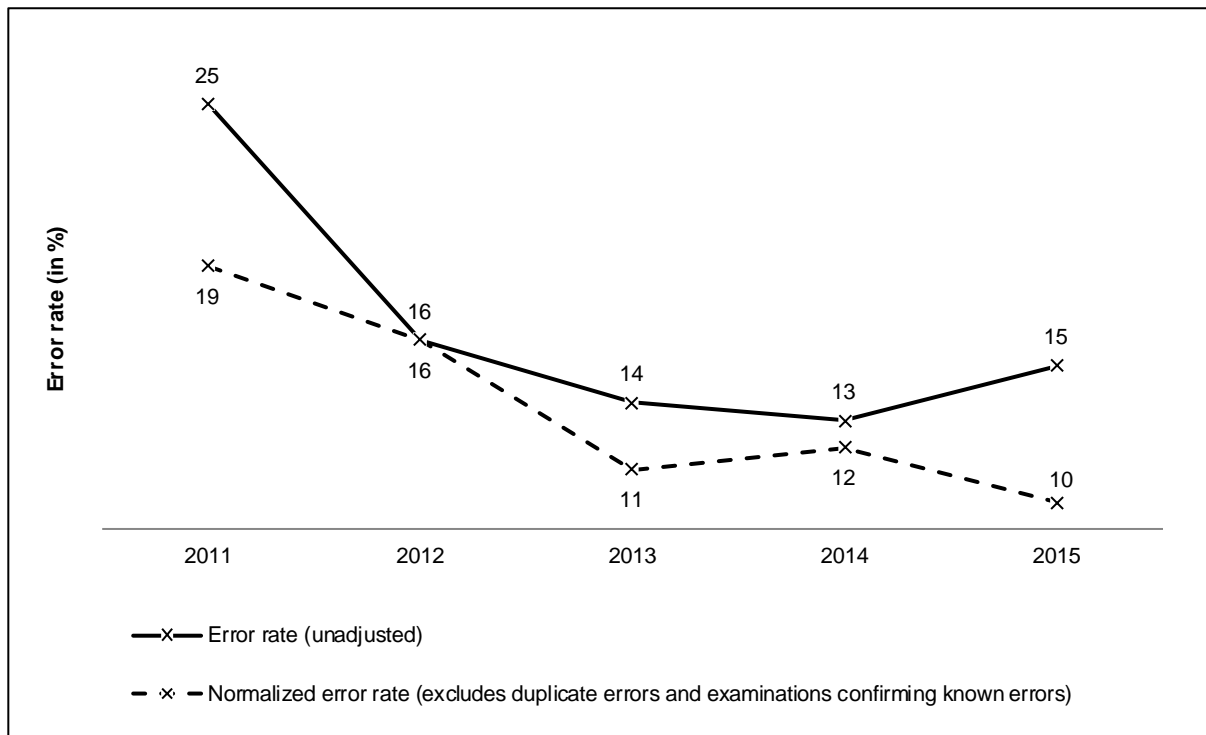


Figure 2: Error rate trend

The decrease in the number of examinations completed in 2015 is partially due to the FREP having approximately 20% fewer members performing examinations. Of the approved 16 positions, an average of only about 12.5 positions was staffed during 2015.

However, the decline in the number of examinations completed is also the result of several extremely complex and, consequently, lengthy and time-consuming examinations being completed in 2015 with the finding of an error. Half of the completed examinations in which the financial statements were found to be erroneous (6 out of 12) related to consolidated financial statements for the 2012 fiscal year or, in one case, the 2011 fiscal year. These examinations utilized significantly more of the FREP members' capacity than is normally the case.

The examinations completed in 2015 consisted of the following: 71 out of 81 examinations completed were sampling examinations. The FREP also completed six indication-based examinations, including three examinations of semi-annual financial reports. Four further examinations were conducted at the request of the BaFin, none related to a semi-annual financial report.

This means that the number of indication- and request-based examinations completed, 10 in total, is twice that of the prior year. While the error rate of 11% for sampling examinations remained flat with prior year, the error rate for the indication- and request-based examinations completed remains high (Fig. 3).

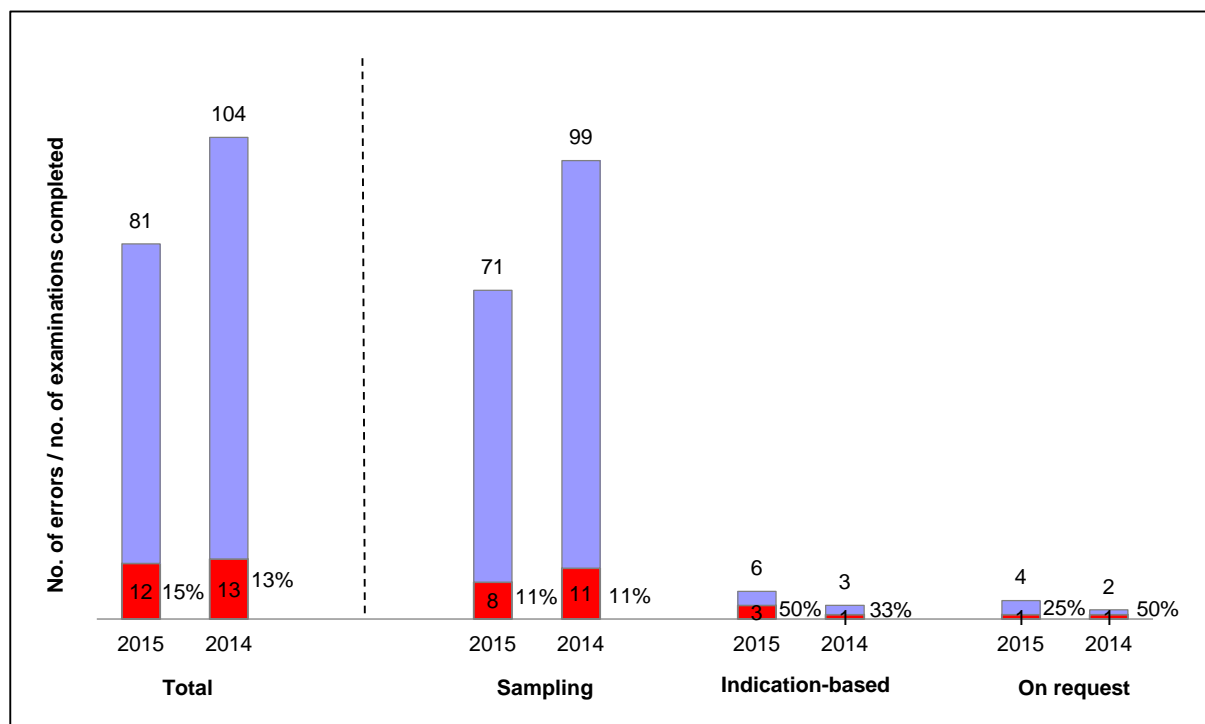


Figure 3: Completed FREP examinations by type of examination and error rate

In 2015, the FREP's Pre-Review Committee initiated seven indication-based examinations: In four cases, the initiative came from the FREP's Media Analysis Committee, which is responsible for analyzing reports in the business press. In one case a member of the FREP initiated an indication-based examination because the results of a follow-up indicated that the financial statements were potentially erroneous (Fig. 9). In another case, a member of the FREP noted as part of the follow-up that the recommendations made in the prior year had been implemented, but there were indications of the financial statements being erroneous with respect to another issue. Finally, one further indication-based examination was the result of information provided by an external third party.

An analysis of completed examinations by company size (i.e. inclusion in a stock index) indicates that the 20% error rate for smaller companies not included in a stock index exceeds the rate for companies included in an index (8%). The error rate of 8% for companies included in a stock index was higher than in the prior year (3%). The 20% error rate for

companies not included in a stock index also exceeds the prior year rate (16%), although it is slightly lower than the rate for 2012 (21%). All companies for which errors were identified had their registered office in Germany (Fig. 4).

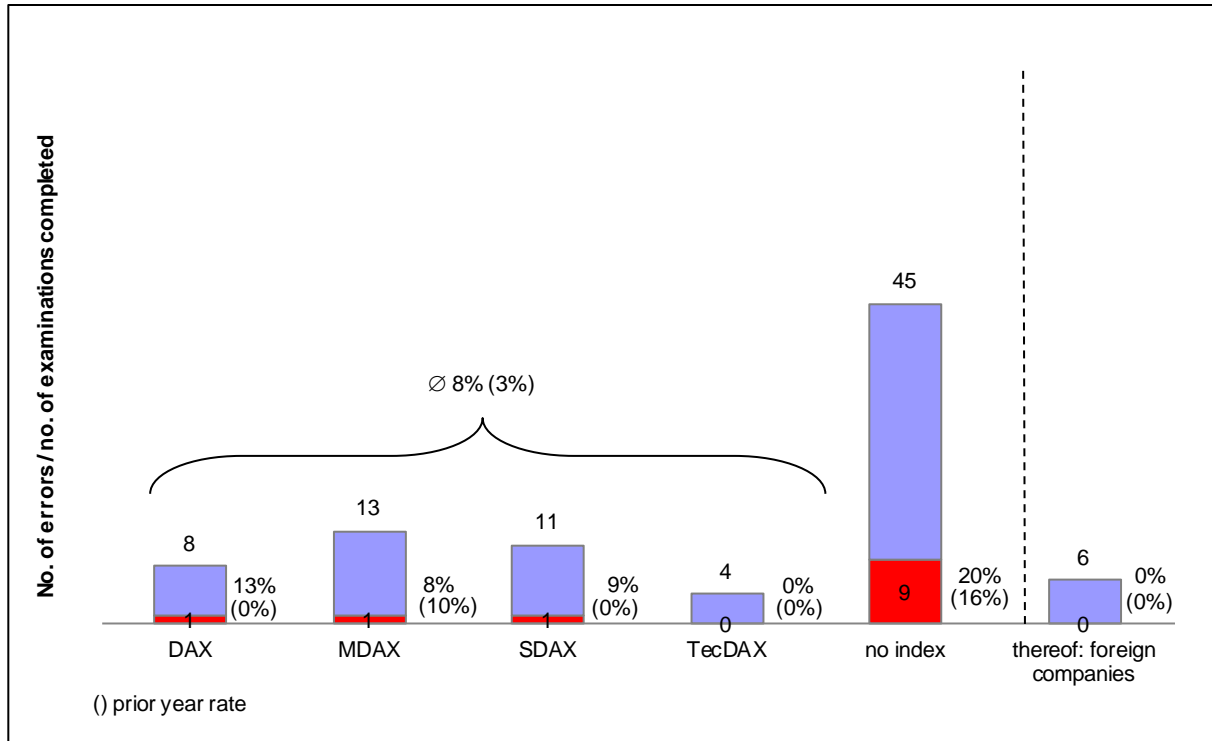


Figure 4: Completed FREP examinations by stock index and error rate

## 2.2 Types of errors and related analysis

The errors found in 2015 were again attributable to the following factors:

- comprehensiveness and application challenges of IFRS with respect to accounting for complex transactions
- insufficient reporting in the notes and in the management report.

Fig. 5 shows the most frequently identified errors:



Figure 5: Most common types of errors

In 2015, reporting in the notes and in the management report represented an important source of errors. Five infringements related to the management report (including the reports on risks and on forecasts); the four infringements in the notes related to general note disclosures not attributable to specific accounting issues (e.g. related party disclosures, disclosures on legal disputes).

Application challenges of certain IFRS with respect to accounting for complex transactions related especially to revenue recognition and business combinations and disposals/goodwill. Errors identified with respect to revenue recognition related primarily to the incorrect accounting treatment of construction contracts under IAS 11. With respect to issues around business combinations and disposals/goodwill, there were three cases of incorrect purchase price allocations and two errors identified in the goodwill impairment test. Finally, three infringements were identified in the area of contingent liabilities/assets consisting of erroneously recognized reimbursement claims.

### 2.3 Acceptance rate

When the FREP identifies an error, it asks the company involved whether it accepts this finding. The finding of an error is normally preceded by a very thorough discussion with the company. The FREP believes that it is important to give companies and their auditors the opportunity to present their views and arguments and to enter into open discussions. In these discussions, the FREP's representatives provide detailed explanations of their rationale for

considering the accounting treatment or presentation in the notes/management report inappropriate. While six out of a total of 12 companies (50%) accepted the FREP's finding of an error in 2015, six companies did not agree with the FREP's finding of an error (Fig. 6).

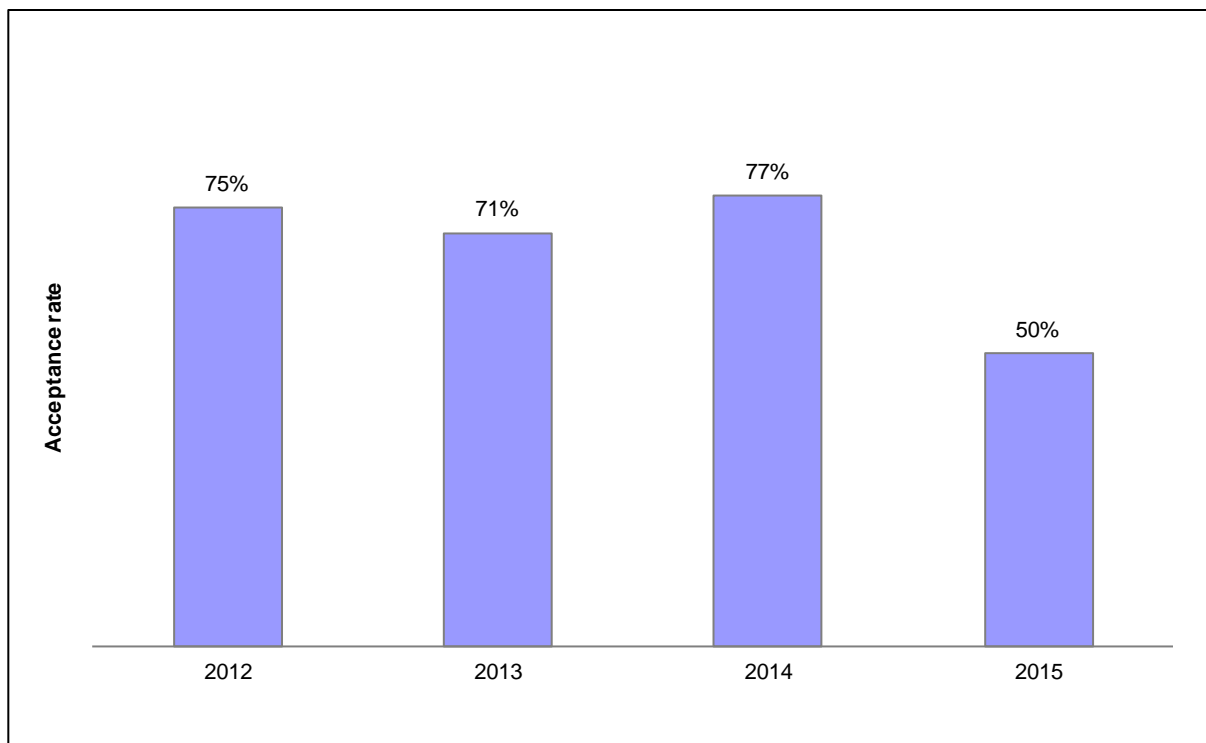


Figure 6: Trend in error acceptance rate

Unusual circumstances have reduced the acceptance rate for 2015 to 50%, lower than in prior years: In four out of six cases without acceptance, the companies decided to delist from the Regulated Market while the examination was still ongoing. When a company does not accept the FREP's finding of an error, a new examination is initiated at the second tier. In these cases, the decision to not accept the FREP's finding of an error may be due to management's expectation that a confirming decision by the BaFin and publication of the error can be avoided by deferring until public interest declines. However, the *Oberlandesgericht* (Higher Regional Court) Frankfurt/Main has issued a decision to the contrary, stating that an examination may be continued following a delisting if the finding and publication of an error is in the public interest. Legislators are currently planning to clarify and confirm this decision by casting it into law.

All examinations in which errors are found are automatically referred to the BaFin, regardless of whether the company has accepted the finding. Where findings are not accepted, the



BaFin performs its own additional examination. The BaFin completed a total of four such cases in 2015. The FREP's result was confirmed in three cases and the error was made public.

**2.4 Length of examinations**

An analysis of the length of examinations over the last ten years shows that, on average, examinations are completed in 7.5 months (Fig. 7). Approximately 86% of examinations were completed within one year, 44% within six months. About 14% of examinations lasted longer than one year. These cases frequently resulted in a finding of an error (43%). In addition, the analysis looked at how many sets of questions it took to complete an examination. During the period from 2008 to 2015, it took an average of 2.6 sets of questions to finalize an examination.

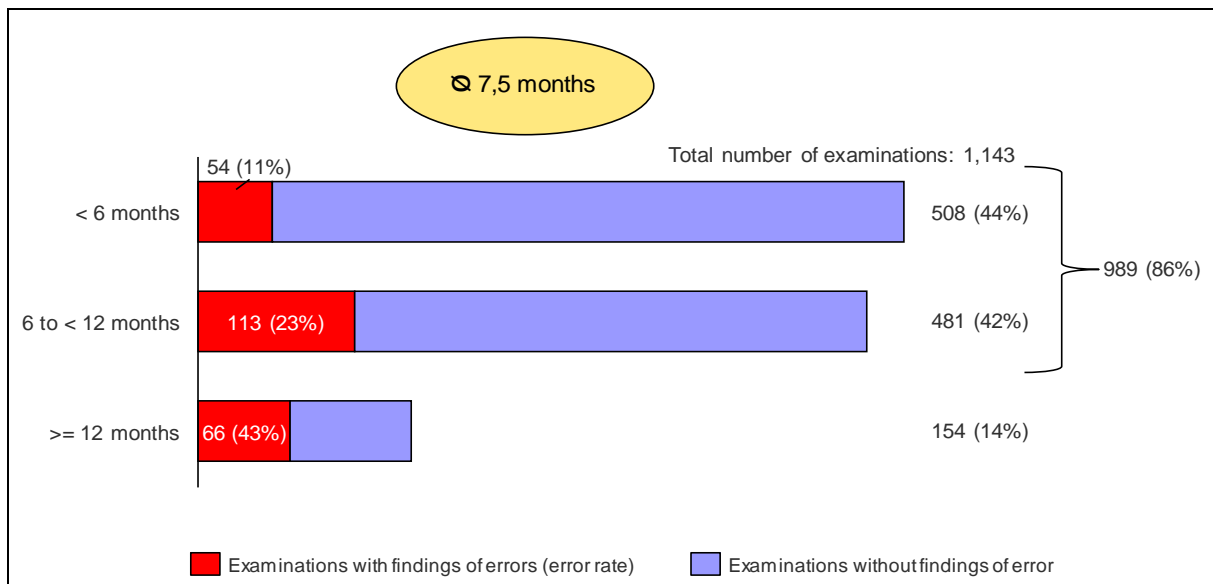


Figure 7: Length of examinations 2005 to 2015

**2.5 Recommendations made**

As part of its error prevention function, the FREP frequently makes recommendations to companies for future financial reporting purposes during the examination in order to eliminate weaknesses in future financial statements and improve the quality of financial reporting.

The most common categories of recommendations are shown in Fig. 8. In 2015, recommendations were primarily attributable to insufficient reporting in the notes and management reports. Recommendations made with respect to management reports where

largely preventative recommendations on the application of GAS 20. Insufficient note disclosures related to business combinations (three recommendations), non-current assets (two recommendations), and other accounting issues (ten other recommendations). Finally, application challenges of IFRS with respect to accounting for complex transactions related especially to business combinations and disposals/goodwill.

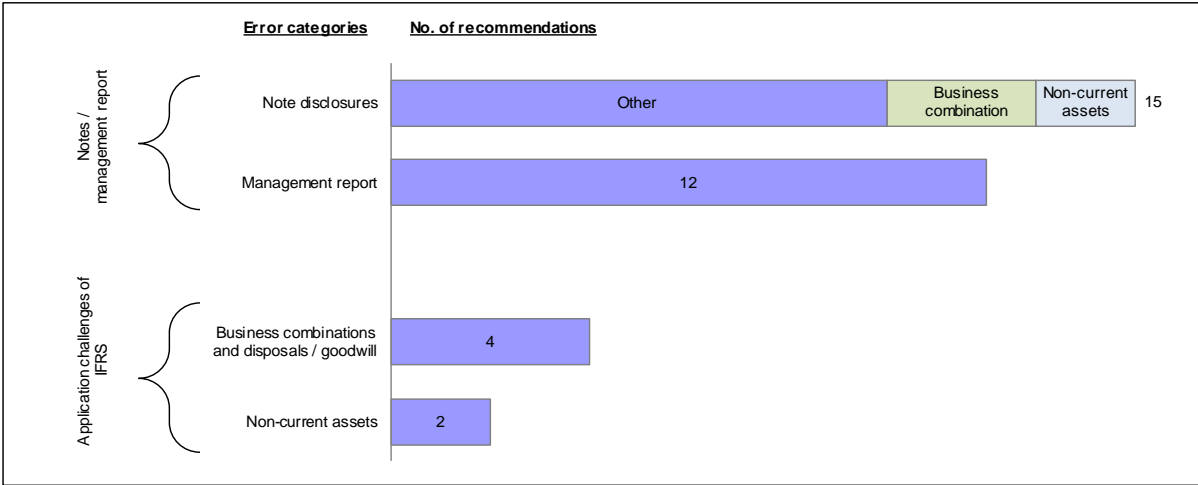


Figure 8: Most common recommendations to companies examined

**2.6 Follow-up on 2014**

Since 2013, the FREP has been systematically following up on the correction of errors found in the prior year as well as on the implementation of recommendations made in the prior year based on publicly available information.

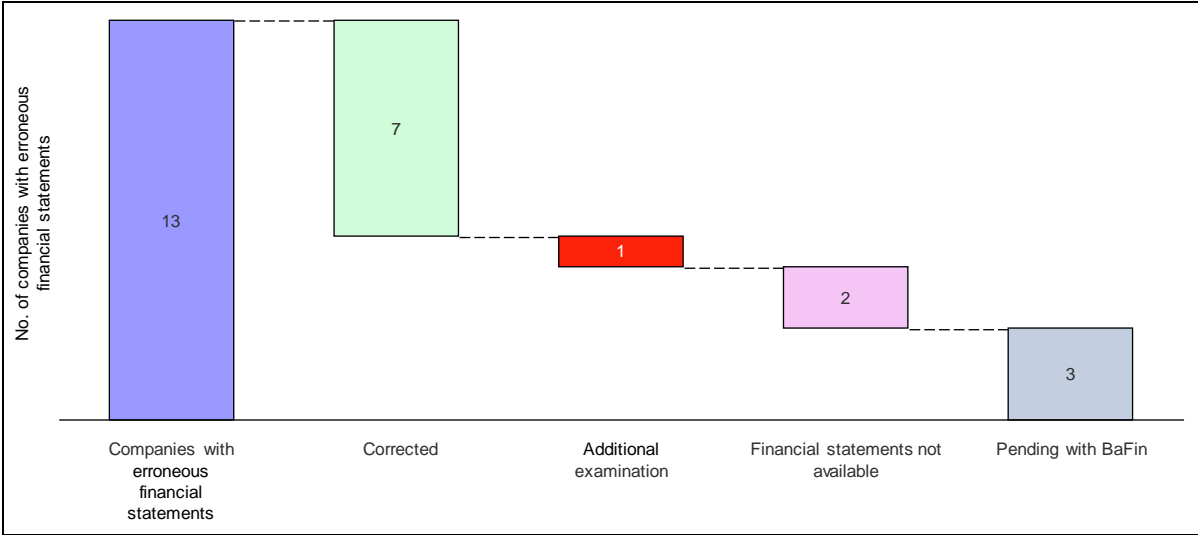


Figure 9: Correction of errors found in 2014

Almost all companies where the FREP identified an error in 2014 and where follow-up was feasible corrected the error in their subsequent financial statements (7 out of 13). In one case the FREP initiated an indication-based examination because the error found by the FREP was not corrected (Fig. 9). For the remaining five companies it was not possible at the time of the follow-up to determine whether errors had been corrected for the following reasons: The financial statements of two companies were not available at the time of the follow-up as the companies had become insolvent. For three companies, the examination was still pending at the second tier, i.e. with the BaFin, at the time of the follow-up, since the companies had not accepted the FREP's finding of an error.

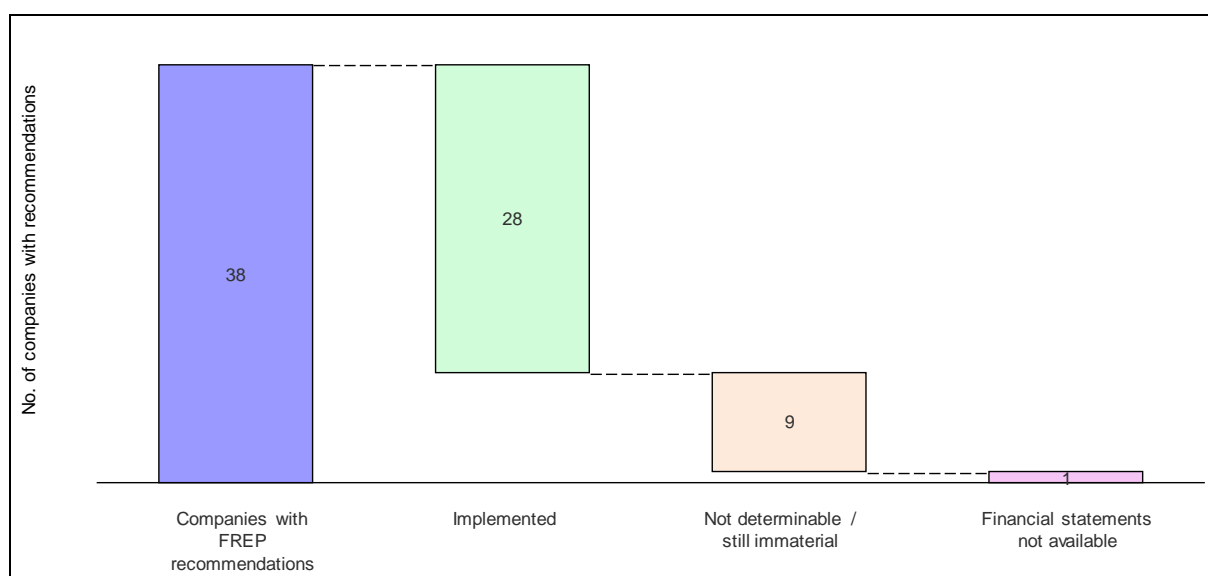


Figure 10: Implementation of recommendations made in 2014

The results of the follow-up on whether recommendations made by the FREP in 2014 were implemented were as follows: Out of a total of 38 companies, 28 companies have implemented the FREP's recommendations (Fig. 10). For nine companies, either it was not possible to determine whether the recommendation had been implemented by merely reviewing the subsequent financial statements, or the recommendation remained immaterial (no material misstatement of net assets, financial position, or earnings). The financial statements of one company were not available at the time of the follow-up as the company had become insolvent.

The FREP will continue to follow up timely on whether errors are corrected and recommendations are implemented.

## 2.7 Implementation of recommendations regarding GAS 20

The group management report in accordance with section 315 HGB (German Commercial Code) in combination with GAS 20 remained one of the FREP's national enforcement priorities in 2015. Examinations focused on the presentation of the most significant performance indicators and on the reporting on legal risks.

In numerous examinations, the FREP made recommendations for future financial reporting purposes (2015: 12 recommendations; 2014: 17 recommendations) where it identified room for improvement with respect to the implementation of GAS 20. The following issues in particular were identified in 2015:

- Identification of and consistent reporting on the most significant performance indicators,
- Reporting on the relevance and potential consequences of all significant risks,
- Informational value of the forecast and completeness of underlying assumptions.

2015 was the first year the FREP included in its follow-up an analysis of whether the recommendations it had made in 2014 regarding GAS 20 had been implemented. The results are encouraging. The recommendations regarding GAS 20 were implemented in 12 out of 17 cases. In five cases it was either not possible to determine whether the recommendation had been implemented or implementation was not necessary (Fig. 11). These instances included, for example, issues that no longer existed in the following year, or cases where implementation could not be determined solely on the basis of publicly available information.

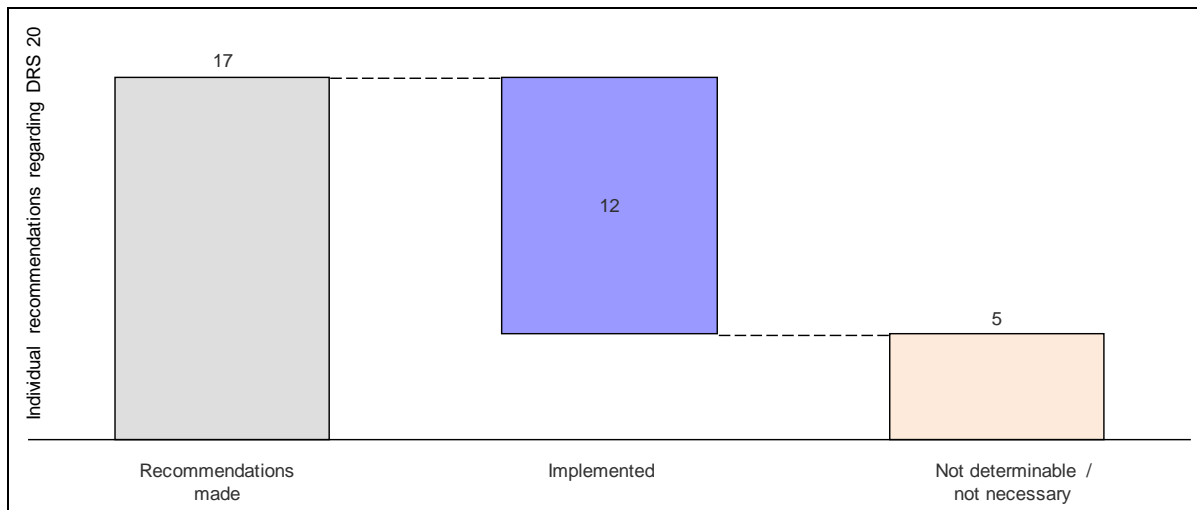


Figure 11: Implementation of recommendations made in 2014 regarding GAS 20

It should be noted that the follow-up includes four examinations where the reporting date was 31 December 2012 and GAS 20 was not applied early in these examinations. However, as recommendations made relate to future financial statements, these examinations were included in the analysis. The subject of one examination was the management report in accordance with section 289 HGB. As application of GAS 20 is also recommended for management reports in accordance with section 289 HGB, this case was also included.

The FREP reported on the results of the follow-up and its experience with GAS 20 in a discussion group including the German Accounting Standards Board (GASB), the Federal Ministry of Justice and Consumer Protection (*Bundesministerium der Justiz und für Verbraucherschutz* – BMJV), and the Institute of Public Auditors in Germany (*Institut der Wirtschaftsprüfer* – IDW) in October 2015. The discussion group with these members has been meeting annually since the introduction of GAS 20 to share information regarding the status of its implementation. The FREP will continue to focus on the group management report in future examinations.

### 3 Error prevention

#### 3.1 Overview

As in prior years, the FREP undertook several error prevention activities in 2015 to help avoid errors (Fig. 12).

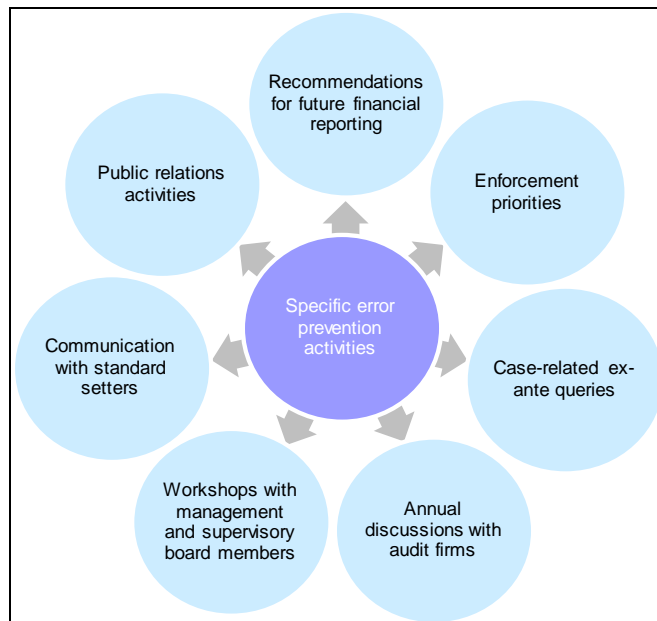


Figure 12: Error prevention activities of the FREP

In addition to making recommendations with respect to future financial statements to companies subject to examinations, the FREP announced its enforcement priorities for the following year in November 2015 in order to give companies and auditors an opportunity to critically review the corresponding accounting issues (see chapter 3.2).

In order to already prevent errors during financial statement preparation and to provide accounting-related guidance to companies, the FREP introduced the case-related ex-ante query in November 2009. This instrument was utilized twice in 2015 (prior year: once).

In 2015, the FREP again held annual discussions with the chairs of the management boards or managing directors of the five largest German audit firms as well as, via the IDW platform, with representatives of medium-sized audit firms auditing publicly listed companies. This regular sharing of experiences is intended to make the FREP's approach transparent to auditors in order to ensure that accounting weaknesses are already identified during their audit.

A similar forum was created by the FREP in the form of workshops with members of supervisory and management boards in the past.

Another error prevention activity essential to improving the quality of financial reporting is a regular exchange of information with standard setters. In 2015, the FREP discussed in

particular management reporting in accordance with GAS 20 with the German standard setter.

The FREP continued to report on its work and experience in speeches and seminars as well as in articles and commentaries as part of its general public relations activities in 2015. More than ten articles and commentaries regarding the FREP's activities and current issues appeared in 2015.

### **3.2 Enforcement priorities for 2016**

As in prior years, the FREP defined its enforcement priorities for the following calendar year in the fourth quarter. These are addressed in all of its sampling examinations to the extent they are material.

Enforcement priorities were selected based on issues that had proven particularly critical or susceptible to error in the past. However, the current situation in the financial markets also gave rise to an enforcement priority.

The following enforcement priorities for 2016 were announced in November 2015:

1. Impact of the financial markets conditions on the financial statements
2. Statement of cash flows and related disclosures
3. Fair value measurement and related disclosures
4. Revenue
5. Business combinations

The first three enforcement priorities represent the "European Common Enforcement Priorities" identified by national enforcers in cooperation with ESMA. A detailed discussion of these first three enforcement priorities is available on the ESMA website. The last two enforcement priorities represent the FREP's national enforcement priorities.

#### **Revenue (IAS 18, IAS 11, IAS 8, IFRS 8, section 315 HGB)**

- Revenue recognition, specifically
  - Transfer of significant risks and rewards (IAS 18.14 (a))
  - Appropriateness of recognition of revenue by reference to the stage of completion (IAS 18.20, IAS 11.22)

- Entity-specific note disclosures on the accounting policies adopted for the recognition of revenue (IAS 18.35 (a)) and for accounting for construction contracts (IAS 11.39 (b) and (c))
- Note disclosures on the possible impact that application of IFRS 15 will have on the entity's financial statements in the period of initial application (IAS 8.30)
- Information about the extent of the company's reliance on its major customers in the notes in accordance with IFRS 8.34 and in the group management report in accordance with section 315 (1) HGB, especially regarding the impact on current and future results of operations (GAS 20.65 et seq., GAS 20.146 et seq.)
- Revenue forecast in the group management report (section 315 (1) HGB), especially
  - Disclosure of significant underlying assumptions (GAS 20.120)
  - Reporting on potential future trends or events that may result in positive or negative variances from the revenue forecast (opportunities and risks in accordance with GAS 20.11)

### **Business combinations (IFRS 3)**

- Contingent consideration
  - Initial measurement (IFRS 3.39 et seq.) and subsequent measurement (IAS 39.47)
  - Determination of whether arrangements for contingent payments to employees and selling shareholders represent consideration in the business combination or are separate transactions (IFRS 3.52 b), IFRS 3 Appendix B54 et seq.)
- Bargain purchase (IFRS 3.34 et seq.)
  - Recognition and measurement of previously unrecognized intangible assets identified in the purchase price allocation (IFRS 3.10 et seq., IFRS 3 Appendix B31 et seq.)
  - Disclosure of the amount of the gain and a description of the reasons why the transaction resulted in a gain (IFRS 3.59, IFRS 3 Appendix B64n))

## **4 Ten years of financial statement oversight in Germany**

The FREP celebrated its tenth anniversary with a ceremony attended by approximately 180 representatives from politics, business, science and government at Konzerthaus at Gendarmenmarkt in Berlin on 3 July 2015. Since July 2005, the FREP has been responsible for the enforcement of financial reporting standards in Germany, representing, together with the BaFin, the third pillar of enforcement in addition to auditors and supervisory boards (Fig. 13).



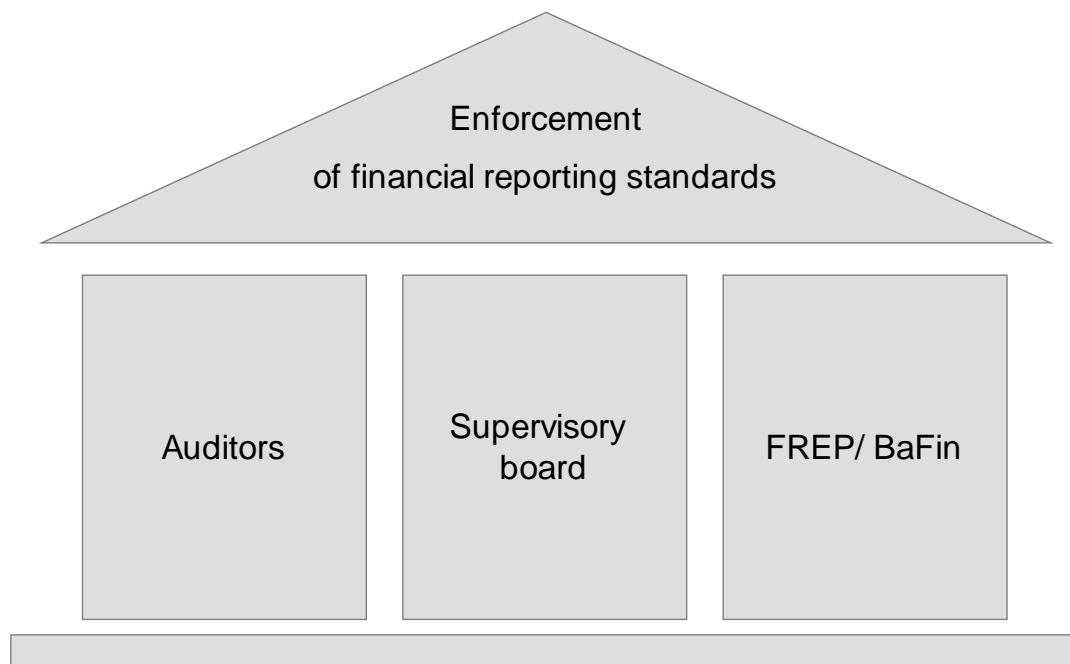


Figure 13: Three pillars of enforcement

During the ceremony, several speakers discussed ten years of financial statement oversight in Germany from various points of view. The Federal Minister of Justice and Consumer Protection, Heiko Maas, opened the anniversary ceremony with a speech entitled “10 years of financial statement oversight in Germany from the perspective of the Federal Government”. Referring to the approximately 1,100 examinations completed during the last ten years, Federal Minister of Justice Heiko Maas stated: *“I would like to congratulate the Financial Reporting Enforcement Panel on its tenth anniversary. The large number of examinations completed impressively demonstrates the importance of this institution to quality and transparency in financial reporting. The Panel’s valuable work will continue to strengthen the capital markets’ trust in the accuracy of financial reporting into the future.”*

Professor Dr. Rolf Nonnenmacher spoke from the auditors’ point of view and had this to say on the introduction of the enforcement procedure in 2005: *“The measures decided upon and implemented approximately 10 years ago have stood the test of time. Particularly during the financial, economic and sovereign debt crisis, which broke out in 2007, the new financial statement oversight system proved effective. There was no trace of financial statement scandals similar to those seen during the dotcom crisis at the beginning of this millennium this time around. Like the financial statement audit, financial statement oversight serves to strengthen trust in the accuracy of financial reporting and, consequently, trust in the capital markets.”*

Dr. Werner Brandt provided the supervisory board perspective. He underlined that the FREP's financial statement oversight procedure provides significant support to the audit committee in discharging its obligations and achieving its objectives: *"From the perspective of the supervisory board and the audit committee, the FREP, with its special advantage of being organized under private law, together with the BaFin, contributes significantly to increasing the reliability of financial reporting, thus strengthening capital market participants' trust in companies' financial reports."*

Professor Dr. Edgar Ernst discussed the development of enforcement from the perspective of the FREP, emphasizing the positive impact made by the error prevention activities established in the past, which is reflected in the declining error rates in the last three years.

Finally, Professor Dr. Hans-Joachim Böcking described key findings on financial statement oversight from the scientific point of view. Based on the results of empirical financial reporting research, his summary was: *"From the scientific perspective, the German enforcement system can be considered effective!"*

An anniversary brochure was issued on the occasion of the FREP's tenth anniversary, summarizing all data, facts on the FREP's activities, as well as the speeches referred to above. The brochure can be downloaded from the FREP's website.

## **5 Developments in Europe**

### **5.1 European Enforcers Coordination Sessions (EECS)**

As in prior years, attending the meetings of the EECS remained a key component of the FREP's international cooperation in 2015. The EECS represents a forum for national enforcers and ESMA to discuss IFRS application issues of transnational interest that meets approximately nine times per year. The EECS generally meets in Paris. The April 2015 EECS meeting was hosted by the FREP in Berlin.

In 2015, the FREP presented, on an anonymous basis, issues to the meetings of the EECS arising either from ongoing examinations as emerging issues (i.e. before a decision was taken in the national enforcement procedure) or from decisions taken in actual examinations. ESMA makes extracts containing selected decisions of national enforcers discussed at the

EECS meetings available to the public. A total of 197 decisions by national enforcers has been published in 18 extracts since 2007, most recently in November 2015.

In addition to the EECS meetings, representatives of the FREP, together with representatives of another national enforcement institution, held an education session on IAS 36 for the other national enforcement institutions.

Furthermore, a two-member working group named “sub-group of EECS on U.S. GAAP” was established in 2015; one of its members is a representative of the FREP who is qualified as a Certified Public Accountant. This working group is available to the national European enforcement institutions for consultation on issues arising in connection with examinations of U.S. GAAP financial statements.

## **5.2 ESMA Guidelines on Alternative Performance Measures**

In June 2015, ESMA issued its final report “ESMA Guidelines on Alternative Performance Measures”. The Guidelines on Alternative Performance Measures are aimed at improving the comparability, reliability and comprehensibility of published financial information (e.g. in management reports, prospectuses, ad-hoc announcements). Examples of alternative performance measures are EBITDA (earnings before interest, taxes, depreciation and amortization) or free cash flow, as these measures are not defined in either IFRS or HGB.

The Guidelines require companies to define and clearly label its alternative performance measures and to disclose their basis of calculation. A reconciliation to amounts presented in the financial statements is also required. Finally, the Guidelines contain requirements with respect to the presentation of comparatives for prior reporting periods and regulations regarding consistent reporting.

In specific FREP examinations, the Guidelines on Alternative Performance Measures will be reflected in the examination of interim management reports to the extent the corresponding documents are published after 3 July 2016 (effective date of the Guidelines).

## **6 Acknowledgements and outlook**

For the tenth consecutive year, the FREP was able to continue its work successfully in 2015 and would like to thank the companies examined and their auditors for their willingness to cooperate and the extensive technical discussions. The FREP would also like to extend its particular gratitude to those who have generously supported it: The members of the FREP

association, its Governing Board and Nomination Committee, as well as our advisory group, the responsible bodies at the BMJV and the German Federal Ministry of Finance (*Bundesministerium für Finanzen – BMF*), and in particular the BaFin, the GASB, the audit firms, the IDW, the *Abschlussprüferaufsichtskommission* (German Auditor Oversight Commission) and the *Wirtschaftsprüferkammer* (German Chamber of Public Accountants). Special thanks go to the vice president, management, panel members, and office staff for their consistently dedicated and exceptionally professional work.

The Act on the Implementation of the Directive Amending the Transparency Directive will result in three changes to the enforcement process effective in 2016:

- In future, only companies with Germany as their home country will be subject to enforcement,
- initiation of indication- and request-based examinations will also be possible for the prior year in the future,
- (consolidated) payment reports will be subject to enforcement as part of indication- and request-based examinations.

In addition, the FREP will continue to fulfill its error prevention role in 2016 in order to improve the quality of financial reporting for the long term.

Finally, maintaining the close cooperation between the FREP and the BaFin remains essential in order to ensure a uniform and effective presence of the German enforcement system at the European level in 2016.

Professor Dr. Edgar Ernst  
(President of the Enforcement Panel)