

Dr. Herbert Meyer

Annual Activity Report 2007

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Berlin, 14 February 2008

1. Overview

- Two-tiered enforcement procedure had got off to a good start
- FREP achieved its goals by completing 135 examinations in 2007 (previous year: 109)
- Further increase in the number of accounting errors to 35 (error rate: 26%; previous year: 17%); errors concentrated among small and medium-sized companies
- Preventive function of the FREP is proving effective, but must be further strengthened

The first stage of the two-tiered enforcement procedure established in mid-2005 has got off to a successful start. In a survey, a large number of the examined companies confirmed that the quality of the examinations and results were excellent and that cooperation and flexibility of the FREP were also very good.

In 2007 FREP completed 135 examinations (previous year: 109), of which 118 were examinations based on random sampling (previous year: 98) and 15 were indication-based examinations (previous year: 10).

However, the proportion of accounting errors also increased to 26% (previous year: 17%); 80% of these errors were accounted for by small and medium-sized companies with revenue of up to €250 million p.a. In the second tier of the enforcement procedure, the *Bundesanstalt für Finanzdienstleistungsaufsicht* (BaFin – German Federal Financial Supervisory Authority) confirmed FREP's findings almost without exception, and ordered the publication of the errors.

The preventive effect of the FREP is already reflected in the fact that accounting issues are being discussed much more intensively by corporate governing bodies (executive boards, supervisory boards) and auditors – with reference to the newly introduced enforcement procedure in Germany. In view of the high error rate, however, it is important to take additional measures to prevent errors in the future and therefore to further support FREP's preventive function.

2. Examinations in 2007

2.1 FREP examinations (tier 1)

Initiated examinations

In the past year, we initiated a total of 146 examinations (see appendix 1), of which **124** were examinations based on random-sampling, **20** were indication-based examinations and **2** were examinations requested by BaFin because it had become aware of evidence of possible infringements of financial reporting requirements.

Examinations during the first tier of the enforcement procedure are based on voluntary cooperation of the companies to be examined. In all cases apart from one, the companies concerned declared their willingness to cooperate in this way. Such cooperation requires the company and the persons appointed by it to provide correct and complete information and to prepare documents. The case in which cooperation was refused was forwarded to BaFin where appropriate measures were taken.

Once a company has declared its willingness to cooperate, the Panel requests the financial statements and management reports to be provided as well as the related long-form audit reports by the auditors. The long-form audit reports by the auditors are an important document because they contain valuable information on company-specific, income-critical or risk-related issues that will be the main focus of FREP's examination. As a rule, auditors are also involved in the Panel's examination as persons appointed to provide information.

The examination itself is conducted primarily by the Examiner-in-Charge via correspondence. However, meetings are increasingly being held at the company's or the Panel's offices to discuss and more rapidly clarify complex issues.

The Panel may consult external appraisers or auditors if necessary. It did so in 10 cases involving expert opinions on property appraisals or certain sector-specific issues, for example.

While indication-based examinations concentrate on the indication in question, examinations based on random-sampling focus on company-specific, income-critical

issues or issues with a significant risk of error. FREP established audit areas of emphasis for examinations in 2007, which related to the following aspects:

- Business combinations
- Impairment of assets
- Deferred taxes on loss carry forwards.
- Composition of cash equivalents
- Share-based payments
- Risk reporting and reporting on expected developments
- Disclosures on the remuneration of the executive board and auditors' fees

Completed examinations

In 2007 FREP completed a total of 135 examinations (previous year: 109; see appendix 2), of which 118 were examinations based on random-sampling (previous year: 98). Based on the number of sampling examinations, we have therefore achieved our target corridor of 120-140 examinations p.a. This number of examinations must be completed if we want to maintain a frequency of sampling examinations of 4 – 5 years for index-listed companies and 8 – 10 years for non-index-listed companies. 15 indication-based examinations and 2 examinations requested by BaFin were also completed.

The completed examinations relate to 6 DAX, 11 MDAX, 16 SDAX and 5 TecDAX companies, as well as 97 companies that are not included in an index (see appendix 3).

Approximately 90% of the examined financial statements were prepared in accordance with International Financial Reporting Standards (IFRSs). This figure also illustrates the penetration of IFRSs, which have now been adopted by more than 100 countries.

FREP completed examinations on a total of 12 foreign companies that are listed in Frankfurt.

Accounting errors

The Panel must conclusively decide whether a company's financial statements comply with the applicable accounting standards or whether they contain errors. In accordance with IASs, financial statements do not comply with IASs/IFRSs if they contain either material infringements of financial reporting requirements or if immaterial errors are made intentionally to achieve a particular presentation of an entity's financial position.

As compared to the previous year, we completed 26 examinations more. However, there was also a disproportionately high increase in the number of cases involving accounting errors from 19 (= 17%) to 35 (= 26%). This growth in the error rate must be further analysed and differentiated.

An analysis of the error rate by company size reveals a high concentration of errors among small and medium-sized companies: 80% of all cases involving accounting errors relate to firms with annual revenue of below €250 million (see appendix 4).

Error categories

The 35 cases involving accounting errors contain an average of around 5 individual errors per company. Here, too, it is important to analyse the type and frequency of these errors in order to prevent them. These errors are broken down into the key error categories presented in appendix 5.

This appendix shows that most errors were made in the accounting treatment of M&A activities, e.g. in purchase price allocation, the calculation of goodwill and the treatment of discontinued operations.

Disclosures on segment reporting, related parties and management/risk reporting represent the second most common source of error, followed by insufficient disclosures in the notes. This high frequency of errors in qualitative disclosures suggests that companies occasionally ascribe less significance to this part of financial reporting than to the pure financial statements. Eliminating this source of error will be one of the main focuses of FREP's preventive measures. In addition, we frequently identified "classic errors" in the balance sheet, which mainly relate to the carrying amounts of investments and receivables being stated too high. Errors were also

identified in the recognition of deferred taxes, in particular with regard to loss carry forwards, and in the preparation and discussion of cash flow statements.

An analysis of the main causes of the identified accounting errors reveals the following picture (see appendix 6): the key cause is the enormous scope and high complexity of IFRSs. From the perspective of the enforcement procedure, the further development of the Standards should much more strongly reflect the need for simplicity, understandability and comparability of IFRSs. Small and medium-sized companies and their auditors in particular often reach the limits of their abilities here.

We gained the impression that a small number of companies were intentionally trying to bypass the accounting standards in order to produce the results they wanted in their financial statements. Our mission is to identify these few “black sheep” and to publish the respective errors in a timely manner.

Where accounting errors are discovered, the Panel asks the company in question whether it agrees with the errors identified. If the company agrees, we notify BaFin, which must then decide whether to publish the errors discovered. If the company does not agree, the examination moves into the second tier of the enforcement procedure, i.e. the BaFin must itself examine and decide whether the financial statements are incorrect or not.

2.2 FREP and BaFin examinations (tier 1 and 2)

What were the results of the overall enforcement procedure (tier 1 and 2) in 2007?

33 tier 1-examinations completed by the FREP involving accounting errors were sent to the BaFin in 2007 (see appendix 7).

At the same time, 33 tier 2-cases were completed in 2007. In 27 of these cases, the companies in question agreed with the errors identified by FREP, and 6 companies did not agree. In 4 of these 6 cases, the BaFin confirmed the errors identified in tier 1. BaFin ordered the publication of the accounting errors in 30 of the 33 tier 2-cases completed.

This data shows that accounting errors identified during stage 1 are confirmed by the BaFin virtually without exception, even if the companies in question do not agree with the errors identified, and the respective errors are almost always published. This is a key requirement for the effectiveness of the two-tier procedure.

2.3 Examination of half-yearly financial reports

Under the new *Transparenzrichtlinie-Umsetzungsgesetz* (TUG – Transparency Directive Implementing Act), half-yearly financial reports have also been subject to enforcement examinations since mid-2007 in case there are indications of possible infringements of financial reporting requirements.

In 2007 we initiated 7 indication-based examinations of half-yearly financial reports for the period ended 30 June 2007.

3. Preventive measures taken by the FREP

The preventive effect of our activities is particularly important to us – and this 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 audit committees, as well as by corporate governing bodies and auditors, and repeatedly with reference to the newly introduced enforcement procedure in Germany. This in turn helps auditors comply with and implement the increasingly complex accounting standards in practice.

In addition to this general preventive effect, the FREP takes specific measures to help companies prevent errors in their financial reporting. The FREP also gives companies guidance on future financial reporting and notifies them of the audit areas of emphasis in the next calendar year.

3.1 Guidance in 2007

In the interest of its preventive activities, the Panel gives the companies examined guidance on new provisions to be complied with or the accounting treatment of critical items. This includes guidance on immaterial errors that could become material for future financial reporting. This procedure is designed to prevent errors in financial reporting in the future.

Appendix 9 shows the most important categories of guidance given by the FREP in 2007 and their frequency. The breakdown into the various categories is similar to that for the types of errors identified, which is unsurprising.

3.2 Audit areas of emphasis for examinations in 2008

Before the beginning of a new calendar year, we establish the audit areas of emphasis for the new year that will be addressed as a matter of principle in each examination based on random-sampling, insofar as they are relevant in each individual case.

These audit areas of emphasis are published in a suitable manner before the beginning of the new year. Our goal is to inform the companies concerned and their auditors about the issues that FREP believes are particularly prone to errors in the coming year's financial statements. In doing so, we aim to help prevent possible errors in the financial statements from the outset.

When determining these audit areas of emphasis, FREP refers to historic examination results and identifiable risks that could arise in the new year.

For example, the first two focus areas for 2008 (see appendix 10) relate to the financial crisis triggered by the USA in mid-2007, which also affects a large number of companies listed in Germany and will have a substantial impact on financial statements for the period ended 31 December 2007. This impact will then be the subject of FREP's 2008 enforcement examinations. Other audit areas of emphasis for 2008 relate to elements that were particularly prone to errors in 2007, such as management and risk reports, or the accounting treatment of business combinations.

3.3 Public relations work

We pass on the experience and knowledge that FREP has gained from enforcement examinations to specialist audiences by giving a large number of presentations at relevant business and accounting events and congresses. For example, the Presidential Board of FREP has given around 20 such presentations.

We also publish commentaries in specialist journals on complex topics that are prone to errors; for example, we recently published an essay on the structure and interpretation of cash flow statements.

4. Costs of enforcement

The costs of the two-tier enforcement procedure were budgeted at approximately EUR 8 million for 2007, of which EUR 6.7 million for FREP. Of the latter figure, the Panel only used EUR 3.9 million (i.e. approximately 40% less than budgeted) due to lower than planned recruitment of additional staff (lower additional demand for staff for half-yearly financial reports due to the change in the legal framework) and economical financial management (see appendix 11).

The total budget for 2007 of approximately EUR 8 million was raised by a charge levied on the around 1,000 publicly listed companies. The charge amounts to an average of approximately EUR 8,000 a 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 2008.

5. Outlook

There was a change in FREP's management on 1 July 2007: as planned, Prof. Dr. Eberhard Scheffler handed over the office of President of FREP to his successor, Dr. Herbert Meyer. We would like to sincerely thank Prof. Scheffler for his excellent work in developing FREP.

As the "newcomer" onboard FREP, I would like to take stock of my first 100 days: what is going well and what in balance sheet terms is on FREP's "credit side" (see appendix 12) and – much more excitingly – where there is potential for improvement ("debit side"; see appendix 13). In order to further objectivise this evaluation, I have also referred to the results of a survey by Deutsches Aktieninstitut (DAI), the association of German exchange-listed stock corporations, other companies and institutions with an interest in the capital market, which was published in 2007. The survey asked companies that were examined by FREP about their experiences with regard to the enforcement examinations.

...on the FREP's "credit side"

The FREP got off to a good start. This is demonstrated by the high quality of its examinations and results, as well as by its preventive effect, which has been growing

since the Panel was established. The highly enforcement-specific knowledge that all of FREP's examiners have now built up is especially remarkable. In the DAI survey, the majority of companies examined also said that FREP was extremely cooperative in its examinations.

This successful start and ramp-up phase has led to FREP's universally favourable image.

...on the FREP's "debit side"

Of course, there is potential for improvement in our newly established enforcement procedure (see appendix 13). A frequently lamented weak point is that the duration of the examinations over the two tiers is too long: 40% of the examinations that comprise both tiers last longer than 10 months. In these cases, the findings of our examinations cannot be incorporated in the following year's financial statements. There are many different causes for this, which relate partly to the examined companies, and partly to the two-tier nature of the procedure. We believe this area offers good opportunities for accelerating the procedure. In the survey, some of the examined companies complained about FREP's lack of understanding of their business operations and internal workflows. We will also address this issue and take suitable measures (hold more meetings with the companies, improve our staff's understanding of the company's business).

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 are still a very long way from achieving this – which makes it another starting point for improvement.

Another weak point is the lack of pre-clearance, i.e. the opportunity for companies to make preliminary inquiries to FREP on complex issues before preparing their financial statements. This is not currently provided for in the description of the FREP's duties.

Future measures

The potential that we have identified enables us to develop measures for improvement in the future (see appendix 14).

We will reduce the duration of the procedures over the two stages by analysing the entire enforcement procedure together with BaFin, and in particular by further optimising the numerous interfaces between tiers 1 and 2. In addition, we are already making our internal workflows and processes more efficient by implementing appropriate IT projects, among other things.

A pre-clearance procedure could sustainably reduce the current high error rate and further strengthen FREP's preventive effect. In this way, the enforcement-specific expertise that the Panel has now built up could be made available to the companies concerned in a highly targeted manner. The enforcement bodies in many countries, such as the USA and France, offer a pre-clearance procedure. Together with the responsible bodies, in particular the German Federal Ministry of Justice, we are examining such an extension to FREP's duties and the requirements for this in detail.

In 2007 we were only able to successfully continue our work because we could again count on the effective cooperation and support of many parties. We would like to take this opportunity to especially thank the examined companies; FREP's members, the Executive Board and the Nominating Committee of FREP and its advisers; the responsible bodies at the German Federal Ministries of Justice and Finance, and in particular BaFin; the audit firms, the *Institut der Wirtschaftsprüfer* (IDW) and the *Wirtschaftsprüferkammer* (WPK – German Chamber of Public Accountants). Our particular thanks go to all of FREP's examiners and the staff at our office for their consistently dedicated and extraordinarily knowledgeable work.

Berlin, 14 February 2008

The President of the Panel
Dr. Herbert Meyer

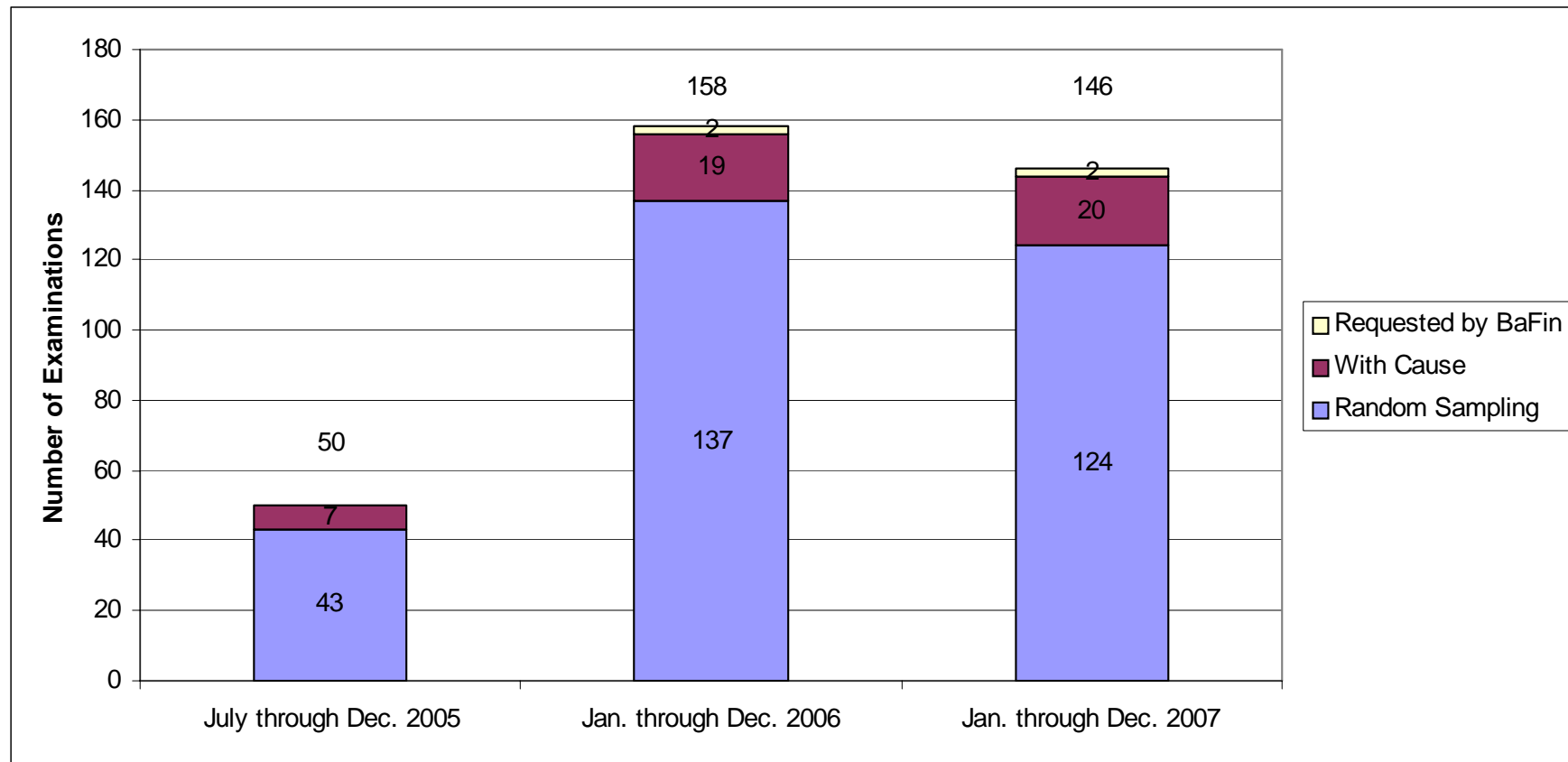
DEUTSCHE PRÜFSTELLE FÜR RECHNUNGSLEGUNG
FINANCIAL REPORTING ENFORCEMENT PANEL

**Appendices to the
Annual Activity Report 2007**

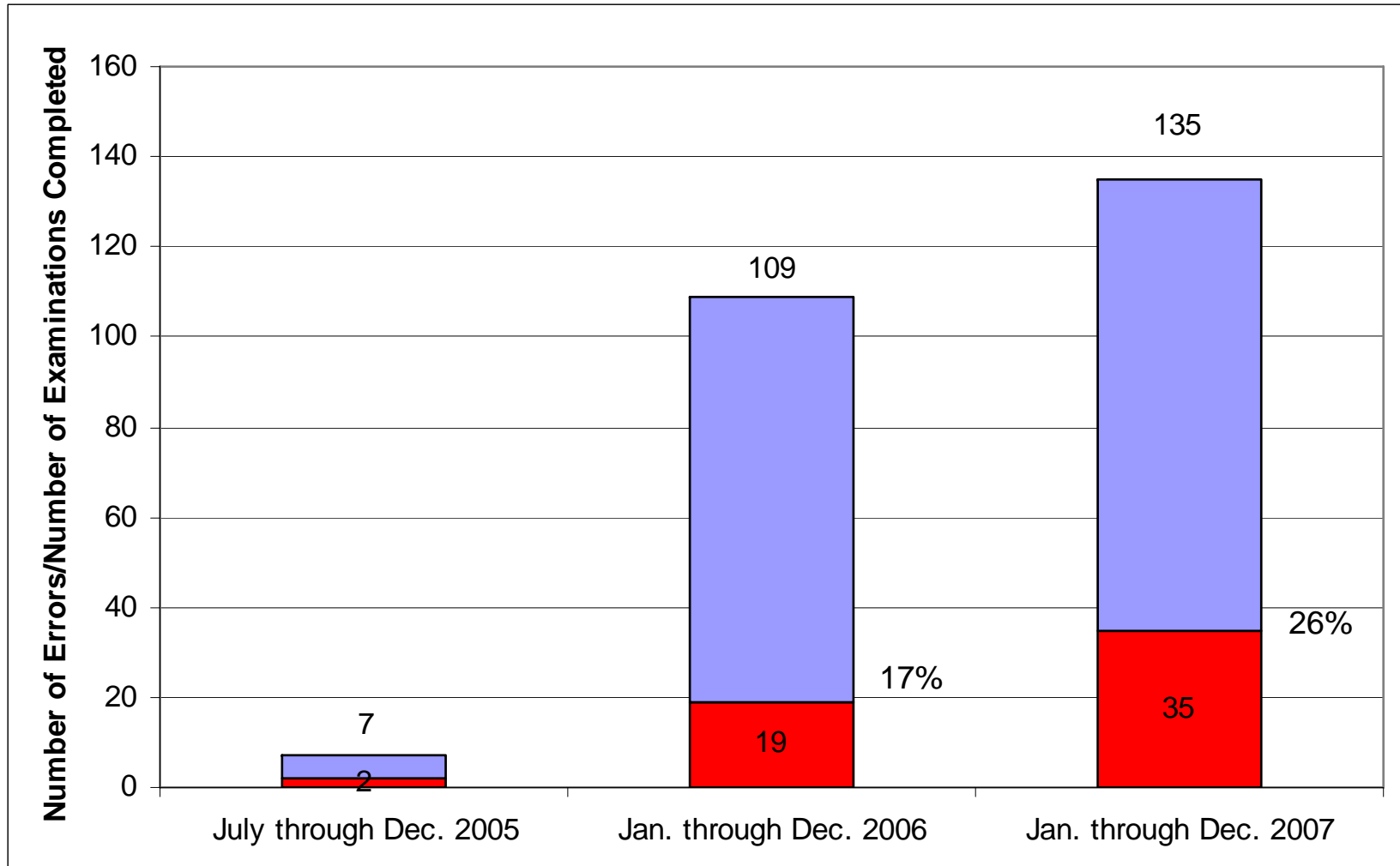
14 February 2008

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Examinations Initiated in 2007



DPR/FREP Examinations Completed, Error Rate Development



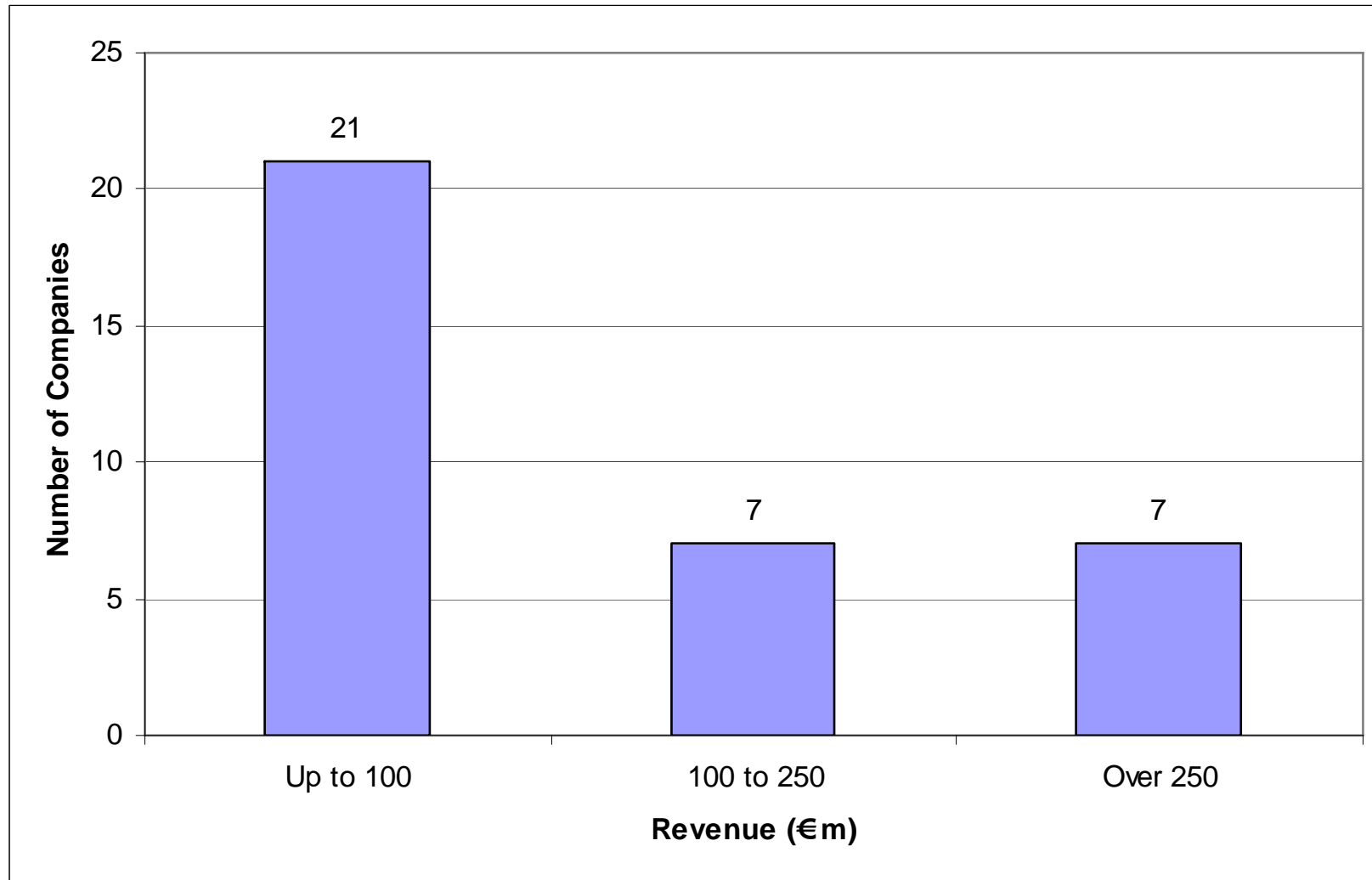
DPR/FREP Examinations in 2007

- o Total examinations completed : 135

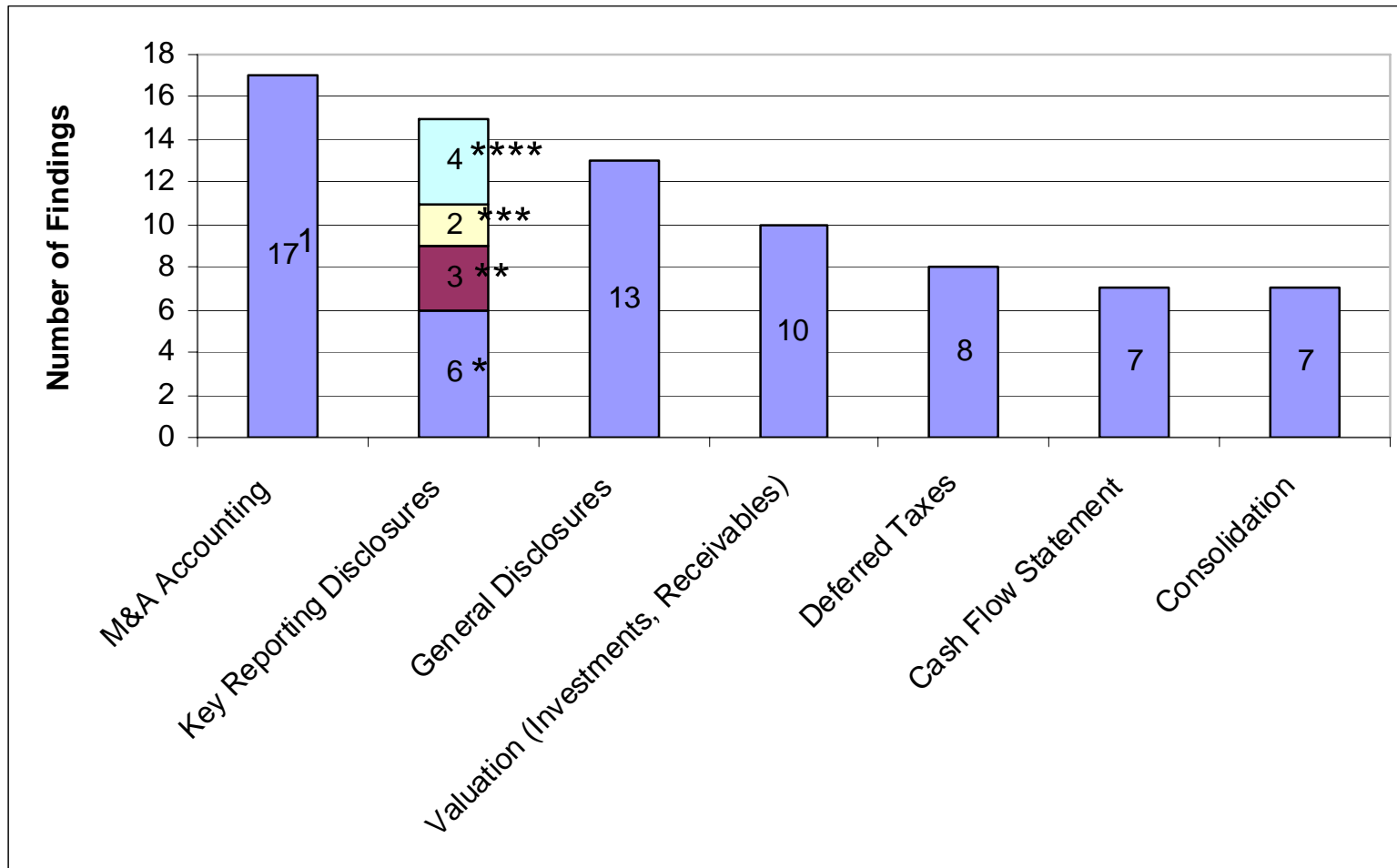
- o including companies in
 - DAX: 6
 - remaining indices: 32
 - other: 97

- o including foreign companies: 12

Allocation of Identified Errors based on the Companies' Revenue (2007)



Most Frequent Errors Identified in 2007



¹ PPA, Goodwill, Information, Discontinued Operations

**** Other Information

*** Segment Reporting

** Management and Risk Reporting

* Related Party Disclosures

Main Causes of Errors

- o Scope and complexity of the IFRS standards
- o Often excessive demands on small and medium-sized companies and their accountants
- o Occasional lack of knowledge of the standards
- o A few “black sheep”

Results of the 2nd Level (BaFin) in 2007

- o Number of error findings sent to BaFin (Incoming): 33
 - o Including those in which the Company accepts DPR's findings 27

- o Completed proceedings by BaFin (Outgoing) : 33
 - o Including those published 30

Preventive Function of the DPR/FREP

1. Guidance from the DPR/FREP

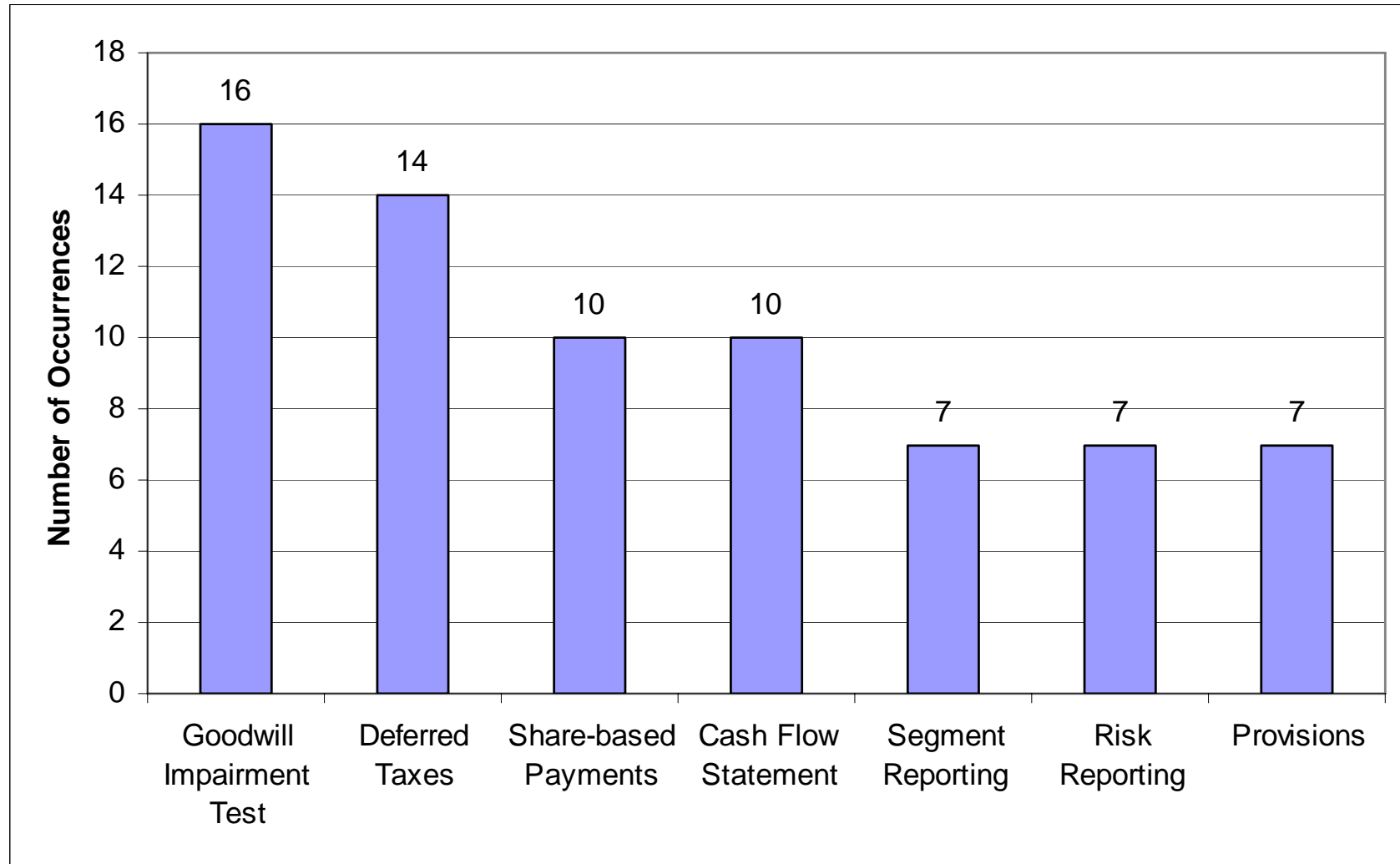
- To avoid material errors in future financial reporting

2. Definition of Audit Areas of Emphasis

3. Public Relations

- Annual activity report
- Publications/lectures

Most Frequent Guidance from the DPR/FREP to Examined Companies (2007)



Audit Areas of Emphasis in 2008

- o Valuation of asset-backed securities
- o Consolidated entities, especially special purpose entities (IAS 27; SIC 12)
- o Review of asset impairment testing (IAS 36), including supporting documentation and note disclosures
- o Management report: Description of risk management goals and methods as well as expected developments
- o Related party disclosures (IAS 24)
- o Business combinations (IFRS 3), in particular purchase price allocation and note disclosures

Enforcement Expenditures (DPR/FREP)

- o **Expenditures in 2007:** 3.9 million euro (with a budget of 6.7 million euro)
 - o 2.8 million euro personnel expense
 - o 0.8 million euro material expenditures
 - o 0.3 million euro external services

... on the “credit side” of the DPR/FREP

- o High quality audits and results
- o Positive preventive impact of DPR/FREP
- o High-level of enforcement-specific know-how
- o Cooperative attitude of DPR/FREP during the examinations
- o Good image

... on the “debit side“ of DPR/FREP (Improvement potential within enforcement)

- o Duration of audits (including 2nd level)
- o Understanding of operational business (DAI survey)
- o Lack of pre-clearance (DAI survey)
- o Different organizational structures among the national enforcers

Outlook

- o More focus on the overall enforcement process
- o Improving enforcement workflows/processes
- o Pre-clearance??
- o International/European cooperation