**FREP Presidential Board** Berlin, 29 January 2013

# Annual Activity Report 2012

# 1 Overview

- In 2012, the FREP completed 113 examinations (prior year: 110), including 110 sampling examinations and 3 examinations that were indication- or request-based. At 16%, the rate of financial statements found to be erroneous was significantly lower than last year's rate of 25%.
- Unlike in the prior year, it was not necessary to normalize the error rate by adjusting for duplicate errors and examinations confirming known errors in 2012. This year's rate of 16% was three percentage points less than last year's normalized rate of 19%.
- The lower error rate is primarily due to significantly fewer indication- and request-based examinations, which normally have a very high error rate.
- Since the FREP was founded in 2005, it has completed approximately 850 examinations covering the vast majority of companies subject to enforcement in Germany.
- Last year, the FREP held discussions aimed at preventing errors with the chairs of the management boards or managing directors of the five largest German audit firms. In 2012, the FREP set up a similar discussion platform for all medium sized audit firms auditing publicly listed companies in cooperation with the *Institut der Wirtschaftsprüfer* (IDW – Institute of Public Auditors in Germany), and the first discussions have been held successfully. Given the positive feedback from participants, these discussions will be continued on a regular basis.
- The cost of the two-tier enforcement process was budgeted at EUR 7.8 million for 2012, including EUR 6.0 million designated for the FREP. The FREP utilized EUR 5.2 million of these funds.

# 2 Examinations in 2012

## 2.1 Completed examinations

In 2012, the FREP completed a total of 113 examinations (prior year: 110, see Figure 1), including 110 sampling examinations (prior year: 90). This result complies with the FREP's policy for sampling examinations, which requires an examination every 4 to 5 years of all companies included in a stock index, and every 8 to 10 years for all other companies. We also replied to 4 pre-clearance enquiries.

It should be noted that the total number of companies subject to enforcement in Germany has decreased by more than 30% (from 1,249 to 825 entities) during the period from 1 July 2005 – the date the FREP started operations – to 1 July 2012.

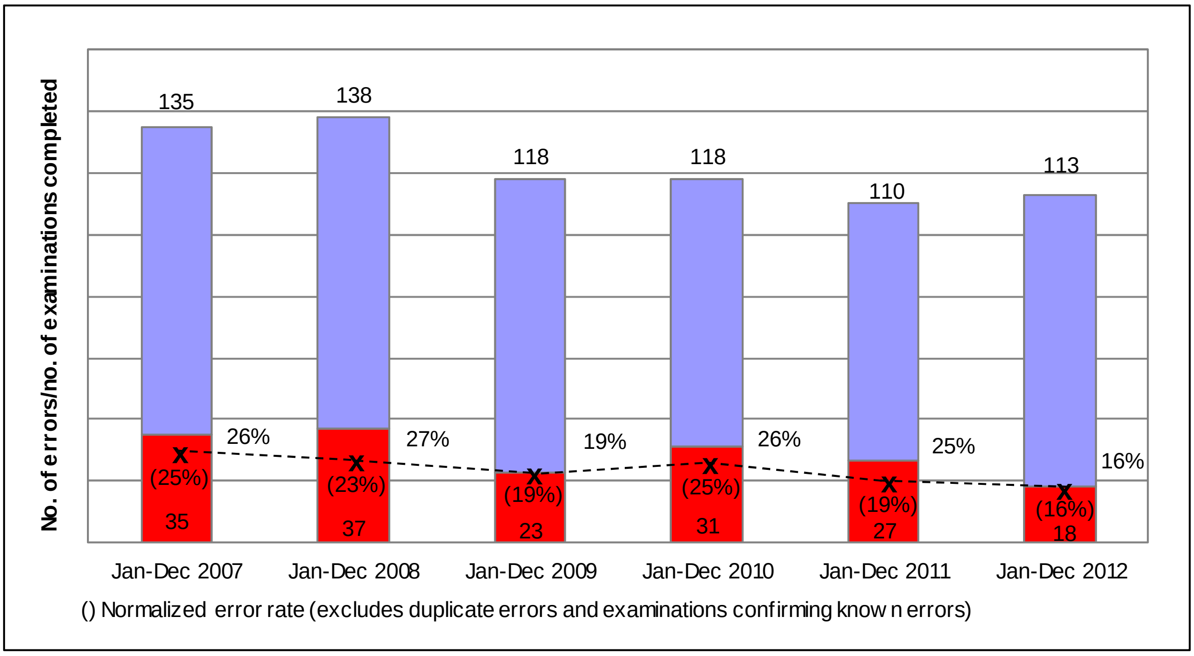


Figure 1: Completed FREP examinations, error rate trend

## 2.2 Examination results

The total error rate of 16% was below its high prior year level (25%), primarily because there were significantly fewer indication- and request-based examinations, which frequently result in findings of errors.

In addition to the sampling examinations, the FREP completed two indication-based examinations in 2012, including one examination of a semi-annual financial report. One additional examination of a semi-annual financial report was conducted at the request of the *Bundesanstalt für Finanzdienstleistungsaufsicht* (BaFin – Federal Financial Supervisory Authority) (see Figure 2). Seven further indication- or request-based examinations were started during the latter half of 2012; however, these examinations were still in progress at year-end.

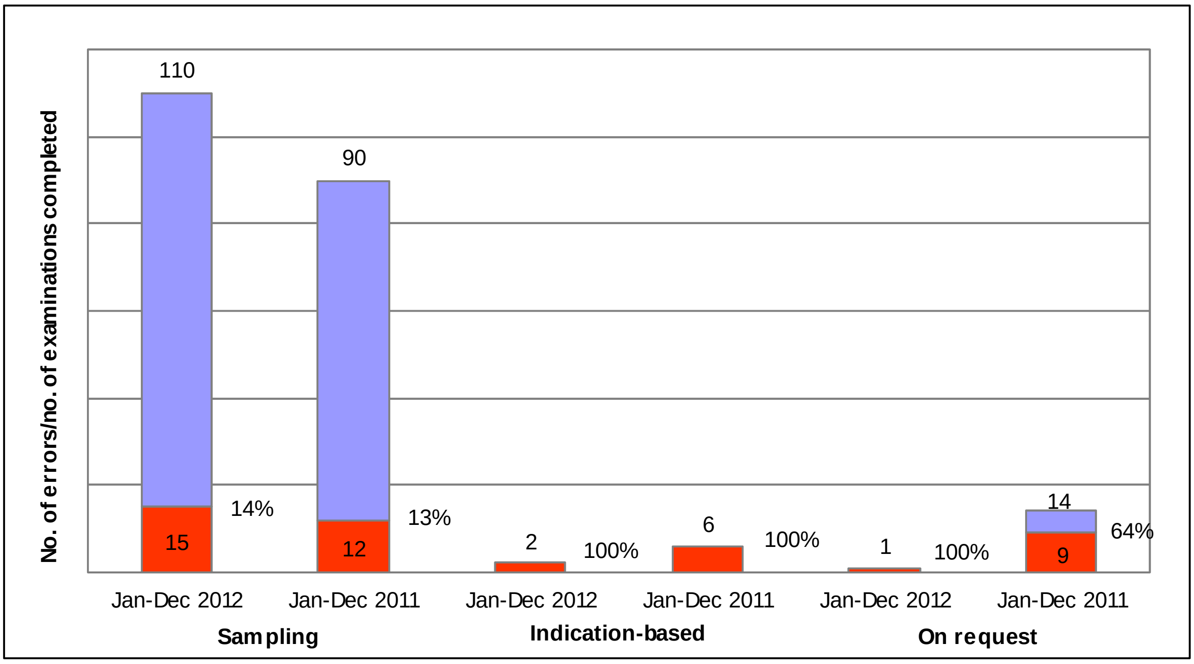


Figure 2: Completed FREP examinations by type of examination and error rate

In 2011, a normalized error rate was determined to facilitate a more refined presentation and analysis. The normalized rate reflected adjustments for duplicate errors and for examinations confirming known errors. The total number of examinations was adjusted by eight such cases in 2011, one indication-based and seven request-based examinations. These adjustments brought the normalized error rate for 2011 to 19%. No duplicate examinations of individual companies and no examinations confirming known errors were completed in 2012. Thus, it was not necessary to normalize the error rate and, therefore, the current year's normalized error rate is the same as the unadjusted rate (see Figure 1).

The following factors have probably also contributed to reducing the error rate in 2012:

- many companies were examined by the FREP for the second time,
- more attention on the part of supervisory boards and/or audit committees,
- the companies' economic situation has improved,
- proportionately fewer smaller companies in the population subject to enforcement,
- several companies left the regulated market following a FREP examination, and
- discussions with audit firms.

Errors were found in all three indication- or request-based examinations completed in 2012. This resulted in error rates of 100% for both of these types of examination, which was at or above the corresponding prior year level (100% for indication-based and 64% for request-based examinations). The error rate for sampling examinations was 14%, representing a slight increase from the prior year (13%, see Figure 2).

When analyzed by company size (see Figure 3), the picture is similar to that seen in the prior year: In 2011, the error rate for large companies, i.e. those included in a stock index, was clearly less than that for small and medium-sized companies not included in an index. This trend has grown even stronger in 2012. In 40 examinations (prior year: 43) of companies included in an index, the FREP found only three financial statements to be erroneous (error rate 8% for the current year and 14% for the prior year). A significantly higher error rate of 21% was observed for small and medium-sized companies not included in an index (prior year 31%), where 15 cases of erroneous financial statements were found in a total of 73 completed examinations.

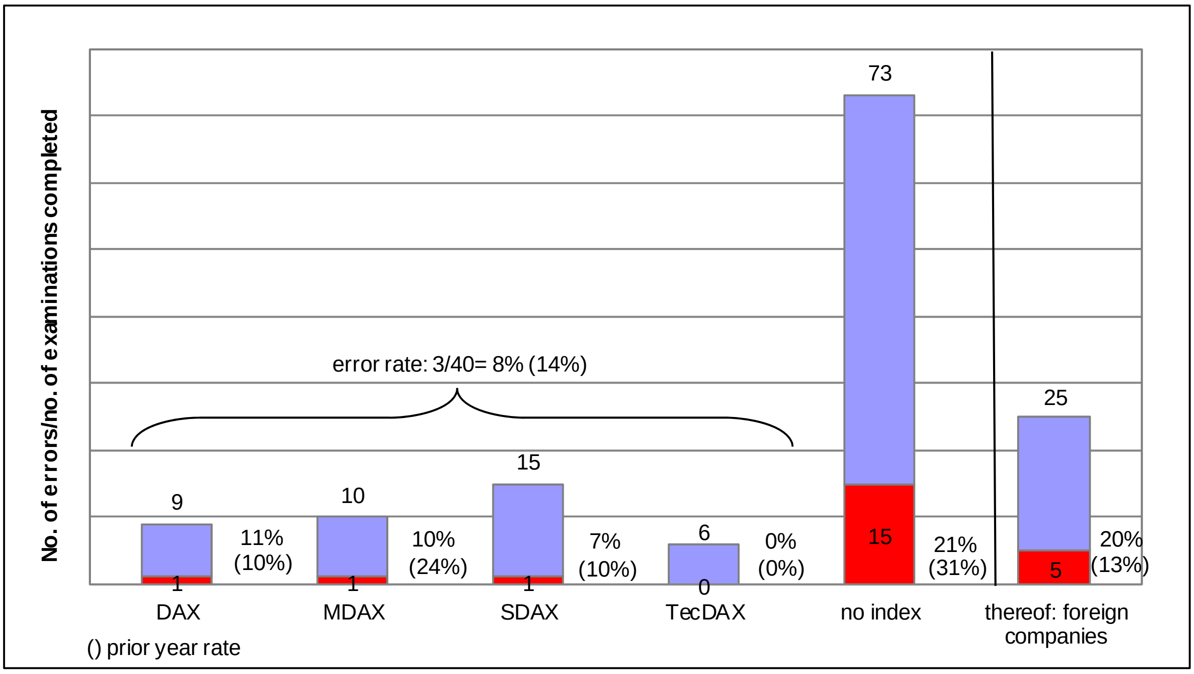


Figure 3: Completed FREP examinations by stock index, error rate

When the FREP finds a set of financial statements to be erroneous, it asks the company involved whether it accepts this finding. This official enquiry is normally preceded by a very thorough discussion with the company. The FREP believes that it is important to give the companies and their auditors the opportunity to present their views and arguments and to enter into open discussions. At 75%, the percentage of companies that accept the FREP's findings of an error remains high (see Figure 4). The FREP sees this as important evidence of the quality of its work.

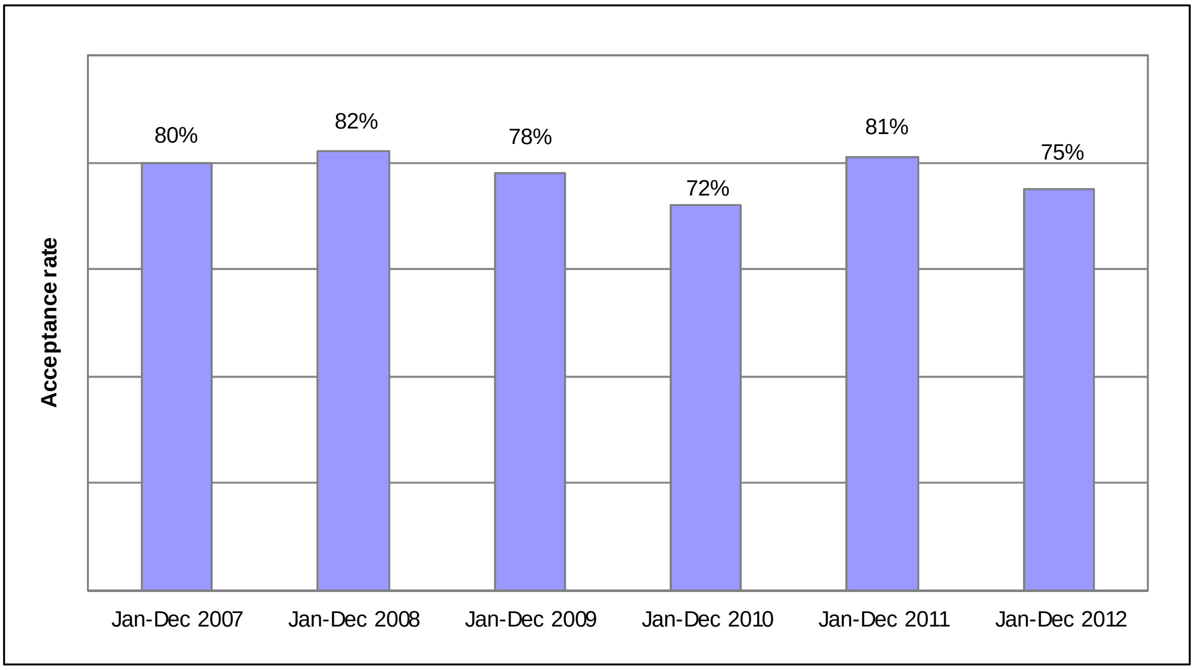


Figure 4: Trend in error acceptance rate

The FREP refers all cases in which it has found errors to the BaFin, regardless of whether the companies have accepted the findings. Where findings are not accepted, the BaFin performs its own additional examination. The BaFin completed a total of eight such cases in 2012. The FREP's result was confirmed in seven cases and the error was made public; in one case no examination was opened at the second enforcement tier, since an examination was no longer in the public interest as the company concerned had delisted.

### 2.3 Types of errors and analysis of errors

The 18 financial statements found to be erroneous include an average of two to three infringements per company. It should be noted that, as a result of a decision of the *Oberlandesgericht* (Higher Regional Court) Frankfurt, the FREP is obliged to also include as errors in the result of the examination any infringements that are individually immaterial to the financial statements examined if the examination finds that the financial statements are erroneous.

As in prior years, frequently recurring errors have been assigned to certain error categories. Figure 5 shows a ranking of the most frequently identified errors.

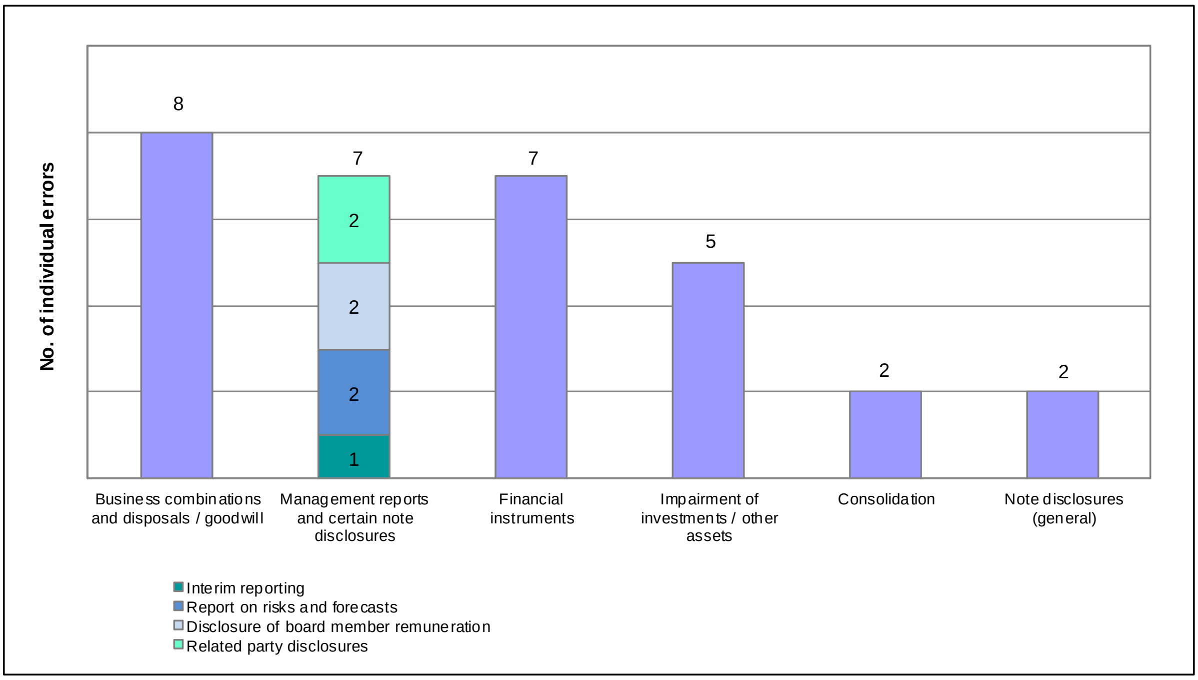


Figure 5: Most common types of errors

The FREP has identified two main causes of errors in 2012:

- o Insufficient reporting in the management report and in the notes and
- o Range and challenging application of certain International Financial Reporting Standards (IFRS).

As in the prior year, the disclosures in the group management report and in the notes were an important source of errors. For instance, the FREP found a total of two infringements related to insufficient or missing related party disclosures. Further errors relate to deficiencies in the disclosures of board member remuneration and future developments and risks facing the company, disclosures in the (interim) management report, as well as other note disclosures.

Errors arising from the range and challenging application and interpretation of certain IFRS were found mainly in the accounting treatment of business combinations with eight individual errors (prior year: seven individual errors), with infringements occurring in the areas of goodwill impairment testing (three individual errors) and purchase price allocation (two individual errors).

Accounting for financial instruments is another area characterized by challenging application and is thus prone to errors on the part of preparers. A total of seven infringements were found here, primarily concerning valuation issues and disclosures required in the notes to the (consolidated) financial statements.

Five additional individual errors were identified in relation to impairment of receivables or equity investments. Examples were overstatements of receivables or unrecognized impairments of equity investments.

Finally, the FREP observed weaknesses in how equity investments are reflected in consolidated financial statements. The two individual errors identified in this area related to incorrect accounting methods selected to incorporate such investments in the company's consolidated financial statements.

## 3 Error prevention

### 3.1 Recommendations to standard setters

In the FREP's more than seven years of operation, it has completed approximately 850 examinations covering the vast majority of companies subject to enforcement in Germany. The FREP incorporated this experience in the comment letter it issued last year on the IASB's Agenda Consultation 2011. The letter points out the weaknesses of selected standards and makes suggestions for remedying them. The deficiencies identified relate to issues including the capitalization of development costs (IAS 38) and accounting for goodwill (IAS 36). In addition, the comment letter criticizes the lack of enforceability of these standards.

These criticisms were also among the issues addressed in a speech held by Hans Hoogervorst, chairman of the International Accounting Standards Board (IASB), at the

International Association for Accounting Education & Research conference in Amsterdam on 20 June 2012. Firstly, Hoogervorst admitted that the valuation of intangible assets is one of the biggest challenges for financial statement preparers. Secondly, he stated that, in practice, goodwill impairment tests are not always done with sufficient rigor and that impairments are often recognized too late. Therefore, the IASB chairman is planning a review of the accounting treatment of goodwill as part of the post-implementation review of IFRS 3. Finally, Hoogervorst emphasized that restricting the scope for abuse in financial reporting standards will make a positive impact on their quality. In our view, reducing the scope for abuse within IFRS would improve their enforceability.

If the IASB follows up Hans Hoogervorst's speech with action, some of the challenges related to the application and enforcement of IFRS can be mitigated in the future.

### 3.2 Discussions with audit firms

As an instrument of prevention, the FREP's Presidential Board held discussions with the chairs of the management boards or managing directors of the five largest German audit firms during the prior year. In 2012, a similar dialogue took place with all medium sized audit firms auditing publicly listed companies in the context of a discussion platform the FREP set up in cooperation with the IDW.

These discussions are primarily aimed at sharing experiences regarding the errors found by the FREP in financial statements of companies audited by the audit firms, despite an unqualified audit opinion having been issued. Both sides benefit equally from these talks: On the one hand, they raise the audit firms' awareness of avoidable errors in order to largely prevent such future errors wherever possible; the FREP, on the other hand, receives useful recommendations from the audit firms, which it incorporates in its examination procedures.

The first round of these discussions showed that both the audit firms and the FREP profited significantly from this sharing of experiences and that it was received very positively by all participants. In light of this, the dialogue will be repeated regularly.

### 3.3 Main focus areas for 2013

During the fourth quarter of each calendar year, the FREP defines the main focus areas for the following calendar year, which are addressed in all of our sampling examinations unless they are immaterial. The main focus areas are primarily selected based on the FREP's experience with standards and/or accounting issues that are frequently applied/treated incorrectly; reference to current economic developments that may impact accounting and reporting; and selected recently issued new standards. In addition to the well known accounting issues that have proven to be particularly prone to error recently, the FREP will also focus its examinations on accounting for defined benefit pension obligations, non-cash income and expenses, and correction of errors in 2013. The following main focus areas for 2013 were established in October 2012:

1. Impairments of assets including goodwill
   - Consistency of cash flow projections for cash generating units with related operating budgets/forecasts, particularly with respect to the forecasting period
   - Reasonableness of forecasted cash flows during the detailed forecasting period, particularly if forecasts were not achieved in the past or if assumptions differ from market data
   - Reasonableness of growth rate and discount rate (determination of the peer group in calculating the cost of capital; derivation of the discount rate according to the timing of the underlying cash flows (IAS 36.56))
   - Sufficiently precise disclosure of valuation methods and underlying assumptions (IAS 36.134)

2. Accounting for defined benefit pension obligations
   - Reasonableness of actuarial assumptions (particularly discount rates) used to determine the obligation (IAS 19.75, IAS 19.78)
   - Determination of the expected return on plan assets (IAS 19.106) and valuation of plan assets (IAS 19.102)
   - Completeness of disclosures on pension obligations and plan assets in the notes to the consolidated financial statements
   - Disclosures on IFRS issued but not yet effective (IAS 8.30) with respect to pension obligations

3. Non-cash income and expenses

   – Additions to and reversals of restructuring provisions
   – Gains and losses on subsequent purchase price adjustments (IFRS 3.58)
   – Gains and losses related to business combinations achieved in stages (IFRS 3.42)
   – Gains on bargain purchases

4. Group management report

   – Presentation of significant factors impacting results of operations (GAS 15.50)
   – Complete and accurate presentation of significant risks in accordance with GAS 5.10
   – Report on forecasts in relation to segments (GAS 15.89)

5. Correction of errors

   – Understandable presentation of the nature of the corrected error in the notes to the consolidated financial statements (IAS 8.49)
   – Correct presentation in the consolidated balance sheet across three periods (IAS 1.39) and in the statement of shareholders' equity (IAS 1.106(b))

### 3.4 Other preventative measures

In many examinations, the FREP makes recommendations to companies for future financial reporting purposes even if no errors are formally identified. This helps avoid weaknesses in future financial statements and improves the quality of financial reporting. The frequency distribution of such recommendations (see Figure 6) shows that they again related particularly to business combinations and disposals as well as to management reports.

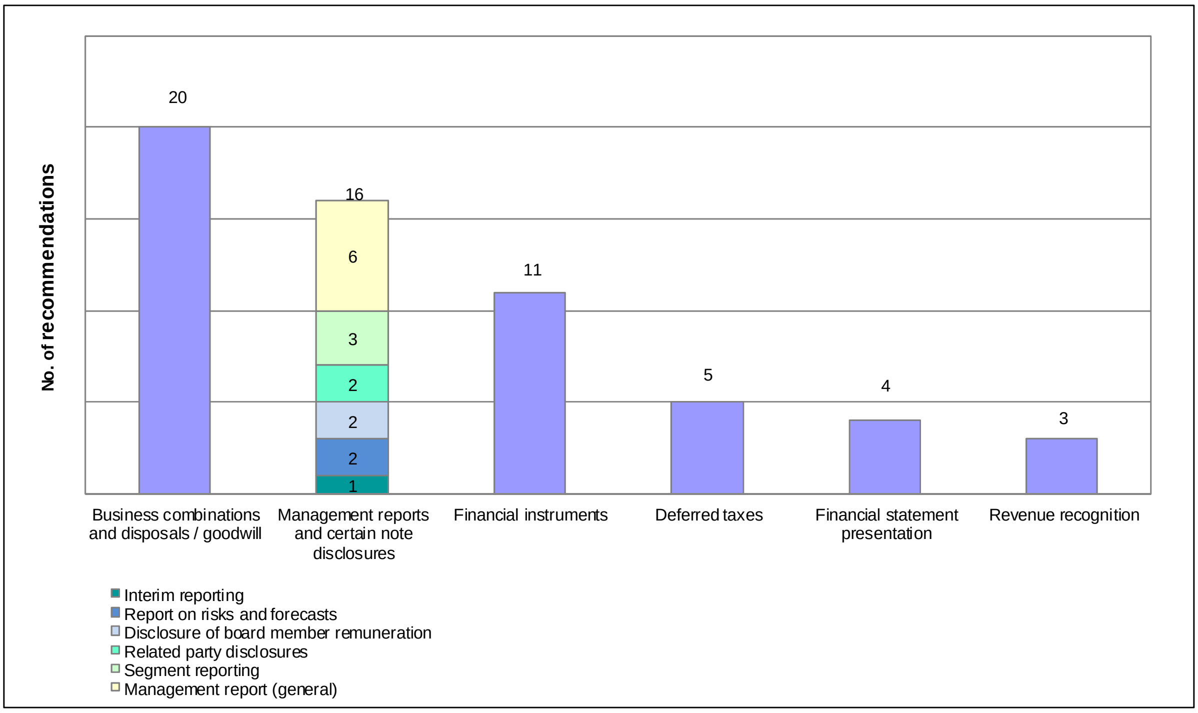


Figure 6: Most common recommendations to companies examined

The pre-clearance enquiry instrument, which was introduced in November 2009, was utilized four times in 2012, while one enquiry was made in the prior year. This procedure helps avoid errors at the time financial statements are prepared and thus strengthens the FREP's preventative function.

All pre-clearance enquiries in 2011 and 2012 met the requirements to be accepted for review by the FREP. Since the introduction of the pre-clearance enquiry, the FREP has considered the proposed accounting treatment acceptable in seven cases, while in four cases it was not considered acceptable. Pre-clearance enquiries were dealt with on a timely basis to provide guidance to the enquiring companies when preparing their financial statements, thus fulfilling the instrument's preventative function.

To help improve the quality of accounting for goodwill, which has proven to be one of the most frequent sources of errors in financial reporting, the FREP participated in the survey on goodwill impairment and amortization by the European Financial Reporting Advisory Group (EFRAG) and the Organismo Italiano di Contabilità (OIC). This survey took place in preparation for the post-implementation review of IFRS 3 "Business Combinations". In its response, the FREP again advocated amortizing goodwill, as it did in its comment letter on the IASB's Agenda Consultation 2011.

In order to encourage a preventative dialogue with the public, the FREP has, as in prior years, presented information on its work and its results through appearances at many events relating to business administration and financial reporting. In addition, the FREP published the results of its most recent examinations and its most important plans through press releases and/or press conferences.

## 4 International cooperation

At the European level, the European Securities and Markets Authority (ESMA) founded in 2011 is responsible for coordinating the work of the national enforcement institutions in order to promote consistency in applying IFRS.

The activities of national enforcers are primarily coordinated by way of the European Enforcement Coordination Sessions (EECS) established by the Committee of European Securities Regulators (CESR), the ESMA's predecessor organization. These meetings, which are held approximately every two months, are used to discuss IFRS application issues of transnational interest in order to promote the uniform interpretation of IFRS requirements and the sharing of initial experiences with the application of new IFRS within Europe. The activities of the EECS and national enforcers in 2011 are summarized in the ESMA's Activity Report on IFRS Enforcement in the European Economic Area in 2011.

To further harmonize enforcement in Europe, the ESMA has asked a working group to revise the CESR Standards on Financial Reporting. The result of this work is expected to be announced in the first quarter of 2013 in the form of "ESMA Guidelines on Enforcement". We appreciate the ESMA's efforts to ensure that European enforcers are following a consistent approach. However, specific national characteristics should not be ignored in this process. A working group has been established to promote the consistent application of the concept of materiality by financial statement preparers, auditors, and enforcers. The group issued a consultation paper entitled "Considerations of materiality in financial reporting" in November 2011 and published a summary of comment letters received in August 2012. Commenters agreed largely unanimously that any clarification regarding the application of the concept of materiality should be developed by the IASB and not by the ESMA. The ESMA held a roundtable on the consultation document and related comment letters on 1 October 2012. Based on these comments and the discussions at the roundtable, the ESMA will publish a final Feedback Statement in 2013. The FREP would sincerely appreciate if the conclusions reached by the ESMA were in line with the results of the consultation. The BaFin and the FREP represented German interests in both working groups.

To promote the consistent application of IFRS in Europe, the ESMA published several reports addressing current financial reporting issues in 2012. The FREP played a key role in preparing the ESMA report “European enforcers review of impairment of goodwill” released in January 2013. It analyzes the accounting practices of 235 European issuers related to impairment testing of goodwill and intangible assets based on a desktop review. The report shows that, although the consolidated financial statements reviewed did provide the major disclosures related to impairment testing, in many cases these disclosures were not informative enough, too general, and not entity-specific (i.e. boilerplate). The ESMA urges financial statement preparers to provide a meaningful and appropriate sensitivity analysis. This applies particularly to companies where the book value of their net assets exceeds their market capitalization. Companies and their auditors are well advised to give due consideration to the recommendations made in the report. They address issues that are significant to the FREP’s main focus area for 2013 “Impairments of assets including goodwill”.

The ESMA report “Review of Greek Government Bonds accounting practices in the IFRS Financial Statements for the year ended 31 December 2011” also criticizes the insufficient transparency of note disclosures.

Low equity bases in the banking sector and the precarious economic situation of many borrowers have moved the issue of forbearance into the focus of European banking regulators. The term “forbearance” is associated with measures taken by banks in response to a deterioration in their borrowers’ credit quality, such as modifying loan terms and conditions or deferring interest and principal payments. While the European Banking Authority (EBA) and the European Systemic Risk Board (ESRB) are dealing with assessing the related systemic risks, the ESMA is calling for a uniform approach to reflecting forbearance-related issues in companies’ financial statements. In its public statement on the “Treatment of Forbearance Practices in IFRS Financial Statements of Financial Institutions“, the ESMA is urging financial institutions to test assets subject to forbearance measures for impairment and to disclose qualitative as well as quantitative information about these assets in the notes.

In 2012, the ESMA and national enforcers have, for the first time, agreed on European common enforcement priorities with respect to separate and consolidated financial statements of publicly listed companies for the fiscal year ended 31 December 2012. The priorities announced by the ESMA in a public statement in November 2012 relate to accounting for financial instruments, defined benefit pension obligations, and provisions, as well as to impairment of non-financial assets. These are largely consistent with the FREP's main focus areas. In particular cases, the issue of accounting for financial instruments, while not one of the FREP's main focus areas for 2013, may nevertheless be covered in an examination.

## 5 Acknowledgements and outlook

The FREP was able to continue its work successfully in 2012, and would like to thank the companies examined 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 German Federal Ministries of Justice and Finance, and in particular the BaFin, the *Deutsches Rechnungslegungs Standards Committee* (DRSC – Accounting Standards Committee of Germany), the audit firms, the IDW, the *Abschlussprüferaufsichtskommission* (APAK – German Auditor Oversight Commission) and the *Wirtschaftsprüferkammer* (WPK – German Chamber of Public Accountants). Special thanks go to the panel members, the management and the office staff for their consistently dedicated and exceptionally professional work.

The normalized error rate has seen a drop of three percentage points to 16% and the total error rate for 2012 of 16% is below the high prior year level (25%). The FREP will continue its prevention-related activities in order to improve the quality of financial reporting for the long term.

In addition, the FREP, together with the BaFin, will cooperate closely with European enforcers with the objective of further harmonizing enforcement activities and promoting the consistent application of IFRS requirements in Europe.

Beginning in 2013, Austria will also have an enforcement institution responsible for strengthening the trust capital market investors place in financial market information. The FREP welcomes this step and views the fact that the Austrian enforcement model incorporates elements of the German system as further confirmation of the effectiveness of this model. Against this background and in light of the regulatory developments in the European context, the FREP will continue to promote the successful two-tier enforcement model.

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