DPR FREP DEUTSCHE PRÜFSTELLE FÜR RECHNUNGSLEGUNG
FINANCIAL REPORTING ENFORCEMENT PANEL

FREP Presidential Board Berlin, 30 January 2014

Annual Activity Report 2013

1 Overview

- In 2013, the FREP completed 110 examinations (prior year: 113), including 98 sampling examinations and 12 examinations that were indication-based or performed at the request of the *Bundesanstalt für Finanzdienstleistungsaufsicht* (BaFin – Federal Financial Supervisory Authority). At 14%, the rate of financial reports found to be erroneous was lower than last year's rate of 16%.

- A normalized error rate was determined again 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 11% in 2013 (prior year: 16%).

- A follow-up on 2012 found positive results: Errors identified were corrected in the subsequent financial statements and companies implemented the FREP's recommendations.

- As part of their efforts to prevent errors, the FREP again held discussions with audit firms auditing publicly listed companies to share experiences in 2013.

- The FREP regularly discusses current issues related to enforcement of financial reporting in Germany and Europe with representatives of the BaFin, the Federal Ministry of Justice and Consumer Protection, as well as the Federal Ministry of Finance.

- The FREP's expenses of EUR 5.4 million were slightly higher than in the prior year (EUR 5.2 million).

2 Examinations in 2013

2.1 Examination results

In 2013, the FREP completed a total of 110 examinations (prior year: 113). 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.

Since the FREP was founded in 2005, the vast majority of companies subject to enforcement in Germany have had at least one examination.

Although examinations remained highly rigorous, the total error rate of 14% was slightly below that of the prior year (16%) (Figure 1).

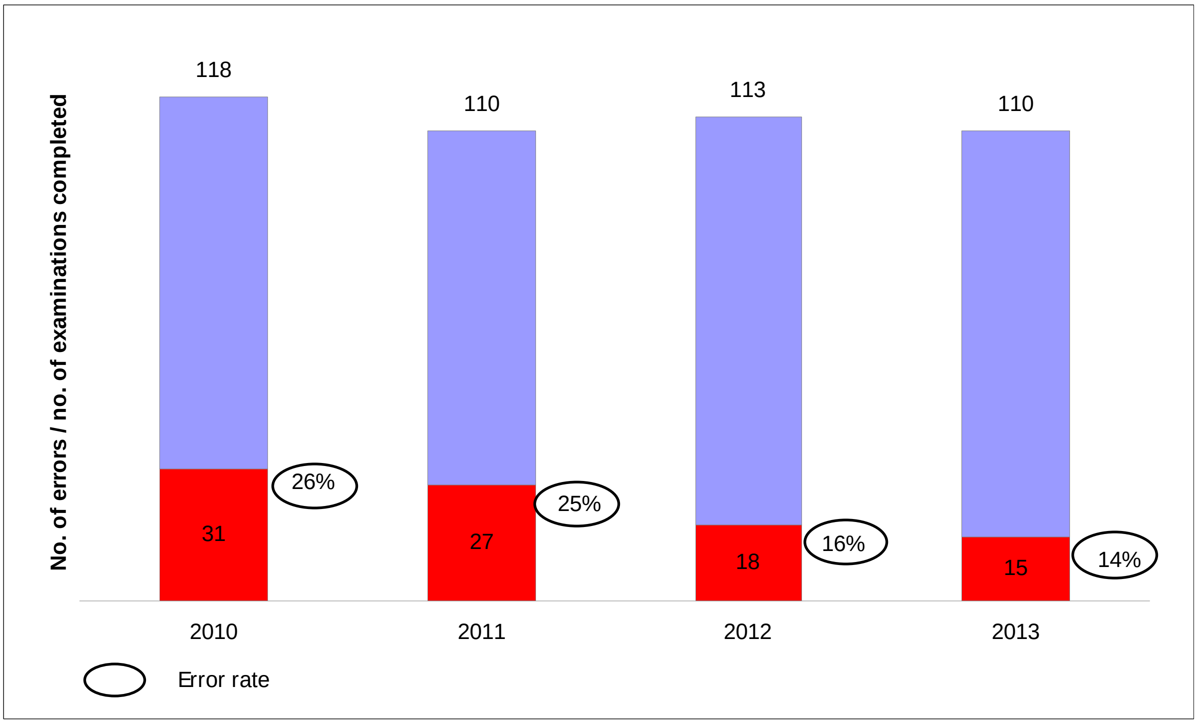

Figure 1: Completed FREP examinations, error rate trend

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. These adjustments, which related to one indication-based and two request-based examinations, brought the normalized error rate to 11% (Figure 2).

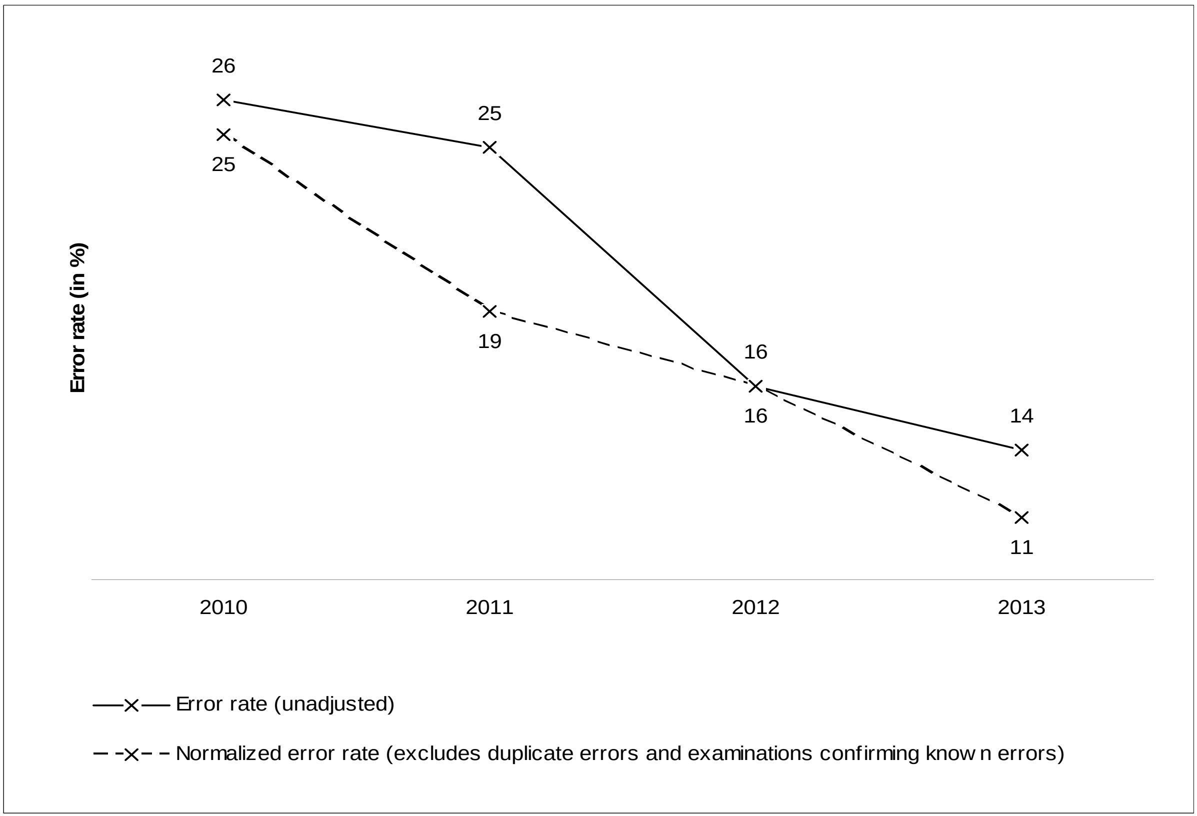

Figure 2: Error rate trend

As in 2012, in the FREP's view, there are several reasons for the decline in the error rate in recent years:

- the second examination for many companies,
- more attention on the part of supervisory boards and/or audit committees,
- the improvement of the companies' economic situation,
- proportionately fewer smaller companies in the population subject to enforcement,
- several companies having left the Regulated Market, and
- discussions with audit firms.

These reasons are supported by a recent study by DAI and PwC[1] summarizing the experience of publicly listed companies with the FREP's examinations as follows:

[1] See DAI/PwC (Ed.): Enforcement of Financial Information 2013. Experience of listed companies with the enforcement of financial reporting by the Financial Reporting Enforcement Panel, Frankfurt/Main and Munich 2013.

"1. Communication, examination processes, and cooperation of all parties to the process are now well established;
2. Companies are preparing the examinations professionally and more comprehensively;
3. FREP examinations have become a well established component of the rules governing publicly listed companies and are clearly perceived as normal;
4. The effect of enforcement of financial information on financial reporting goes beyond mere findings of errors;
5. "Normality" also includes the fact that companies have come to perceive the impact on the capital markets of a potential error in financial reporting as less dramatic;
6. However, findings and FREP examinations continue to command great respect among companies."[2]

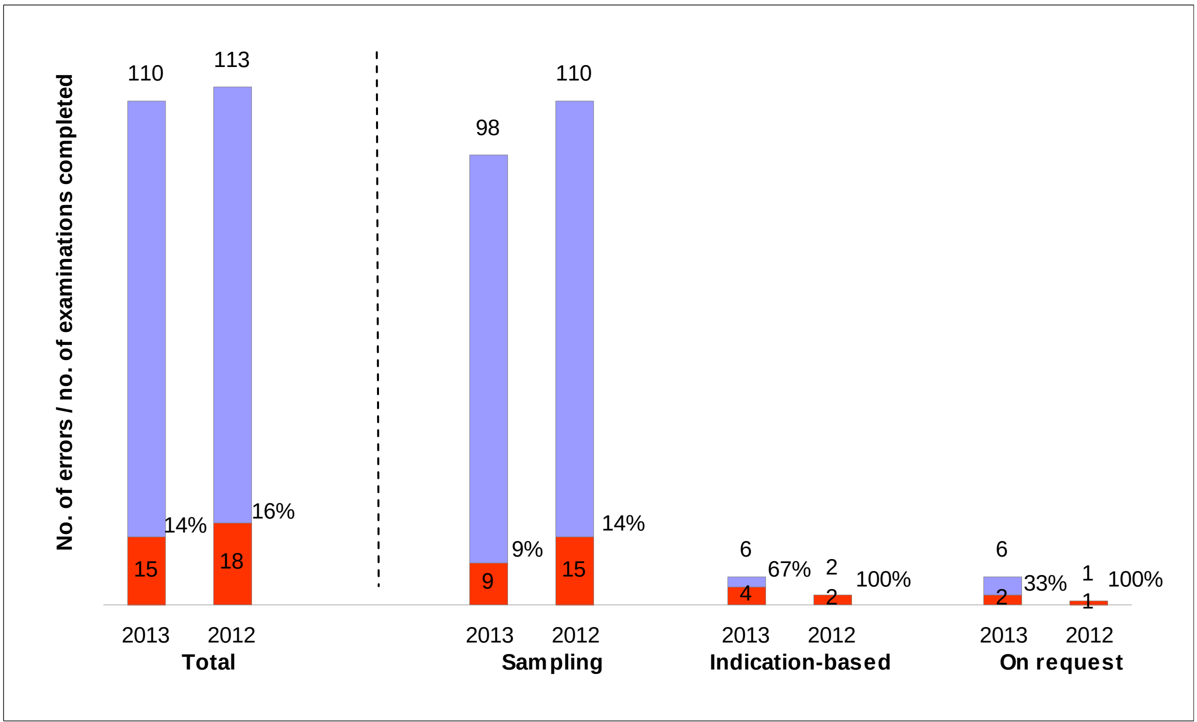

Figure 3: Completed FREP examinations by type of examination and error rate

The total number of examinations in 2013 was structured as follows: In addition to the 98 sampling examinations, the FREP completed six indication-based examinations, including three examinations of semi-annual financial reports. Six additional examinations were

[2] See Kliem, Bernd: Enforcement of Financial Information 2013. Speech at DAI Annual Convention "Enforcement of Financial Information 2013/2014" on 15 October 2013 in Frankfurt/Main, pg. 22.

conducted at the request of the BaFin, including one examination of a semi-annual financial report (Figure 3).

That brings the total number of indication- and request-based examinations for 2013 to 12, significantly more than in the prior year (3). As expected, the error rate for these examinations exceeds that found in sampling examinations.

Looking at company size, the situation has changed from the prior year: In 2013, the error rate of 13% for large companies (those included in a stock index) was at a similarly high level as the 14% error rate for small and medium-sized companies (which are not included in an index) (Figure 4).

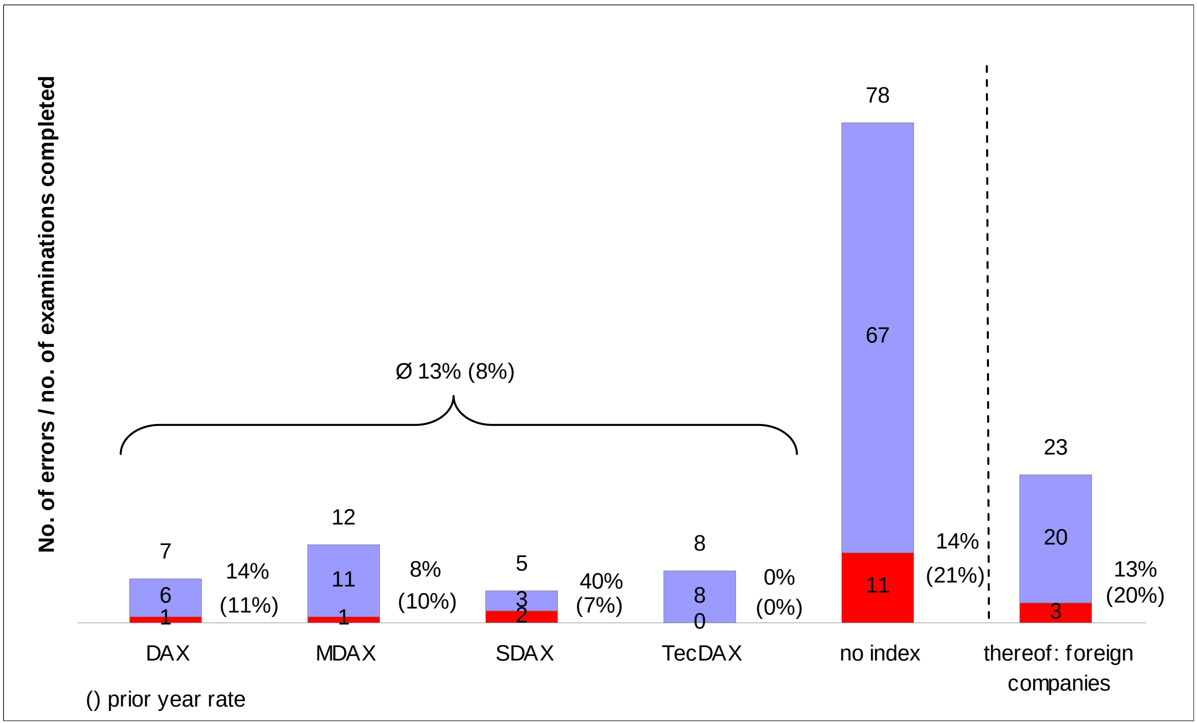

Figure 4: Completed FREP examinations by stock index and error rate

2.2 Types of errors and analysis of errors

The 15 financial reports 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.

In 2013, as in the prior years, the errors found were primarily attributable to the following factors:

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

Figure 5 shows a ranking of the most frequently identified errors.

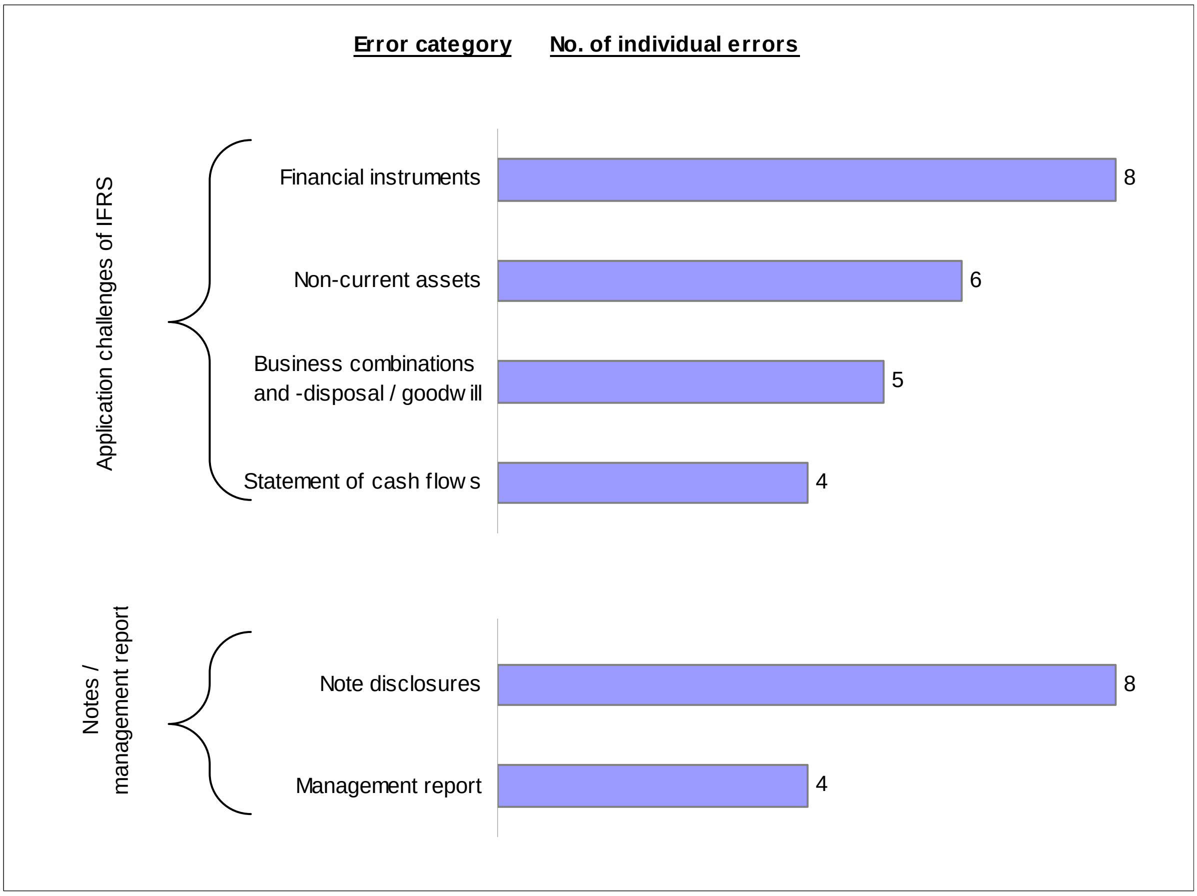

Figure 5: Most common types of errors

Errors arising from the comprehensiveness, application challenges and interpretation of certain IFRS were found mainly in the accounting treatment of financial instruments, with a total of seven individual errors affecting profit or loss.

Another six infringements affected the accounting for non-current assets, including four relating to the incorrect presentation of property, plant and equipment, investments in subsidiaries, or intangible assets.

Accounting for business combinations is another area characterized by application challenges and is thus frequently prone to error. A total of five infringements were found here, primarily concerning the purchase price allocation and goodwill impairment testing. The FREP also identified weaknesses in the presentation of statements of cash flows.

As in prior years, the group management report and the notes were an important source of errors. For instance, the FREP found a total of three infringements related to insufficient or missing related party disclosures. In another three cases, the FREP criticized that the group management report did not contain a balanced and comprehensive analysis of the company's course of business and situation.

2.3 Acceptance rate

When the FREP finds a financial report to be erroneous, it asks the company involved whether it accepts this finding. A finding of an error is normally preceded by very thorough discussions 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. The percentage of companies that accept the FREP's findings of an error remains high (Figure 6). The FREP sees this as important evidence of the quality of its work.

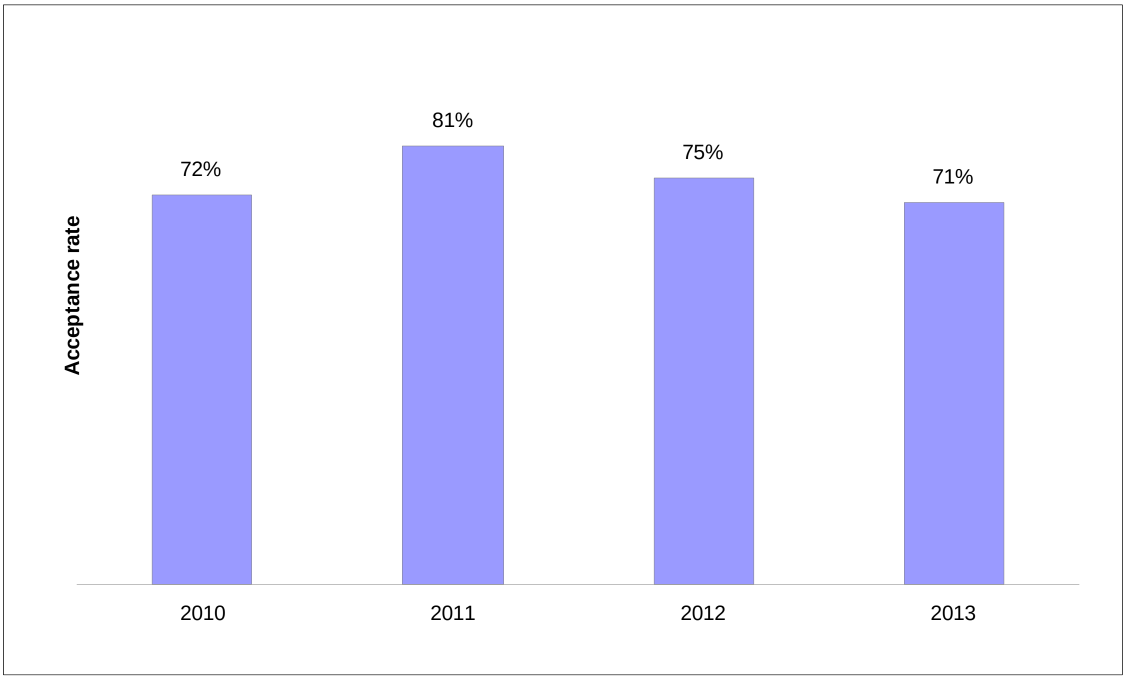

Figure 6: Trend in error acceptance rate

All cases in which errors are found are automatically referred to the BaFin, regardless of whether the companies have accepted the finding. Where findings are not accepted, the BaFin performs its own additional examination. The BaFin completed a total of three such cases in 2013. The FREP's result was confirmed in two cases and the error was made public; in one case the examination was stopped at the second enforcement tier, since an examination was no longer in the public interest as the company concerned had delisted.

2.4 Correction of errors

In 2013, the FREP for the first time systematically followed up on the correction of errors found in the prior year (Follow-up 2012). All companies where the FREP identified an error and that are still listed in the Regulated Market (10 out of 18) corrected the error in the subsequent financial statements. For the remaining companies (8 out of 18) which have issued shares or listed debt instruments, the situation is as follows: Three companies delisted by way of a merger or acquisition, three companies moved to the over-the-counter market, and the remaining two repaid their debt instruments (Figure 7).

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

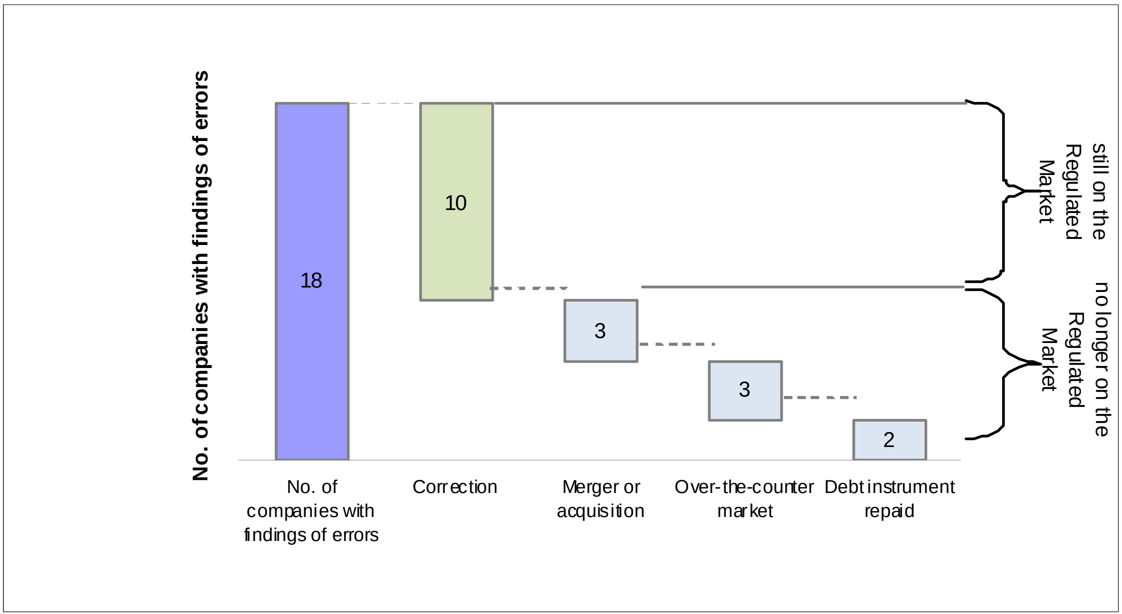

Figure 7: Correction of errors found in 2012

3 Error prevention

3.1 Implementation of recommendations

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 shows that they were made primarily with respect to notes and management reports, financial instruments, current and deferred taxes, revenue recognition, as well as business combinations and disposals (Figure 8).

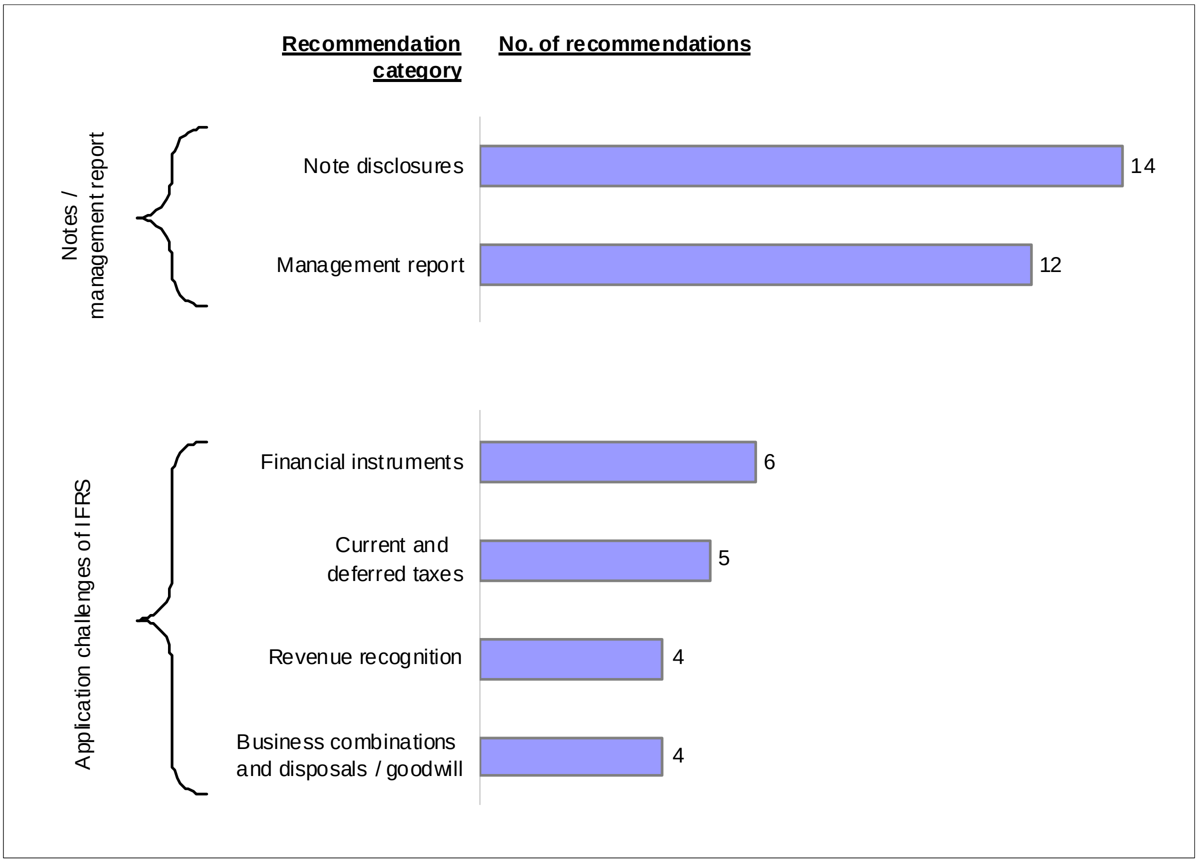

Figure 8: Most common recommendations to companies examined

The first review of the implementation of FREP recommendations, performed in 2013, provides an encouragingly positive view: Out of a total of 40 companies with recommendations, all 27 companies where the recommendations were still relevant to the subsequent financial statements implemented the FREP's recommendations. For 12 companies, however, either it was not possible to determine whether the recommendation had been implemented by just reviewing the subsequent financial statements[3], or the errors remained immaterial, and the error correction was not omitted to achieve a certain presentation of net assets, financial position, or earnings. Only one company with recommendations left the Regulated Market for the over-the-counter market. To help prevent errors, the FREP will continue to regularly follow up on whether recommendations are implemented.

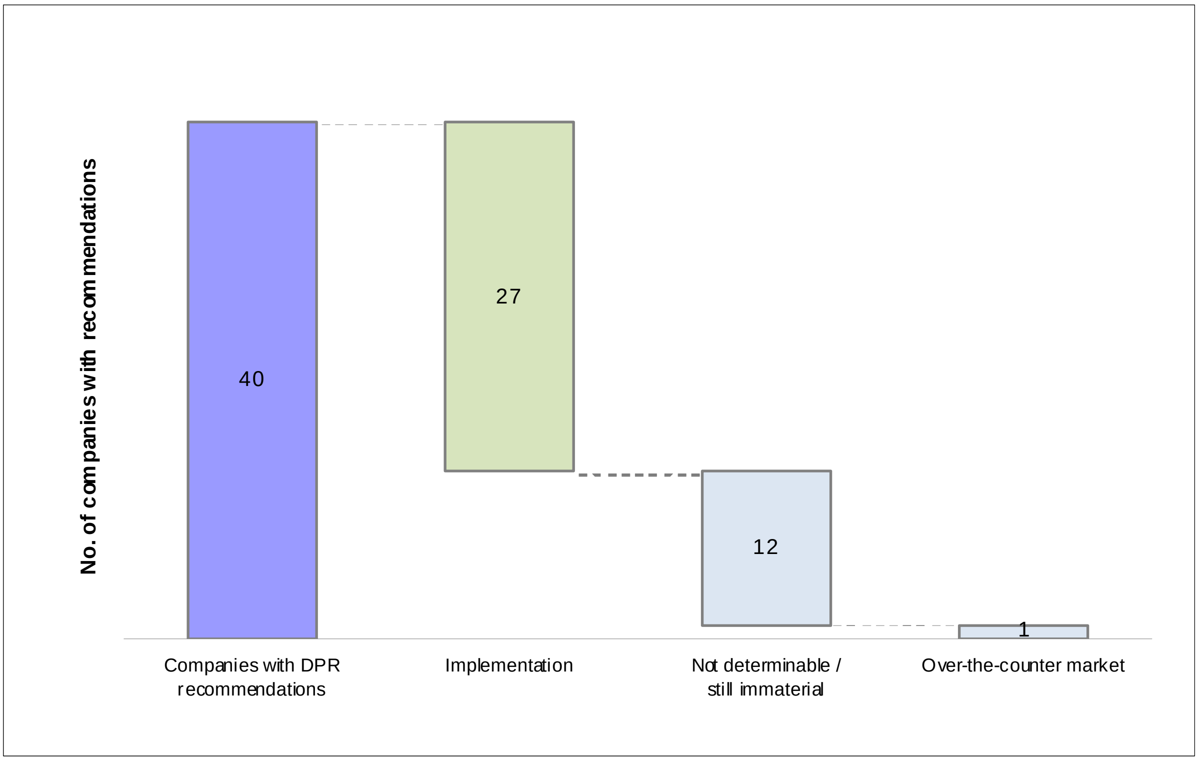

Figure 9: Implementation of recommendations made in 2012

The preventative effect of the recommendations was documented in the study by DAI and PwC: Only 10% of the companies participating in the study had received a finding of an error from the FREP, but 38% confirmed that they had changed their accounting practices following a FREP examination[4].

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[3] E.g. recommendations on the method of determining the discount rate for impairment testing purposes.

[4] See DAI/PwC (Ed.), Enforcement of Financial Information 2013. Experience of listed companies with the enforcement of financial reporting by the Financial Reporting Enforcement Panel, Frankfurt/Main and Munich 2013, pg 20.

3.2 Pre-clearance enquiries

The pre-clearance enquiry instrument, which was introduced in November 2009, was utilized four times in 2013 (prior year: 4). This procedure helps avoid errors at the time financial statements are prepared and thus strengthens the FREP's preventative function.

All pre-clearance enquiries received in 2013 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 eight cases, while in seven 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.

3.3 Main focus areas for 2014

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 its sampling examinations to the extent they are material. 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 focus its examinations especially on the goodwill impairment test, business combinations, and accounting for defined benefit pension obligations in 2014.

The following main focus areas were defined in October 2013 for 2014:

1. Goodwill impairment test
   - Consistency and reliability of cash flow forecasts (external sources, management reports, past plan achievement)
   - Derivation of growth rate and discount rate (peer group analysis, derivation of beta and debt to equity ratio) (IAS 36.55 et seq.)
   - Sufficiently detailed description of key valuation assumptions (IAS 36.134 (d) and (e), IAS 1.125)

2. Business combinations
   - Determination of fair values with respect to the principles of IFRS 13
   - Meaningful note disclosures regarding the factors giving rise to goodwill or a gain on a bargain purchase and regarding the financial effect of the business combination (IFRS 3.59 et seq., IFRS 3 Appendix B64 (e), (n) and (q))

3. Accounting for defined benefit pension obligations
   - Transparency and consistency in the determination of the discount rate (IAS 19.135 et seq.)
   - Description of the characteristics of the benefit plan and the associated risks (IAS 19.139)
   - Presentation and sensitivities of actuarial assumptions (IAS 19.144 et seq.)
   - Presentation of a third statement of financial position where initial application of IAS 19 (2011) has a material effect (IAS 1.40A)

4. New consolidation standards
   - If IFRS 10, 11, 12 are applied early in 2013:
     - Determination of entities to be consolidated in accordance with IFRS 10
     - Assessment of joint arrangements (joint operation versus joint venture) in accordance with IFRS 11
     - Note disclosures in accordance with IFRS 12
   - If the new consolidation standards are initially applied in 2014:
     Meaningful note disclosures on the expected impact in accordance with IAS 8.30

5. Group management report, particularly new requirements arising from GAS 20
   - Comparison of prior year forecast with actual results (GAS 20.57)
   - Increased requirements regarding level of detail of forecasts (GAS 20.128)
   - Presentation of risks (GAS 20.146 et seq.) and the risk management system (GAS 20.K137 et seq.)

3.4 Discussions with audit firms

Since 2011, the FREP's Presidential Board has held annual discussions with the chairs of the management boards or managing directors of the five largest German audit firms. A similar dialogue with all medium-sized audit firms auditing publicly listed companies takes place in the context of a discussion platform the FREP has set up in cooperation with the *Institut der Wirtschaftsprüfer* (IDW – Institute of Public Auditors in Germany).

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.

3.5 Discussions with representatives of "China-AGs" listed on German stock exchanges

Since 2007, the Regulated Market of the Frankfurt Stock Exchange has seen 13 initial public offerings of German AGs with operations located exclusively in China ("China-AGs"). As a result of their listing on the Regulated Market, the "China-AGs" are part of the population of companies subject to examination by the FREP. Except for the auditors, the FREP generally does not have a contact person in Germany for its examinations since the operating company, including its management, is located in China. Information is exchanged in English by telephone and e-mail with the chief financial officer resident in China. In addition to the problems with communication, the FREP faces significant challenges in performing its examination. For example, it is difficult to assess ownership of assets, recoverability of real estate and receivables and the extent of transactions with related parties.

In order to improve the reliability and credibility of the financial reporting of "China-AGs" in the future, thus strengthening confidence in the capital market, the FREP held discussions with the auditors, supervisory boards, and – at the German Equity Forum in Frankfurt – with the representatives of the executive boards of the "China-AGs". During these discussions, the participants were made aware of the existing problems and risks.

4 Cooperation with ESMA

4.1 Overview

The objectives of the European Securities and Markets Authority (ESMA), which emerged from the Committee of European Securities Regulators (CESR) in 2011, include developing uniform standards for high-quality enforcement in Europe and ensuring the consistent application of IFRS. ESMA coordinates the activities of national enforcers primarily by way of the European Enforcement Coordination Sessions (EECS). In addition, ESMA prepares comment letters and opinions and establishes working groups e.g. to perform reviews of how selected IFRS standards are applied in the financial statements of European publicly listed companies.

In 2013, the ESMA and national enforcers have, for the second time, agreed on European common enforcement priorities with respect to consolidated financial statements of publicly listed companies for the fiscal year ended 31 December 2013. The priorities announced by the ESMA in a public statement in November 2013 relate to impairment of non-financial assets, defined benefit pension obligations, and fair value accounting. These are largely consistent with the FREP's main focus areas. The ESMA issues "Disclosures related to significant accounting policies, judgments and estimates" and "Measurement of financial instruments and disclosure of related risks" will be covered in a FREP examination if they are significant to the financial statements being examined and there are no other issues that are more relevant to these financial statements.

4.2 Participation in the European Enforcers Coordination Sessions

At the EECS sessions, which are held approximately nine times per year, national enforcers discuss, among other things, 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.

In 2013, the FREP presented numerous cases arising from ongoing examinations as emerging issues to the EECS, i.e. before a decision was taken in the national enforcement procedure. To the extent that the discussion at the EECS level shows that there is diversity in practice or that the interpretation of the standard is unclear, the case was or is being presented to the IFRS Interpretations Committee (IFRS IC). In addition, the FREP has provided decisions reached in specific examinations to the EECS for information.

The activities of the EECS and national enforcers were summarized in the ESMA's "Activity Report of the IFRS Enforcement activities in Europe in 2012" published in July 2013.

4.3 Working group on the ESMA Guidelines on Enforcement

To further harmonize enforcement in Europe, the ESMA has asked a working group, which includes representatives of the BaFin and the FREP, to revise the CESR Standards on Financial Reporting. In July 2013, the preliminary results of this work were announced in the form of a consultation paper titled “ESMA Guidelines on enforcement of financial information”. In November 2013, 31 comment letters on this consultation paper, including 7 from Germany, were published on the ESMA website. All of these comment letters welcome the ESMA’s efforts to ensure that European enforcers are following a consistent approach. However, several commenters point out that ESMA is not authorized to establish requirements regarding the structure and activities of national enforcers that go beyond the scope of applicable EU law. Rather, the responsibility for developing their national enforcement systems lies with the legislative bodies of the various member states. This view was also expressed by the Federal Ministry of Justice[5] and the Federal Ministry of Finance in their comment letter. With respect to the German two-tier enforcement process, several national comment letters commented positively on the general acceptance enjoyed by the Financial Reporting Enforcement Panel and the effectiveness and efficiency of its work.[6] The comment letter by the two Federal Ministries states, for instance: “Germany has a recognized and functioning two-tier enforcement system that ensures effective enforcement of financial reporting. This system has proven successful. Therefore, the Federal Government has no reason to question the existing two-tier enforcement model.”[7] The FREP, too, would very much welcome the ESMA foregoing requirements regarding the structure of national financial reporting enforcement systems in its efforts to harmonize enforcement and instead focusing more on requirements increasing the quality of enforcement in Europe.

4.4 Participation in other ESMA projects

To promote the consistent application of IFRS in Europe, the ESMA published two reports addressing current financial reporting issues in 2013. The FREP played a key role in preparing the ESMA report “European enforcers review of impairment of goodwill and other intangible assets in the IFRS financial statements” 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 sufficiently informative, too

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[5] Now: Federal Ministry for Justice and Consumer Protection.

[6] E.g. in the comment letters issued by the Federal Ministry of Justice and Consumer Protection and the Federal Ministry of Finance, the *Deutsche Schutzvereinigung für Wertpapierbesitz* (German Society for the Protection of Securities Holders), the *Deutsches Aktieninstitut (German Stock Institute) and the Institut der Wirtschaftsprüfer* (Institute of Public Auditors in Germany).

[7] The comment letter is available in German from the ESMA website (www.esma.europa.eu/system/files/anschreiben_weis_holle.pdf; retrieved on: 7 January 2014).

general, and not entity-specific (i.e. boilerplate). The ESMA Review of Accounting Practices "Comparability of IFRS Financial Statements of Financial Institutions in Europe" published in November 2013 criticizes a lack of transparency and comparability of note disclosures. Representatives of the BaFin and the FREP participated in this review of the financial reports of 39 European financial institutions.

5 Acknowledgements and outlook

The FREP was able to continue its work successfully in 2013 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 German Federal Ministry of Justice and Consumer Protection and the Federal Ministry of Finance, and in particular the *BaFin,* the *Deutsches Rechnungslegungs Standards Committee* (German Accounting Standards Board), the audit firms, the IDW, the *Abschlussprüferaufsichtskommission* (German Auditor Oversight Commission) and the *Wirtschaftsprüferkammer* (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.

We would like to take this opportunity to express our sincerest gratitude and heartfelt appreciation to WP StB Dr. h.c. Axel Berger, who retired from the FREP as of 30 June 2013. He has held the office of vice president of the enforcement panel since the beginning of the two-tier enforcement process in Germany. During these eight years, together with the various enforcement panel presidents, he built and maintained the high regard enjoyed by the enforcement panel within the German business community through his exceptional technical expertise and good judgment in performing enforcement examinations. To mark Dr. h.c. Berger’s retirement, a scientific symposium was held in Berlin on the issues of “IFRS and enforceability” and “Public perception of the FREP” on 6 June 2013.

WP StB Prof. Dr. Bettina Thormann, who has been working for the FREP since its start in 2005, took over as vice president effective 1 July 2013.

Recent years were characterized by a declining error rate. While the unadjusted error rate for 2010 was 25%, it decreased to 14% for 2013, despite FREP examinations being perceived by companies that had experienced more than one examination as having become more rigorous in recent years[8].

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[8] See DAI/PwC (Ed.), Enforcement of Financial Information 2013. Experience of listed companies with the enforcement of financial reporting by the Financial Reporting Enforcement Panel, Frankfurt/Main and Munich 2013, pg 19.

The FREP will continue to focus on prevention-related measures in order to improve the quality of financial reporting for the long term. In this context, the FREP is planning to establish a forum for regularly exchanging information directly with the financial experts or audit committee chairs on the supervisory boards of publicly listed companies. These discussions will provide both the FREP and the supervisory board members with the opportunity to report on observations and results of past examination procedures, specific findings of errors, and problems encountered in examination procedures from their own point of view. These talks are aimed at providing a better understanding of the approach and work of the FREP, identifying areas for improving future enforcement procedures on both sides, and raising the supervisory board members' awareness of errors the FREP considers avoidable.

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

Prof. Dr. Edgar Ernst

(President of the Enforcement Panel)